Conditions for successful investments in fragile and conflict-affected states

A TrustWorks-led project in partnership with NIRAS for the Dutch Entrepreneurial Development Bank (FMO)

Authored by Josie Lianna Kaye with Jihed Hannachi and Marc Jacquand
With support from Thelma Tajirian, Mer Wais Jabarkhail and Isaac Kurewa

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About the entities involved in this study

The MASSIF Fund of the Dutch Entrepreneurial Development Bank (FMO)
FMO manages the MASSIF fund on behalf of the Dutch Government. MASSIF reaches out to end-beneficiaries through financing local financial intermediaries and institutions that can contribute to their development. With the fund, FMO is able to invest early on, taking high risks and by doing so, catalyze new investors into the financial inclusion space, which includes FMO. MASSIF provides access to financial services such as bank accounts, savings products and loan products for micro-, small- and medium-sized entrepreneurs. Supporting these entrepreneurs is key in creating job opportunities and better livelihoods for the Base of the Pyramid (BoP) to support their families. MASSIF invests through a variety of instruments from seed capital, local currency debt and mezzanine structures to direct equity and investment funds. MASSIF also offers capacity development grants to strengthen the organizational capabilities of its investees.

TrustWorks Global
TrustWorks Global (TrustWorks) – a social enterprise based in Geneva, Switzerland - engages public and private actors to prevent conflict, promote peace and foster sustainability. Working with a wide range of international organizations, governments, business actors and civil society organizations in a diversity of fragile contexts, TrustWorks: supports local approaches to peace; fosters innovative multi-sectoral collaboration to address complex challenges; and equips international organisations with analytical, risk and resilience capacities. TrustWorks has a particular specialisation in including business actors in peace and advising and/or equipping private sector actors with conflict-sensitivity capabilities in conflict-affected and fragile states. The TrustWorks team is made up of leading experts in conflict and collaboration in complex environments, and our regional expertise spans the globe.

NIRAS
NIRAS is a multidisciplinary consulting group with the vision to be the next generation consulting organization by serving our clients to build future sustainable societies. NIRAS International Consulting's services relate to policy development; project management; capacity development; organizational development; and monitoring, evaluation and learning in the context of international development assistance. This includes analytical studies and reviews; training; advisory services; and facilitation of processes which are all undertaken with the ambition to provide sustainable impact.

Abbreviations

AfDB	African Development Bank
AFD	Agence Française de Développement (French Development Bank)
CCLs	Counter-cyclical lending contracts
CSOs	Civil Society Organisations
DAC	Development Assistance Committee
DER	Development Effectiveness Rating
DFIs	Development Financial Institutions
DFS	Digital Financial Services
EIB	European Investment Bank
ESG	Environmental, Social and Governance
FCS	Fragile and Conflict-affected States
FDI	Foreign Direct Investment
FMO	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (Dutch Entrepreneurial Development Bank)
G7+	Group of Seven Plus
G20	Group of Twenty Finance Ministers and Central Bank Governors
GSMA	Global System for Mobile Communications Association
ICRC	International Committee of the Red Cross
IDPS	International Dialogue on Peacebuilding and Statebuilding
IFC	International Finance Corporation
IFIs	International Financing Institutions
IO	International Organisation
KfW	Kreditanstalt für Wiederaufbau(German Development Bank)
KYC	Know Your Costumer
LICs	Low Income Countries
LDCs	Least Developed Countries
MDBs	Multilateral Development Bank
MSMEs	Micro, Small and Medium-sized Enterprises
NGO	Non-Governmental Organisation
ODA	Official Development Assistance
ODI	Overseas Development Institute
OEDC	Organisation for Economic Co-operation and Development
PSD	Private Sector Development
SDGs	Sustainable Development Goals
SOTCs	Severely Off-Track Countries
TA	Technical Assistance
USAID	United States Agency for International Development
UK-FCDO	United Kingdom - Foreign, Commonwealth & Development Office
UN	United Nations
UNDP	United Nations Development Programme

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Overview

Background

This independent study was commissioned by the Dutch Entrepreneurial Development Bank (FMO) in 2021 and led by Swiss-based TrustWorks Global (TrustWorks) in partnership with NIRAS. Entitled 'Conditions for Successful Investments in Fragile and Conflict-affected States' (FCS), the study is motivated by the interest in FCS on the part of the Netherlands Ministry of Foreign Affairs and the related intent to increase FMO exposure in such contexts, particularly on the part of MASSIF - the financial inclusion fund managed by FMO. This study therefore builds upon the 2017-2026 MASSIF strategy, *The Next Frontier,* designed to contribute to more inclusive and equitable economics through a focus on 'unbanked' MSMEs in the least financially penetrated and fragile countries.

About this report

This report seeks to distil the learnings and rich insights from the extensive research undertaken for FMO and to make them available to the broader community of development financial institutions, multi-lateral development banks and impact investors. The purpose of this report is to then use these findings to stimulate much-needed discussion on how to foster more transformative development and peace-related impacts on the part of DFIs in FCS. The report is structured around five questions that FMO considers fundamental for the development of its own fragility strategy in FCS. The answers to these questions are relevant to all investors seeking to increase their footprint in FCS:

- What is 'fragility' and why does it matter?
- How relevant is the country context when investing in FCS?
- Should the investor approach be tailored to FCS?
- How do financial instruments and tools shape FCS investments?
- What are the most important non-financial tools that should be used in FCS?
- Based on these findings, the report then outlines minimum standards, options and recommendations for DFIs operating in FCS.

Methodology

The study is based on a desk review of over 200 publications from four main sources of literature on the topic of fragility and investing in FCS: academic; publications by international financial institutions and international development banks, along with multilateral and inter-governmental actors; by bilateral agencies; and, from independent think-tanks, NGOs and academic experts as and where relevant. This literature review was then supplemented by 50 interviews with key stakeholders from these institutions. These findings were also informed by three in-depth case studies selected by FMO as being demonstrative of FMO's approach to FCS: Burkina Faso, Afghanistan, and Zimbabwe. These cases were selected since they are not only countries where FMO has clients, they also represent examples of three different categories of fragility as defined by the World Bank: medium and high levels of conflict, and institutional fragility, respectively. These case studies involved a detailed literature review and interviews with 45 relevant stakeholders. While the case studies themselves cannot be included here due to the sensitivity of the client information, the findings from these case studies combined with the thematic review informed the recommendations.

Key findings

What is 'fragility' and why does it matter?

The analysis finds that the definition of FCS is vague, contested and potentially counter-productive. Organisations categorise 'fragility' according to different criteria and methods. While many converge around the notion of 'power' and the ability/ willingness of the state to deliver core functions[1], the concept is criticised for being politically motivated and having potentially counter-productive effects by creating 'self-fulfilling prophecies' in which investors focus on risk rather than opportunities.[2] In spite of this conceptual ambiguity, there is consensus amongst experts that investing in FCS is an imperative, not an option for development actors: the world's poor will be increasingly concentrated in FCS. Given SDG funding shortfalls – around USD 2.5 trillion annually over the 2015-2030 period[3] – combined with declining Official Development Assistance (ODA),[4] it is evident that responsible private sector development may become increasingly critical. Investing in FCS, however, cannot be 'business as usual' since conventional aid instruments are not suitable for FCS: this message has been reiterated for the past 15 years throughout high-level policy processes.[5] Indeed, the 2007 Principles for Good International Engagement in Fragile States and Situations, and the 2011 'New Deal' combined with many other milestone agreements emphasise the fact that more finance alone will not necessarily bring about peace nor sustainable development.[6] Investments must be undertaken in a manner that does not compound conflict fault-lines and/or inequalities.

How relevant is the country context when investing in FCS?

Each FCS is different and contains significant sub-regional specificities; ex-ante characteristics within each FCS may vary from one sub-region or even from one community to another. There is no standard set of characteristics or recommendations for FCS:[7] each FCS requires a tailored approach. As such, state-centric, formal assessments – which tend to be used by DFIs – can be misleading given that patterns of inclusion and exclusion are not easily captured in assessments that focus on state-based dynamics.[8] Such assessments focus on the lack of governance rather than competing sources of governance. Assessments of FCS must take into consideration informal dynamics - including customs, traditions, morals, beliefs and other customary factors - if they are to be used for decision-making and designing effective strategies. Indeed, the informal aspects of operating in FCS must not be under-estimated: informal power relations influence all business decisions. Moreover, state-centric

1 *Amorós, José Ernesto; Ciravegna, Luciano; Mandakovic, Vesna; Stenholm, Pekka, 'Necessity or opportunity? The effects of state fragility and economic development on entrepreneurial efforts', Entrepreneurship Theory and Practice, Vol. 43, No. 4, pp. 725-750, 2019, page 728.*

2 *Shields, Robin; Paulson, Julia, 'Analysing donor conceptualisations of state fragility', Education and Conflict Review, 2, 20-27, 2019.*

3 *International Dialogue on Peacebuilding & Statebuilding, 'How to scale up responsible investment and promote Sustainable Peace in fragile environments', 2016, page 13.*

4 *Nwajiaku, Kathryn; Profos, Jolanda, 'Backing Recovery in Fragile States', Part III, Chapter 20, OECD, 2014, page 229.*

5 *See for example: OECD-DAC Principles for investment in fragile states; the 2011 World Development Report: Conflict, Security and Development, World Bank, 2011; OECD Development policy papers, 'Financing for Stability in the Post 2015 Era', OECD publishing, February 2018 N°10.*

6 *International Dialogue on Peacebuilding & Statebuilding, 'How to scale up responsible investment and promote Sustainable Peace in fragile environments', 2016.*

7 *Poole, Lydia, 'Financing for stability in the post-2015 era', Documents d'orientation de l'OCDE sur le développement, n° 10, Éditions OCDE, Paris, 2018.*

8 *African Development Bank Group, 'Addressing fragility and building resilience in Africa', Strategy 2014-2019, page 42.*

analyses often overlook the unpredictable nature of FCS: uncertainty about the future – changes of government, last minute tax hikes, attacks on assets, increases in capital controls etc. – is endemic to FCS.[9] Similarly nuanced analyses are required regarding sectors since sector specific-risks and opportunities are also context-specific.

Should the investor approach be tailored to FCS?

Extensive analysis undertaken by the World Bank demonstrates that "internal implementation factors play a more important role – over external factors – in influencing project success"[10] i.e. well-designed/implemented projects tend to be successful; badly designed/implemented projects fail, irrespective of the context. While 'fintech'-based approaches to financial inclusion are an effective entry-point for DFIs to help close the 'missing middle', they are not without drawbacks. Fintech will not help the 'internet-less'[11] and many marginalised communities remain suspicious of digital finance and/or are unable to access it due to high fees and/or financial illiteracy.[12] Furthermore, Technical Assistance (TA) remains an under-utilised comparative advantage for most DFIs that can be used more strategically to accompany higher risk projects. TA, however, requires a field presence of staff with the right skillset to be effective.[13] Most experts suggest moving away from the 'bankable deals' approach towards more transformative approaches to maximise the use of scarce resources.[14] More strategic approaches could involve: a greater focus on 'pioneering firms';[15] country-based screening processes and/or labelling schemes;[16] sector- and value-chain based strategies;[17] a greater focus on the development impacts of investments;[18] and, incentive structures that are purpose rather than profit-driven.[19] At the heart of transformative approaches are partnerships: DFIs must find ways to work together[20] and to work with other key strategic actors across the humanitarian-development-peace nexus - replacing competition with collaboration on the basis of comparative advantage.[21]

How do financial instruments and tools shape FCS investments?

In terms of financing mechanisms, dynamics and impacts, blended finance is gaining increasing attention.[22] While blended finance can help foster innovation at the early stages of projects, it shifts risks from the private to the public sector, can be time-consuming and can 'tie aid', which contradicts the aid effectiveness agenda.[23] While lending is the dominant *modus operandi* for most DFIs, equity comes with many benefits which are clearly aligned with the catalytic role that DFIs aspire to play in FCS: equity enables investees to take a longer-time horizon; provides a strong and positive signal to other investors; and, allows for a more hands-on approach.[24] While this exposes DFIs to greater reputational and financial risks, it is important that recognise that loans also come with the risk of defaulting. There are a number of other tools that can assist in FCS: bonds are gaining traction,[25] with the proliferation of green, social and peace-related bonds - an innovative albeit complex tool that may

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9 *Appel, Benjamin J; and, Loyle, Cyanne E, 'The economic benefits of justice: Post-conflict justice and Foreign Direct Investment', Journal of Peace Research, Vol. 49, No. 5, pp. 685-699, 2012, page 687.*

10 *Liu, Chaoying and Harwit, Emil, 'The effectiveness of private sector development interventions in Fragile and Conflict-affected situations: Evidence from evaluations', Development Impact Department, IFC, World Bank Group, November 2016*

11 *Ozili, Peterson K., 'Impact of digital finance on financial inclusion and stability', Borsa Istambul Review, 2018, page 335.*

12 *Ibid, page 332.*

13 *Botzung, Michel, 'What tools to finance the private sector in Fragile states? The experience of the International Finance Corporation', Private Sector & Development, Proparco, August 28, 2017.*

14 *Papoulidis, Jonathan, 'Time to rethink development finance in Fragile States', Devex, 27 February 2020.*

15 *Collier, Paul, 'The private sector in Fragile Countries: what role for the DFIS?', PROPARCO Groupe Agence Française de Développement.*

16 *International Dialogue on Peacebuilding & Statebuilding, (2016), page 26.*

17 *Internal documents shared by Proparco.*

18 *The Commonwealth Development Corporation (CDC Group), 'Investing to transform lives', strategic frameworks 2017-2021, CDC: the UK's development finance institution, page 23.*

19 *Expert interview, April, 2021*

20 *The International Growth Centre (IGC), 'Escaping the fragile trap', April 2018.*

21 *Collier, Paul; Kriticos, Sebastian; Logan, Sarah; and, Sacchetto, Camilla, 'Strengthening development finance in Fragile contexts, Policy Paper, IGC, State Fragility Initiative, 2021.*

22 *OECD Development policy papers, 'financing for stability in the post 2015 Era', OECD publishing, February 2018 N°10, page 12.*

23 *For more on the pros and cons of blended finance including sources see section one of study.*

24 *Paul Collier, Sebastian Kriticos, Sarah Logan, and Camilla Sacchetto, 'Strengthening development finance in fragile contexts, Policy paper, IGC, State Fragility Initiative, 2021*

25 *Barder, Owen and Talbot, Theodorem, 'Guarantees, Subsidies, or Paying for Success? Choosing the right instrument to catalyse private investment in developing countries', Center for Global Development, 2015, page 9.*

increase the indebtedness of FCS; equity investments can incentivize investments in 'risky' sectors/contexts[26]; credit guarantees can encourage DFIs to lend to a particular sector; local currency financing can help reach SMEs and financial intermediaries; and, counter-cyclical lending contracts can help manage risk and vulnerability.[27] Financial additionality is considered vital in order to avoid market distortions that run counter to development priorities but, given the dearth of investments in FCS most investments are likely to be financially additional.[28] Additionality, therefore, must factor in development and/or value-related objectives.[29]

What are the most important non-financial tools that should be used in FCS?

As investments in FCS increase, shareholders will need to reorient their ambitions away from exploring how to do more transactions in FCS towards exploring how to achieve a more (positive) impact in FCS. To support efforts to focus on positive impact, the OECD and UNDP in May 2021 launched 'Impact Standards for Financing Sustainable Development' which will be useful for DFIs and private sector partners alike.[30] Moreover, in July 2020, the United Nations Working Group on the issue of human rights, transnational corporations and other business enterprises issued its report on 'Business, Human Rights and Conflict-affected Regions: Towards Heightened Action' – building upon the Guiding Principles for Business and Human Rights. The report states clearly that since the risk of human rights abuses is heightened in FCS, due diligence by business should be heightened accordingly.[31] As such, there are three best practices for engaging in FCS:[32] ensure investments are analysis-informed (make strategic investment decisions based on context analysis e.g. fragility assessments, political economy analyses, conflict analyses, etc); proactively engage businesses (foster upstream support to the ESG/SDG strategies on non-exclusionary basis); and, foster conflict-sensitivity (ensure investments and TA 'do no harm' before trying to 'do good' by undertaking conflict sensitivity analyses and developing related appropriate strategies).

Recommendations

Looking ahead

The findings of this study suggest that despite a growing willingness on the part of DFIs to engage in FCS, attention to development impacts of these investments – beyond the number of jobs created – is sub-optimal. Many DFIs aspire to contribute to the SDGs but few have the kind of development-related indicators, monitoring and assessment mechanisms to understand whether these objectives are being consistently achieved. While it is reasonable to assume that such investments have made development contributions, there is insufficient evidence to consistently support this assertion. In a similar spirit, there is little evidence to support the notion that DFIs are consistently doing 'no harm' nor is there evidence to suggest whether investments are, in fact, positively contributing to peace. What is evident is that, as it stands, most DFIs do not undertake the type of context analyses required to understand the dynamics of political economy in FCS, including the interaction between formal and informal factors, actors and realms and nor do they regularly conduct the type of enhanced due diligence required of actors operating in such contexts. What is missing from DFI approaches, therefore, is a commitment to conflict-sensitivity. Bluntly put, conflict-sensitivity is there to ensure actors like DFIs work *on* the conflict or at least *around* it, but that they avoid – at all costs – becoming *part* of it. With 80% of the world's poor predicted to be living in FCS by 2030, conflict-sensitivity is increasingly an imperative, not an option. Lastly, there is significant scope for DFIs to be much more 'strategic':

26 UNDP, Financing the SDGs in the least development countries (LDCs): Diversifying the Financing Tool-box and Managing Vulnerability, May 2016, page 47

27 Ibid, page 47.

28 Paul Collier, Sebastian Kriticos, Sarah Logan, and Camilla Sacchetto, 'Strengthening development finance in fragile contexts, Policy paper, IGC, State Fragility Initiative, 2021

29 The Commonwealth Development Corporation (CDC Group), 'Investing to transform lives', strategic frameworks 2017-2021, CDC: the UK's development finance institution, page 26.

30 OECD, UNDP, 'OECD-UNDP impact standards for financing Sustainable Development', OECD Publishing, Paris, 2021.

31 United Nations, General Assembly, seventy-fifth session, Item 72 (b) of the provisional agenda*, 'Promotion and protection of human rights: human rights questions, including alternative approaches for improving the effective enjoyment of human rights and fundamental freedoms', A/75/212, 21 July 2020.

32 See, for example: Independent Commission for Aid Impact, 'CDC's investments in low-income and Fragile states', ICAI, 2019; Penh, Borany, 'New convergences in poverty reduction, conflict and state fragility: what business should know', Journal of Business Ethics, Vol. 89, No. 4, pp. 512-528, 2009; Datzberger, Simone and Denison, Mike, 'private sector development in Fragile States', ESP PEAKS, 2013; Collier, Paul; Kriticos, Sebastian; Logan, Sarah, and Sacchetto, Camilla, 'strengthening development finance in Fragile Contexts', Policy paper, IGC, State Fragility Initiative, 22 March 2021; Liu, Chaoying and Harwit, Emil, 'The effectiveness of private sector development interventions in Fragile and Conflict - affected Situations: Evidence from evaluations', Development Impact Department, IFC, World Bank Group, November 2016; Findev Blog, 'can financial services promote stability in Fragile States?', 21 march 2017. Based on an extensive review of documents and interviews with stakeholders. See in-text examples and references for more information.

strategic investments are ones which, while meeting DFI requirements for financial returns, are most likely to have transformative development impacts.

Minimum standards for investing in FCS

Three minimum standards for operating in FCS must be in place before extending or beginning new investments in FCS.

1. **Ensure clear strategic positioning in FCS with a comprehensive conceptual framework which:** clarifies, defines and articulates key concepts such as depth of impact, success, return, performance, do no harm and conflict-sensitivity; reframes that rationale and narrative, where necessary, acknowledging the reality of the direct link between development and peace through the inclusion of SDG 16; develops clear principles for engagement, focused on depth of impact over volume, the primacy of partnerships, tailored investments and a commitment to learning and transparency.
2. **Invest in conflict-sensitivity analyses and strategies through a commitment to four phases:** understanding the context; understanding how investments interact with the context; defining and implementing mitigation measures; and undertaking conflict-sensitivity monitoring.
3. **Extend investment-specific due diligence through:** the elaboration of more nuanced due diligence analysis to answer about the context and the experience of other DFIs; broadening the consulted stakeholders; ensuring Know Your Customer (KYC) considers all types of risks; and, enhanced ESG due diligence.

Four investor profiles for investing in FCS

Four scenarios or DFI 'options' for FCS have been mapped out according to two dimensions which build upon the key findings of this study: i) Approach to conflict: This dimension reflects the willingness and/or strategic choice of the DFI towards conflict ranging from managing the risk of 'doing harm' to positively impacting fragility and conflict. And, ii) approach to development: This dimension reflects the focus of the DFI on development impact when making investment decisions ranging from seeking narrow development impacts to transformative development impacts. This makes it possible to elaborate four profiles which have different implications for how the DFI operates in a given country context:

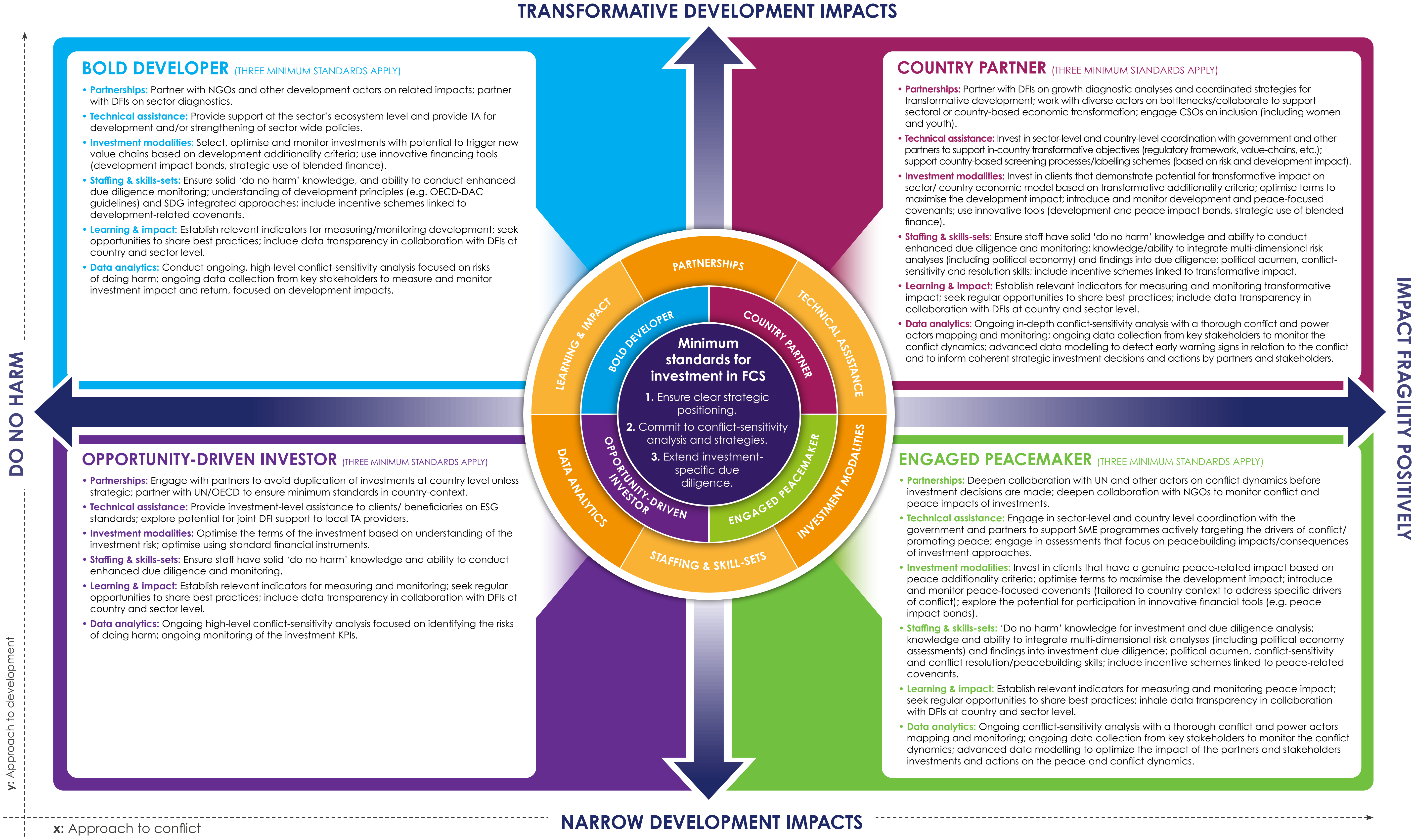
- **Opportunity-driven investor:** Seeks some development impact through targeted deals while avoiding feeding into conflict dynamics.
- **Bold developer:** Fosters robust development impact while avoiding feeding into conflict dynamics.
- **Engaged peacemaker:** Commits to contributing to peace by focusing on investments with high positive impact on conflict and peace dynamics.
- **Country partner:** Partners with a wide range of stakeholders to trigger robust transformative development impacts.

Tailoring DFIs approach to the FCS context

The below recommendations can then be adapted to the investor profile:

4. **Harness the power of partnerships:** DFIs should consider partnerships at headquarters and field level with DFIs, multi-lateral institutions, Ministries of Foreign Affairs and Embassies and the private sector to maximise impact.
5. **Leverage Technical Assistance:** DFIs can act across three levels: i) Investee: to support compliance with investment requirements; ii) sector: to create sector fundamentals/capabilities; iii) country: to support government programmes.
6. **Adapt investment modalities:** To the extent possible - given the DFI strategy for the country - instruments (type, pricing, currency, term), conditionalities and non-financial targets should be adapted to increase the chances of success.
7. **Develop FCS relevant staffing modalities and skillsets:** DFIs should consider the expansion of investment officer profiles/skill-sets to include: political economy analysis; conflict-sensitivity and risk management skills. Physical presence may need to increase; incentive structures should be oriented to impact.
8. **Invest in granular data for objective/up to date monitory of fragility:** Collect granular data on fragility and collaborate with other DFIs to ensure monitoring and generation of data-driven insights to feed into investment decisions.
9. **Invest in institutional learning and impact assessments:** Investing in FCS requires a 'learning by doing' approach, and ensuring learning is integrated into programmes. Regular reflection exercises and impact assessments foster a greater understanding and allow for greater tailoring of approaches.

Figure 1: A DFI model for successful investments in FCS



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CONDITIONS FOR
SUCCESSFUL INVESTMENTS IN
FRAGILE AND CONFLICT-AFFECTED STATES

Introduction

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Introduction

Fragile and Conflict-affected states (FCS) are not only the world's toughest markets, but they are also the most challenging places to live and thrive. These are contexts where access to basic services – education, health, infrastructure – is minimal or lacking and compounded by the absence of security and rule of law. These dynamics not only have immediate effects on lives and livelihoods, they also affect generations to come.

Perceived as 'risky' contexts to invest in, FCS are increasingly in the spotlight of development financial institutions (DFIs)[1]. The World Bank expects around 80% of the global extreme poor to be living in FCS by 2030. While the risks may often appear to outweigh the benefits – particularly for private investors - exploring how investments can contribute to pathways out of fragility carries increasing moral weight if the international community's promise of 'leave no one behind' is to be met.

Investing in FCS carries well-known risks for the investor: reputational, financial, legal and security-related, to mention only a few; the investment may lead to unintended consequences, it may fail to reap any returns, create legal challenges or even put the lives of staff at risk. Less understood and taken into consideration are the risks that the investment may also pose to the context itself. If insufficiently managed, the investment may exacerbate the dynamics of power and inequality underpinning the conflict; it may trigger human rights violations and violence, or contribute to negative environmental impacts, compounding the effects of poverty and violence on the most vulnerable such investments are and should be designed to assist.

On the flipside, well-designed and well-managed investments have the power to transform entire communities, sectors and economies. Through the provision of jobs, services and the necessary regulatory reforms, well-targeted and sufficiently tailored investments can bring both developmental and peace-related dividends. Investing in FCS, however, requires specific know-how to minimise not only the possibility that well-meaning actors

1 The term Development Finance Institution (DFI) is used throughout this report to denote: international financial institutions (IFIs), as well as bilateral and multilateral development banks that invest public funds for development impact.

'do harm' but, to ensure - where possible - that limited resources have the maximum positive impacts to help catalyse the very transformations such societies need to sustain peace and foster inclusive development. This will, in turn, require new partnerships between the public and private sectors, and new ways of ensuring such partnerships are effective. This report seeks to answer one simple question: but how?

About this study

This study was commissioned by the Dutch Entrepreneurial Development Bank (FMO) in 2021 and led by Swiss-based TrustWorks Global (TrustWorks) in partnership with NIRAS. Entitled 'Conditions for Successful Investments in Fragile and Conflict-affected States' (FCS), the study is motivated by the interest in FCS on the part of the Netherlands Ministry of Foreign Affairs and the related intent to increase FMO exposure in such contexts, particularly on the part of MASSIF - the financial inclusion fund managed by FMO. This study therefore builds upon the 2017-2026 MASSIF strategy, The Next Frontier, designed to contribute to more inclusive and equitable economics through a focus on 'unbanked' MSMEs in the least financially penetrated and fragile countries.

Objectives

This report seeks to distil the learnings and rich insights from the extensive research undertaken for FMO and to make them available to the broader community of development financial institutions, multi-lateral development banks and impact investors. The purpose of this report is to then use these findings to stimulate much-needed discussion on how to foster more transformative development and peace-related impacts on the part of DFIs in FCS.

The report is structured around five questions that FMO considers fundamental for the development of its own fragility strategy in FCS. The answers to these questions are relevant to all investors seeking to increase their footprint in FCS:

- What is 'fragility' and why does it matter?
- How relevant is the country context when investing in FCS?
- Should the investor approach be tailored to FCS?
- How do financial instruments and tools shape FCS investments?
- What are most important non-financial tools that should be used in FCS?

Based on these findings, the report then outlines minimum standards, options and recommendations for DFIs operating in FCS.

Methodology

The study is based on a conceptual framework which allowed for cross-triangulation of results from the desk review and interviews. The conceptual framework comprised six key categories:

1. **Rationale for investment in fragile states:** To explore how different actors define and engage with the concept of fragility, and their objectives in FCS.
2. **Ex-ante characteristics:** To explore different types of fragility; typical sectors and institutions of focus and rationale; and the extent to which ex-ante characteristics negatively impact the success of engagements.
3. **Investor approach:** Selection of stakeholders/clients according to which criteria; financial structure in FCS, including equity, debt, guarantees, blending and hybrid (with/without revenue shares); how technical assistance, due diligence and collaboration with partners compares in FCS to non-FCS.
4. **Financial impact:** Direct and indirect financial effects on intermediaries and stakeholders; common challenges and strategies in FCS for overcoming such challenges; criteria for assessing and measuring financial additionality; the extent to which investments are catalytic in nature.
5. **Non-financial impact:** The role of due diligence; strategies for assessing and mitigating human rights impacts; gender-related issues; ESG approach and ESG additionality; the role of conflict-sensitivity, conflict prevention and peace.
6. **Lessons learnt:** Including minimum conditions for investing in FCS; best practices; key success factors; and most effective strategies for investing in fragile states.

The study is based on a desk review of over 200 publications from four main sources of literature on the topic of fragility and investing in FCS: academic; publications by international financial institutions and international development banks, along with multilateral and inter-governmental actors (e.g. OECD, G7+, etc); publications by bilateral agencies (e.g. USAID, UK-FCDO, AFD, etc.); and, publications from independent think-tanks (e.g. Brookings, Institute for Economics and Peace), NGOs (e.g. International Alert) and academic experts as and where relevant.

This literature review was then supplemented by 50 interviews with stakeholders, including representatives from multi-lateral organisations, development banks, development financial institutions, impact investors, non-governmental organisations as well as academics and independent experts. The findings from the literature review were then triangulated with the findings from the interviews and organised into key messages for DFIs in FCS - which then structure this report.

These findings were also informed by three in-depth case studies selected by FMO as being demonstrative of FMO's approach to FCS: Burkina Faso, Afghanistan, and Zimbabwe. These cases were selected since they are not only countries where FMO has clients, they also represent examples of three different categories of fragility as defined by the World Bank: medium and high levels of conflict, and institutional fragility, respectively. These case studies involved: a detailed review of publicly available literature and FMO internal documents; and, interviews with 45 stakeholders including: FMO staff (thematic specialists, investment officers); representatives of the client companies; representatives from MDB/DFI and impact investors, and other country-level experts.

While the case studies themselves cannot be included here due to the sensitivity of the client information, the findings from these case studies combined with the more thematic review outlined above informed the development of the minimum standards, options and recommendations for DFIs operating in FCS.

2

CONDITIONS FOR
SUCCESSFUL INVESTMENTS IN
FRAGILE AND CONFLICT-AFFECTED STATES

What is ‘fragility’ and why invest in FCS?

What is 'fragility' and why invest in FCS?

The definition of FCS is vague, contested and potentially counter-productive

There is no agreed upon definition of fragility and different actors categorize FCS in different ways.[1] The World Bank 2021 list includes 32 FCS, and an additional seven 'small states.' The categorization is further based on three major distinctions: high-intensity violence; medium-intensity violence; and high institutional and social fragility. The OECD 'States of Fragility'[2] list includes 57 countries, ranked into 'severe' and 'minor' levels of fragility across five dimensions.[3] The 'Fragile States Index'[4], on the other hand, measures risk and vulnerability in 178 countries, of which only 15 are labelled as 'stable.'[5] FCS also do not follow previously assumed linear 'phases' into/out of fragility or conflict but rather exist in situations of multi-dimensional complex crisis.[6] Despite the lack of an agreed upon definition, most definitions converge around "the degree to which state power is unable and/or unwilling to deliver core functions to the majority of its people: security, protection of property, basic public services, and essential infrastructure."[7] The concept - which proliferated following the 9/11 attacks - is criticized by some for being: politically motivated; a power tool for Western nations; and, analytically defunct.[8] Most importantly, some view the concept as being counter-productive on two counts: first, it provides the false illusion that FCS 'are all the same'; second, the label itself may be part of the problem by creating "self-fulfilling prophecies"[9] and encouraging investors to focus on the risks rather than the opportunities.

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1 *See Annex 1: Examples of how DFIs characterise and approach 'fragility'*

2 *http://www3.compareyourcountry.org/states-of-fragility/overview/0/*

3 *Economic, environmental, political, security and societal.*

4 *https://fragilestatesindex.org/*

5 *Austria, Australia, Belgium, Canada, Denmark, Germany, Iceland, Ireland, Portugal, New Zealand, Netherlands, Norway, Sweden, Finland, Switzerland.*

6 *Anderson, Thea, Mercy Corps, 'Can financial services promote stability in Fragile States?', FinDev Gateway, FinDev Blog, 21 March 2017.*

7 *Amorós, José Ernesto; Ciravegna, Luciano; Mandakovic, Vesna; Stenholm, Pekka, 'Necessity or opportunity? The effects of state fragility and economic development on entrepreneurial efforts', Entrepreneurship Theory and Practice, Vol. 43, No. 4, pp. 725-750, 2019, page 728.*

8 *Shields, Robin; Paulson, Julia, 'Analysing donor conceptualisations of state fragility', Education and Conflict Review, 2, 20-27, 2019.*

9 *Collier, Paul; Gregory Neil; and, Ragoussis, Alessandros, 'Pioneering firms in Fragile and Conflict-Affected States, why and how development finance institutions should support them', Policy Research Working Paper 8874, World Bank Group, March 2019, page 20.*

Investing in FCS is an imperative, not an option for development actors

The world's poor are increasingly concentrated in FCS. According to the OECD, almost one quarter of the world's population live in FCS and projections suggest that over 80% of the world's poor will live in FCS by 2030.[10] In Sub-Saharan Africa - the region with the most FCS - poverty rates are 20% higher in FCS than in countries with comparable levels of economic development, and the gap is the widest for countries experiencing repeated cycles of conflict.[11] FCS are increasingly indebted: their average debt-to-GDP ratio has risen steadily from 37.5% in 2012 to around 50.5% in 2017.[12] As stated by the African Development Bank (AfDB), despite the challenges of engaging in FCS "the risks associated with not engaging generally outweigh the risks of engaging."[13] If the international community is to meet the aspiration to "leave no one behind", FCS must be the focus of efforts to end poverty.

Responsible private sector development could off-set SDG funding shortfalls

Based on current levels of investment in SDG-related sectors in developing countries broadly speaking, there will be an average annual funding shortfall of around USD 2.5 trillion over the 2015-2030 period.[14] The majority of what are referred to 'Severely Off Track Countries' (SOTCs) are FCS: of the 31 SOTCs, 24 are on either one or both of the World Bank's Fragile States list and the Fund for Peace's Fragile States Index.[15] Meeting these challenges will require new ways to channel public and private resources towards the SDGs[16] and the scale of resources required will necessitate funding increases of "several orders of magnitude."[17] Currently, estimates suggest that Official Development Assistance (ODA) is the largest source of (formal, traceable) external financing to FCS, followed by remittances. Foreign Direct Investment (FDI) makes up only a small proportion of flows to FCS[18], and a large proportion goes to only three countries (Republic of Congo, Nigeria and Myanmar).[19] Moreover, ODA to FCS as a whole experienced an "erratic downward trend" from 2005 to 2014.[20] ODA generally speaking flatlined in 2016 only to experience another fall in 2020.[21] Indeed, from 2019-2020, bilateral donors decreased aid commitments by 36% whilst IFIs increased commitments by 38%; as a result, ODA grants as a proportion of ODA have shrunk, while loans have grown.[22] Responsible, inclusive and conflict-sensitive private sector investment may be key to meeting the funding shortfall, and instrumental to stimulating the levels of economic growth and job creation required to transition out of fragility.

Investing in FCS is not business as usual

Conventional aid instruments and approaches are not suitable for FCS.[23] This message has been echoed for over 15 years throughout diverse high-level policy processes. In response to the body of evidence that FCS require different approaches than more developed countries, the OECD-DAC countries – in 2007 - endorsed the "Principles for Good International Engagement in Fragile States

10 *Ciuffreda, Mariella; Cosic, Sladjana and Schölzel, Harald, 'Development solutions: How to be sensitive', Part of the Series "Development Solutions", European*

11 *Anderson, Thea; and, Johnson, Diane, 'Financing the frontier: Inclusive financial sector development in Fragility-Affected States in Africa', Mercy Corps, FSD Africa, February 2017.*

12 *OECD Development policy papers, 'Financing for stability in the Post-2015 Era', OECD publishing, February 2018 N°10, page 16.*

13 *African Development Bank Group, 'Addressing fragility and building resilience in Africa', Strategy 2014-2019, page 10.*

14 *International Dialogue on Peacebuilding & Statebuilding, 'How to scale up responsible investment and promote Sustainable Peace in fragile environments', 2016, page 13.*

15 *Gertz, Geoffrey; and, Kharas, Homi, 'Leave no country behind ending poverty in the toughest places', Brookings, Global Economy & Development Working Paper 110, February 2018, page 8.*

16 *Agence Française de Développement (AFD) and the United Nations Development Programme (UNDP), 'Financing the SDGs in the Least Developed Countries (LDCs): Diversifying the financing tool-box and managing vulnerability', May 2016.*

17 *UNDP, Financing the SDGs in the least development countries (LDCs): Diversifying the financing tool-box and managing vulnerability, May 2016 (page 13) citing World Bank Group, 'From billions to trillions: Transforming development finance, Post-2015 financing for development: Multilateral Development Finance', April 2015.*

18 *Mayer, Hannah, 'Political risk insurance and its effectiveness in supporting private sector investment in Fragile States', Commission on State Fragility, Growth and Development, 2018, page 6.*

19 *See: World Bank foreign direct investment net inflows for 2019 – undertaken using the OECD rather than World Bank definition of fragility.*

20 *Nwajiaku, Kathryn; Profos, Jolanda, 'Backing Recovery in Fragile States', Part III, Chapter 20, OECD, 2014, page 229.*

21 *Dodd, Amy; Knox, Duncan; and, Breed, Dean, 'Aid data 2019–2020: Analysis of trends before and during Covid', Development Initiatives, Briefing, 8 February 2021.*

22 *Ibid.*

23 *See for example: OECD-DAC Principles for investment in fragile states; the 2011 World Development Report: Conflict, Security and Development, World Bank, 2011; OECD Development policy papers, 'Financing for Stability in the Post 2015 Era', OECD publishing, February 2018 N°10.*

and Situations." In 2011, in recognition of the pressing need to translate this knowledge into practice, members of the International Dialogue on Peacebuilding and Statebuilding (IDPS) developed a "New Deal for Engagement in Fragile States." Then, in 2015, the UN General Assembly adopted a resolution on the post-2015 development agenda designed to ensure tailored approaches to FCS. Moreover, in the context of the g7+ grouping of fragile and conflict-affected states, representatives of FCS themselves demanded a paradigm shift in the way international partners engage in such contexts. In the IDPS 2019-2021 Peace Vision, launched in July 2019, "supporting a peace-promoting private sector" is one of the three focus areas - highlighted as a fundamental condition for peace.[24] At the heart of these initiatives is one key message: More finance alone will not necessarily bring about peace nor sustainable development.[25] The way in which investments are made will determine whether they consolidate or undermine peace. Investments that compound conflict fault-lines and exacerbate inequalities increase rather decrease levels of poverty and may further undermine any development gains made. And yet, most investors engaged with for the purposes of this study use the same approaches, tools and processes for both FCS and non-FCS. DFIs, IFIs and impact investors may therefore be working at cross purposes with peace and security actors, to the detriment of the lives and livelihoods of the most vulnerable living in FCS.

Figure 2: OECD-DAC 2007 Principles for Good International Engagement in Fragile States and Situations

1. Take context as the starting point.
2. Do no harm.
3. Focus on statebuilding as the central objective.
4. Prioritise prevention.
5. Recognise the links between political, security and development objectives.
6. Promote non-discrimination as a basis for inclusive and state societies.
7. Align with local priorities in different ways in different contexts.
8. Agree on practical coordination mechanisms between international actors.
9. Act fast but stay engaged long enough to give success a chance.
10. Avoid pockets of exclusion.

24 *International Dialogue on Peacebuilding and Statebuilding (IDPS), '2019-21 Peace Vision', July 2019.*

25 *International Dialogue on Peacebuilding & Statebuilding, 'How to scale up responsible investment and promote Sustainable Peace in fragile environments', 2016.*

3

CONDITIONS FOR
SUCCESSFUL INVESTMENTS IN
FRAGILE AND CONFLICT-AFFECTED STATES

How relevant is the country context when investing in FCS?

How relevant is the country context when investing in FCS?

Each FCS is different and contains sub-regional specificities

Each FCS is different. Even within each FCS the ex-ante characteristics may vary from one sub-region to another, or even from one city to another. A sub-region of Yemen may well have more in common with a sub-region of Libya, than it will with its capital, Sana'a. As underscored by the OECD, *"there is no standard set of characteristics or accompanying policy prescriptions for situations affected by fragility, violence or risk."*[1] Categorisations are also misleading: while Burkina Faso, for example, is listed as a 'medium conflict context' in the World Bank's 2021 Fragility ranking, almost 7,000 people were killed in the tri-border area of Liptako Gourma in 2020; moreover, in the Burkinabe sub-regions of Sahel, Nord and Center there are over 22 active armed groups, including non-state armed groups, terrorist groups, defence groups and military forces.[2] The extent to which any DFI is engaged in a high violence context will depend upon the exact location of the client/investment and their operational 'footprint' through their supply/value chains. Similarly, while situations of high political and institutional fragility may not exhibit physical violence, high numbers of criminal networks often undermine stability, exacerbate inequalities, and increase the chances of violent conflict occurring.

State-centric, formal assessments are misleading

Most assessments of ex-ante characteristics particularly those used by most IFIs/DFIs – and to the extent that such analyses are conducted at all - focus on state-centric, 'formal' – rather than 'informal' actors and dynamics (see Figure Three, below). Formal actors, institutions and dynamics can be defined as all those based on the constitution, contracts and/or government; informal actors, institutions and dynamics arise from customs and traditions, morals, religious beliefs, and other customary factors. An analysis that focuses only on the former is likely to be deficient on several counts. First, while the drivers of fragility can be categorized into four main types (economic, social, political, and environmental – as used by the AfDB, for example), "at the core of most drivers of fragility is the element of exclusion of a category of citizens

1 *Poole, Lydia, 'Financing for stability in the post-2015 era', Documents d'orientation de l'OCDE sur le développement, n° 10, Éditions OCDE, Paris, 2018.*

2 *TrustWorks' own analysis of ACLED data, 2020.*

from services, resources, opportunities or rights."[3] These patterns of inclusion/exclusion permeate almost every aspect of FCS and too often are made 'invisible' in the context of 'formal' assessments. Second, such assessments overlook the fact that state weaknesses/deficiencies are substituted by competing sources of power, informal institutions or personalised 'rules of the game'; FCS are not characterised by lack of governance but by competing sources of governance. The informal aspects of operating in FCS must not be under-estimated: informal power relations influence all business decisions. Third, such assessments fail to capture the 'unpredictable' nature of FCS: uncertainty about the future – changes of government, last minute tax hikes, attacks on assets, increases in capital controls etc. – is endemic to FCS.[4] As underscored by Clingendael, formal or 'state-based' assessments lead to the design of private sector development (PSD) strategies focused on "removing institutional barriers to entry (macro level) and providing financial and technical assistance to firms aimed at removing (some of) these barriers (micro level)."[5] Lastly, this type of formal-level assessments do not then seek to analyse how the client in particular fits in with the political economy of the context in question: without an analysis that combines the (formal and informal) country-level analysis of the context with (formal and informal) specificities of clients in particular (the sector, its staff, its operations, its supply and values chains), it is difficult to be able to assess what kind of impact the investment will have on drivers of conflict. As demonstrated by Figure Three below – based on an analysis of interviews and literature – such analyses and subsequent strategies insufficiently account for formal-informal dynamics. Informal power dynamics are central rather than peripheral in FCS.

Sector-specific risks and opportunities are context-specific

No sectors are immune to the dynamics of fragility: different sectors come with different types of risks and opportunities. The extractives sector, infrastructure and telecommunications, for example, come with their own set of risks but offer high returns, which helps explain why natural resources and telecommunications received the largest amount of DFI long-term financing investment (2008-2016).[6] At the same time, a growing middle class in FCS are "generating a rising demand for consumer goods, services and agribusiness, which could provide new opportunities for investors."[7] The World Bank Export Dynamics Database demonstrates an average of 50-70 percent missing product lines from custom transactions in FCS compared to only 20-30 percent in non-FCS – demonstrating that there are potential markets for some of these products, and therefore potential investment opportunities.[8] While there are evident development impacts to be accrued from investing in electrification, the exact role played by a sector in driving fragility, conflict, stability or development must be analysed on a case-by-case basis. No assumptions can be made a priori about a sector's perceived or actual impacts from a risk perspective – neither in terms of risks to DFIs nor in terms of risks to the context itself.

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3 *African Development Bank Group, 'Addressing fragility and building resilience in Africa', Strategy 2014-2019, page 42.*

4 *Appel, Benjamin J; and, Loyle, Cyanne E, 'The economic benefits of justice: Post-conflict justice and Foreign Direct Investment', Journal of Peace Research, Vol. 49, No. 5, pp. 685-699, 2012, page 687*

5 *Clingendael, 'international perspective on SMEs in fragile settings in crisis situations', Chapter 1, 2016.*

6 *International Finance Corporation (IFC), 'Understanding DFIs' private sector engagement in African Fragile and Conflict-Affected Situations', December 2018, page 5*

7 *International Dialogue on Peacebuilding & Statebuilding, 'How to scale up responsible investment and promote Sustainable Peace in fragile environments', 2016.*

8 *Ibid*

Figure 3: Common 'formal' and 'informal' characteristics of FCS[9]

Nature of FCS characteristics			
	"Formal"	"Informal"	Examples of potential mitigating measures
Political			
1	Lack of basic security.	High presence of competing non-state authorities.	• Deep local knowledge based on political economy analysis. • Reform-based efforts to facilitate market creation, particularly around the regulatory framework and enforcement rule of law and quality standards. • Context-specific PSD strategies that bridge rather than fuel societal divides. • Carefully sequenced and highly coordinated interventions.
2	Weak legal and regulatory frameworks.	Strong reliance on customary arrangements, and highly personalised/informal institutions.	
3	Low state legitimacy, weak access to justice.	Incentive structures favour the production of violence and exclusive power dynamics; state captured by certain groups.	
4	Corruption and bribery.	Informal arrangements and coping mechanisms based on mutual exchange of good, services, favours.	
5	Endemic human rights violations; low political participation.	Strong inter-relationships between politicians and business based on identity and personal interests that exclude others.	
Economic			
6	Macro-economic and currency risks; lack of credit rating.	Budgetary resources allocated in non-transparent ways to the benefit of patronage networks.	• Investments in electricity, land and infrastructure. • Mechanisms for under-writing risk. • Innovative financial instruments/ investment vehicles adapted to the needs of FCS and the goals of DFIs in FCS. • Establishment of clear conditions for support to investors. • Focusing on "pioneering investments". • Engage in partnerships to ensure comprehensive, tailored, coherent approach.
7	Protectionist trade policies and sluggish growth.	Private sector highly enmeshed with powerful political inter-ests in both licit and illicit economies.	
8	Inadequate access to electricity and poor/ damaged infrastructure.	Reliance on traditional social networks for doing business, cultural affiliations determine access to goods and services.	
9	Prevalence of illicit and/or war economies.	High SME dependence on supporting informal/illicit political marketplace for their own survival.	
10	Under-developed private sector; low access to finance.	High levels of informal employment/ informal MSMEs; markets are highly exclusive and distorted by power relations.	
Social			
11	High levels of inequality and exclusion of certain individuals and groups.	Strong influence of history, culture and power on social spheres, and their relationship with political and economic domains.	• Ensure financing options are adapted to the needs of refugees and IDPs. • Identify sectors with high potential for development results and tailor approach. • Engage local communities in PSD project design. • Ensure sustainability is addressed from the outset Foster opportu-nity-based over necessity-based entrepreneurship. • Ensure engagement address mul-ti-faceted barriers facing women and youth.
12	Lack of national identity.	Strong loyalty/identification with non-national alternatives, social relations determine the "rules of the game".	
13	Endemic exclusion of women and youth.	Difficulty obtaining permits due to social status, requirement to pay bribes.	
14	High levels of population movements (eco-nomic and forced migration).	Domestic demand limited by high levels of poverty, insecurity and dependence on social networks.	
15	Low levels of education and skills; low levels of innovation.	Domestic demand limited by high levels of poverty, insecurity and dependence on social networks.	
Environment			
16	Environmental pressures create competition over natural resources.	Natural resources targeted by warring parties, exploited by armed/illicit groups..	• Ensure political economy analysis is informed by natural resource and climate lens. • Support regulatory reforms and implementation capacity. • Support clients seeking to address the challenges of climate change. • Support diversification of livelihoods. • Ensure community and civil society engagement.
17	Lack of government capacity/will to address remote vulnerable areas.	Political leaders encourage natural resources investments for their own personal benefit.	
18	Weak natural resource regulatory framework and/or implementation.	Licit-illicit partnerships between political and business elites seek control over trafficking nodes/networks.	
19	High dependence on natural resources.	Employment/business opportunities beyond subsistence awarded on kinship.	
20	Climate change compounding pressures.	Financial resources dedicated to climate resilience diverted to military/defence ends.	

NB. Gender dynamics must be mainstreamed throughout the analysis as each of the key characteristics of FCS have differentiated impacts on men and women; similarly, the drivers of fragility will have differentiated impacts on minorities which should also be incorporated into the analysis.

9 *This section is based on an analysis of the following sources: Interviews with key stakeholders (see Annex 1); African Development Bank Group, 'Addressing fragility and building resilience in Africa', Strategy 2014-2019; Amorós, José Ernesto; Ciravegna, Luciano; Mandakovic, Vesna; and, Stenholm, Pekka, 'Necessity or opportunity? The effects of state fragility and economic development on entrepreneurial efforts', Entrepreneurship Theory and Practice, Vol. 43, No. 4, pp. 725-750, 2019; Anderson, Thea; and, Johnson, Diane, 'Financing the frontier: Inclusive financial sector development in Fragility-Affected States in Africa', Mercy Corps, FSD Africa, February 2017; Asiedu, Elizabeth, 'Foreign direct investment in Africa: The role of natural resources, market size, government policy, institutions and political instability', The World Economy, Vol. 19, No. 3, pp.63-77, 2006; Avis, William R., 'Private sector engagement in fragile and conflict-affected settings', GSDRC, University of Birmingham, January 2016; Botzung, Michel, 'What tools to finance the private sector in Fragile States ? The experience of the International Finance Corporation', Private Sector & Development, Proparco, August 28, 2017; Bray, John, 'Foreign direct investment in Conflict-affected contexts - Peacebuilding essentials for economic development practitioners', International Alert, 2010; Clingendael, 'International perspective on SMEs in fragile settings in crisis situations', CRU Report, Chapter 1, August 2016; Collier, Paul; Gregory Neil; and, Ragoussis, Alessandros, 'Pioneering firms in Fragile and Conflict-Affected States, why and how development finance institutions should support them', Policy Research Working Paper 8874, World Bank Group, March 2019; Collier, Paul; Kriticos, Sebastian; Logan, Sarah; and, Sacchetto, Camilla, 'Strengthening development finance in fragile contexts, Policy Paper, IGC, State Fragility Initiative, 2021; Datzberger, Simone; and, Denison, Mike, 'Private sector development in Fragile States', ESP PEAKS, 2013; Dimitrova, Anna and Triki, Dora, 'Does state fragility matter for foreign direct investment? Evidence from Southern and Eastern Mediterranean countries', Management decision, Vol. 56, No.8, pp.1787-1803, 2018; Dutch Good Growth Fund (DGGF), Financing Local SMEs, Impact report, 'Enabling entrepreneurship in frontier markets', June 2019; Hameed, Sadika; and, Mixon, Kathryn, 'Private-sector development in Fragile, Conflict-Affected, and Violent Countries', Centre for Strategic Studies, 2013; International Dialogue on Peacebuilding & Statebuilding, How to scale up responsible investment and promote Sustainable Peace in fragile environments, 2016; International Finance Corporation (IFC), 'Understanding DFIs' Private sector engagement in African Fragile and Conflict-Affected Situations', December 2018; Klugman, Jeni; and, Quek, Yvonne, 'Women's Financial Inclusion and Economic opportunities in Fragile and Conflict-Affected States, An overview of challenges and prospects', Georgetown Institute for Women, Peace, and Security, 2018; Mayer, Hannah, 'Political risk insurance and its effectiveness in supporting private sector investment in Fragile States', Commission on State Fragility, Growth and Development, 2018; Nawo, Larissa and Njangang, Henri, 'Co-investments and African infrastructure deficit: Understanding and mitigating political risks in Conflicts Affected and Fragile States', Munich Personal RePEc Archive, 2018; OECD Development policy papers, 'Financing for stability in the post 2015 Era', OECD publishing, February 2018 N°10; Peschka, Mary P., Emery, James J., 'The Role of The Private Sector in Fragile and Conflict-Affected States', World Development Report 2011 Background Papers. World Bank, 2011; Seyoum, Belay; and, Camargo, Andrea, 'State fragility and Foreign Direct Investment: The mediating roles of Human Right and economic decline', Thunderbird International Business Review, Vol. 63, No. 2, pp. 159-174, 2021.*

4

CONDITIONS FOR SUCCESSFUL INVESTMENTS IN FRAGILE AND CONFLICT-AFFECTED STATES

Should the investor approach be tailored to FCS?

Should the investor approach be tailored to FCS?

Internal factors play a more important role than external factors in achieving 'success'

Interventions of IFIs, DFIs and commercial investors in FCS tend to fall into four main thematic areas (outlined below). Deciding which area to focus on is often a matter of preference; however, the decision is best informed by a combination of Growth Diagnostic Tools and Political Economy Analyses which, together, provide insights into "the causes and effect relationships behind constraints to growth…and inform what types of programming are likely to most effective."[1] While some areas demonstrate more potential for 'success' (financial and developmental) than others, according to an extensive analysis undertaken by the World Bank *"internal implementation factors play a more important role – over external factors – in influencing project success"*[2] i.e. well-designed/implemented projects tend to be successful; badly designed/implemented projects fail, irrespective of the context. According to the World Bank evaluation key 'success factors' by intervention include:

1. **SME and entrepreneurs**, including technical assistance for micro or small businesses to assist vulnerable populations. Success factors include: meeting the needs of local markets; building on pilot programmes; designing programmes based on needs of target populations; taking a holistic approach; identifying champions; ensuring sustainability in the design phase.[3]
2. **Financial intermediaries/access to finance**, including support to microcredit banks, credit guarantees for specific business actors and other financial tools to increase access to finance amongst underserved populations. Success factors include: training of staff from financial intermediaries; knowledge of local market needs; building upon pilots; monitoring; and, a clear and active role for investors.[4]

1 *Curtis, Lisa; Davis, Peter; Gündüz, Canan; Ockenden, Andrew; Pedrick, Thomas; Vaux, Tony; and, Van Der Zwan, Joost, 'Private sector development in Conflict-affected environments: Key resources for practitioners', The Donor Committee for Enterprise Development, 2010, page 19.*

2 *Liu, Chaoying and Harwit, Emil, 'The effectiveness of private sector development interventions in Fragile and Conflict-affected situations: Evidence from evaluations', Development Impact Department, IFC, World Bank Group, November 2016*

3 *Ibid.*

4 *Ibid.*

3. **Infrastructure development**, including investments in roads, pipeline projects and other key infrastructure to provide access for vulnerable populations. Success factors include: working closely with the local government; investments by the private sector; ensuring infrastructure projects are linked to economic growth and local business needs.[5]
4. **Business investment climate/enabling environment,** including public-private dialogue, informal to formal transitions, trade regulations and custom controls, taxation, investment promotion. Such interventions tend to be less successful irrespective of the context and are hindered by ambitious project design, short timeframes, lack of private sector engagement and lack of sound analysis.[6]

Financial inclusion and 'Fintech' approaches are effective but not risk-free

Access to finance is consistently identified as a key constraint to business and, therefore, it is understood as an effective "entry-point" for DFIs. The financial sector is also perceived as combining comparatively low financial and reputational risks, and good development impact (the financial sector, however, is also shaped by societal divisions and exhibits strong formal/informal dynamics). Supporting inclusive financial services is an effective way to "help people make their way out of poverty, or at least maintain incomes in times of crisis or economic shocks"[7] which effectively closes the 'missing middle' between commercial finance and microfinance services.[8] Fintech moreover provides innovative avenues for further expanding current approaches to financial inclusion, particularly since 50% of people in developing countries own a mobile phone. Fintech can be particularly transformative for women.[9] However, it should be noted that while Fintech *can* improve financial inclusion - particularly for rural and poor communities who cannot easily access banks due to poor transportation networks – not all Fintech improves the welfare of the unbanked population and most, but not all, Fintech will not help the "internet-less."[10] Furthermore, "digital finance users in indigenous and poor communities despite persuasion can refuse to use digital finance services" for several reasons, including superstitious and religious beliefs, unaffordable fees, and financial illiteracy.[11] Data suggests that digital financial systems are more likely to be used by urban, wealthier individuals[12] – not those at risk of 'being left behind.' Indeed, mobile phone ownership, particularly smartphone ownership, is an entry-point to Digital Financial Services (DFS) inclusion. But a mobile phone does not automatically result in DFS adoption - meaning the use of digital methods to store and transfer funds, make and receive payments, borrow, save, insure and invest, and manage overall finances. The GSMA's 'The Mobile Gender Gap Report 2020' states that even mobile users who are aware of the capabilities of the mobile internet do not always possess the required digital literacy and skills.

5 Ibid.

6 Ibid.

7 Mercy Corps, FSD Africa, 'Financing the frontier: inclusive financial sector development in Fragility-Affected States in Africa', reducing poverty through financial sector development, Report, February 2017, page 6.

8 International Finance Corporation (IFC), 'Understanding DFIs' private sector engagement in african Fragile and Conflict-Affected Situations', December 2018, page 22.

9 Klugman, Jeni; and, Quek, Yvonne, 'women's financial inclusion and economic opportunities in Fragile and Conflict-Affected States, an overview of challenges and prospects', Georgetown Institute for Women, Peace, and Security, 2018, page 26.

10 Ozili, Peterson K., 'Impact of digital finance on financial inclusion and stability', Borsa Istambul Review, 2018, page 335.

11 Ibid, page 332.

12 Ibid, page 337.

Greater efforts are needed to build women's knowledge and confidence in order to use DFS. [13] Unless designed and implemented in a conflict-sensitive manner, financial inclusion programmes can create or exacerbate conflict by: creating a real or perceived bias in the distribution of project resources ("discriminatory lending"); enabling diversion of resources to conflict parties (e.g. through "cyber-laundering"[14]); contributing to inflation; and, changing existing power structures through increased market competition, to mention only a few.[15]

Technical assistance is an under-utilised comparative advantage for most DFIs

Technical assistance (TA) is a vital tool for DFIs; it has several benefits in terms of "market intelligence gathering, relationship-building with key stakeholders, and building critical business skills and capacity for local or regional companies."[16] DFIs would benefit, however, from transforming the way they use TA in order to maximise its impact in four key ways:

- First, TA should be used to both foster "bankable deals" and a "project pipeline" and **accompany higher risk projects** in their early stages.
- Two, **DFIs must have a field presence to be effective**. TA cannot easily be provided in impactful ways from HQ or by parachuting in from 'time to time'. As underscored by a representative from IFC, "one cannot develop local market intelligence, liaise with authorities' companies, local business groups, and finance, customs or judiciary bodies without being in the field, close to clients, partners and key stakeholders."[17]
- Third, DFIs must ensure that staff/IOs working in FCS **have the right profile and skillset**; highly experienced staff are required, who are proactive, "entrepreneurial, passionate, and able to weather the ups and downs of such markets."[18]
- Fourth, TA must include support to clients to ensure they are **operating in conflict-sensitive and, where possible, peace-positive ways** (whether provided directly by DFIs or local partners). More will be covered on this topic later in the section.

13 *Tiwari, Akhand; and, Steady, James, 'A phone can only do so much: Why mobile access isn't leading to digital financial service usage among women in India', Microsave Consulting, November 2020.*

14 *World Bank, 'Enabling digital development - Digital finance', World Development Report, 2016, page 98.*

15 *Mercy Corps, FSD Africa, page 26.*

16 *International Finance Corporation (IFC), page 29.*

17 *Botzung, Michel, 'What tools to finance the private sector in Fragile states? The experience of the International Finance Corporation', Private Sector & Development, Proparco, August 28, 2017.*

18 *Ibid.*

Experts suggest moving from one-off "bankable deals" to transformative approaches

More strategic, less 'scattershot' and/or opportunistic approaches are required in FCS in order to: avoid the risk that investments feed into and exacerbate conflict dynamics; prevent investments from augmenting exclusionary practices; meet increasing needs; ensure increasingly scarce resources are being used in the most strategic way; and, to maximise opportunities to have positive impacts which will, in turn, create a more constructive operating environment for business actors. This will require a shift from a "one-off deals" mentality towards an approach focused on market strengthening that can increase production and wages while diversifying markets and growth.[19] This, in turn, requires a shift away from incentive structures that prioritise "making deals" (and making a sufficient *volume* of deals), towards focusing on *strategic deals*. Strategic deals are both 'additional' and catalytic, and focus on addressing risks and fostering resilience.[20] There are several proposals for how to make DFI investments in FCS more strategic:

- First, a greater focus on what Paul Collier calls "**pioneering firms**" i.e. domestic, large firms that create new markets in any sector of economic activity and which induce other firms to enter the market.[21]
- Second, the elaboration of a **country-based screening process** or "labelling scheme" to systematically identify and single out 'investment worthy' companies and investor intermediaries based on a methodology that "combines existing standards and due diligence approaches with criteria that are relevant from a sustainable peace perspective."[22] Such a labelling scheme would help simplify the process of matching investments with opportunities, and enable ample opportunities for engagement with civil society.[23]
- Third, **sector- and value-chain based approaches**, focused on transforming strategic sectors for any given country. Sector- and value-chain based approaches entail selecting and supporting investees based on their ability to contribute to the development of the sector as a whole and/or their ability to reinvigorate existing or trigger new value chains.
- Fourth, strategies must be significantly more focused on evaluating the **potential development impacts of investments**; CDC, for example, in their 2017-2021 framework developed a *Development Impact Grid*. Potential investees are awarded a development impact score: the more difficult the investment context and the higher propensity of the investment to generate employment, the higher the investee will score and the more likely it will receive support.[24] Development frameworks, however, must measure more than only job creation to be effective and transformative. In a similar spirit, Proparco has developed 'Propulse' as a framework for measuring impact at country-level[25], and KfW has developed a *Development Effectiveness Rating* (DERa) based on a comprehensive points system measuring both client and societal impact.[26]
- Fifth, it is imperative for DFIs to transform their culture, starting with their **incentive structures**, to ensure they become purpose rather than profit/volume driven.[27]

19 *Papoulidis, Jonathan, 'Time to rethink development finance in Fragile States', Devex, 27 February 2020.*

20 *Ibid.*

21 *Collier, Paul, 'The private sector in Fragile Countries: what role for the DFIS?', PROPARCO Groupe Agence Française de Développement.*

22 *International Dialogue on Peacebuilding & Statebuilding, (2016), page 26.*

23 *Ibid.*

24 *The Commonwealth Development Corporation (CDC Group), 'Investing to transform lives', strategic frameworks 2017-2021, CDC: the UK's development finance institution, page 23.*

25 *Proparco, 'Propulse, Accelerator of Impacts', March 2021.*

26 *KfW DEG, 'Development Effectiveness Rating' (DERa), January 2017.*

27 *Expert interview, April, 2021.*

Partnerships are the entry-point to more strategic investments

Most importantly, DFIs must find ways not only to work together, but also to work with other key strategic actors across the humanitarian-development-peace nexus. The current way of working puts development actors with shared goals in direct competition with one another, while simultaneously leading to sub-optimal use of resources; rather than 'slicing up the pie', working together would increase the size of the pie for DFIs - with catalytic impacts on FCS. Indeed, pressure is mounting for DFIs to better coordinate their efforts in FCS.[28] Both the LSE-Oxford Commission on State Fragility, Growth and Development in their 2018 report on '*Escaping the fragility trap*'[29] and the Report of the G20 Eminent Persons Group on Global Financial Governance, entitled '*Making the global financial system work for all*'[30] underscore the imperative of inter-DFI partnerships (and beyond) to ensure resources are put to optimal use and that public funds are not wasted. And, the opportunities for such partnerships are plentiful: each DFI does not need to do a political economy analysis; each DFI does not need to do a country or sector diagnostic; each DFI does not need to become an expert in conflict-sensitivity; each DFI does not have to take the responsibility of supporting 'pioneering firms' alone; each DFI should certainly not be competing for the same deals or undermining one another's efforts. DFIs should be working based on their comparative advantages. DFI collaboration would require a dramatic transformation of working methods, particularly strong country-level coordination as well as longer time-horizons, but the results could be formidable. Comparative advantage-based formulation of strategies would not only help maximise development impacts but also help share risk,[31] particularly if well-coordinated with the broad range of international and national humanitarian-development-peace partners, including civil society, operating in FCS. This idea has been piloted in the context of five countries under the auspices of the DFI Fragility Forum.[32] The challenge, as with all 'international coordination models' will be to go beyond information-sharing to more meaningful, structured and purpose-driven collaboration.

28 Papoulidis, Jonathan, February 2020.

29 The International Growth Centre (IGC), 'Escaping the fragile trap', April 2018.

30 Report of the G20 Eminent Persons Group on Global Financial Governance, 'Making the global financial system work for all', October 2018

31 Collier, Paul; Kriticos, Sebastian; Logan, Sarah; and, Sacchetto, Camilla, 'Strengthening development finance in Fragile contexts, Policy Paper, IGC, State Fragility Initiative, 2021.

32 Mathewson, Patrick, 'State Fragility initiative, State Fragility Initiative, International Growth Centre, An assessment of the DFI country pilot initiative, LSE, Oxford, UKAid, March 2021.

Figure 4: Data transparency and DFIs in FCS

The increasing amounts of public funding being directed to public institutions has focused attention on the need for greater transparency and accountability on the part of DFIs. Research undertaken by the 'Publish What You Fund'[33] initiative finds that the "current state of DFI transparency makes it difficult to see what DFIs are doing, what impact their investments are making, whether they are adhering to their accountability and environmental, social, and governance (ESG) responsibilities, and to what extent they are successfully crowding in the private sector."[34] The report finds that while many DFIs may have policies related to transparency in place, in practice the right kind of information is not consistently shared, is not shared in a way that is accessible or comparable or is quite simply lacking.[35] As underscored by the Center for Global Development, while some DFIs are transparent in some areas, "no DFI publishes all the information that could and should be provided."[36] As a result, understanding the contribution that DFIs make to the SDGs is currently difficult to assess. Similarly, the OECD – in support of the 'Tri Karana Roadmap for Blended Finance' - has outlined the pressing need to enhance transparency and accountability in relation to the use of blended finance – ensuring such financial flows are tracked, reported and communicated.[37]

As part of this research project, attempts were made to compare DFIs at the country level, focusing on the World Bank's fragile states list. While a select few DFIs share some country-level information (sector, clients, size of investment), it was not possible to compare with any level of granularity or comparability across the 22 DFIs selected for comparison which DFIs are operating in which country contexts, in which sectors, with which funds, using which instruments and – most importantly - to what effect. Based on publicly available information, it was only possible to compare at the regional level and even then there were challenges: there is a significant lack of convergence amongst DFIs on their use of terminology. For example, when trying to understand the 'total volume of investment portfolio for each DFI, it became evident that they use 'close yet different' terms to provide this information including: Total Portfolio, Total assets under Management, Overall Portfolio, Total disbursed portfolio, Total Portfolio Exposure, Total committed portfolio, Outstanding portfolio amount. As a result, even at the basic level of how much DFIs are each investing it is challenging to identify comparable data points. Data transparency in FCS is a critical issue to address for many reasons which are central to the findings of this report:

- First, it undermines one of the core principles of **aid effectiveness** as outlined in the Paris Declaration on the imperative for donor coordination and accountability for development results.
- Second, it hampers the ability to **'do no harm**' – a cornerstone of the OECD-DAC 2007 Principles for Good International Engagement in Fragile States and Situations – since without greater transparency it is impossible to know whether DFIs are, in fact, working at cross purposes and undermining one another's efforts. As stated clearly by the Publish What you Fund initiative, "how can responsible decisions be made about the risks to communities if that information is not accessible to project-affected communities and the organisations that advocate for them?"[38]
- Third. It is more challenging to **work strategically** without understanding how the activities of one DFI complement, work in harmony or at the very least does not interfere with the work of other DFIs. An understanding of the impact projects have on the SDGs is part of working strategically, with a view to learning from the results and integrating these learnings to maximise impact.
- Fourth, data transparency is a 'minimum condition' upon which **partnerships** can be built. On this basis it is possible to understand better the comparative advantage of each DFI, their respective strategies and the complementarity of their approaches.

33 *For an overview of the work conducted so far please see: https://donortracker.org/policy-updates/publish-what-you-fund-release-third-working-paper-and-webinar-development-finance*

34 *https://www.publishwhatyoufund.org/projects/dfi-transparency-initiative/*

35 *Publish What You Fund, Advancing DFI Transparency, The rationale and roadmap for better impact, accountability and markets', November 2021.*

36 *Kenny, Charles 'Transparency at Development Finance Institutions, Moving to Better Practice', Center for Global Development, July 2020, page 1.*

37 *https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/tri-hita-karana-roadmap-for-blended-finance.htm*

38 *Publish What You Fund (2021).*

5

CONDITIONS FOR
SUCCESSFUL INVESTMENTS IN
FRAGILE AND CONFLICT-AFFECTED STATES

How do financial instruments and tools shape FCS investments?

How do financial instruments and tools shape FCS investments?

The promise and perils of blended finance: An informed choice not a default option

While there is no agreed upon definition of 'blended finance', it is defined by Collier et al. as a "co-financing strategy which involves combining concessional finance from aid budgets with commercial finance from DFIs and the private sector."[1] Blended finance is gaining increasing attention in development circles; indeed, "hopes are pinned on blended finance as a means to help bridge the Sustainable Development Goals (SDG) investment gap"[2] which has the "potential to unlock significant new resources for development, especially in areas such as infrastructure"[3] – particularly in FCS. As outlined by UNDP, the rationale of using blended finance is three-fold: i) increases capital leverage; ii) enhances impact; iii) and, delivers risk-adjusted returns, particularly since the 'grant' part of blended finance packages can be used for TA, under-writing risk, or providing market incentives.[4] Despite the enthusiasm, a recent survey by OECD of 30 blended finance providers found that the six leading providers were responsible for 80% of funds mobilised, and blended finance represents less than 1% of external financing flows to developing countries.[5] In low-income countries, many of which are FCS, an analysis by ODI, furthermore, demonstrates that MDBs/DFIs have, on average, picked up 73% of the cost of blended-finance instruments (compared to 57% in other contexts). Moreover, 1 dollar of public investment mobilises just 0.37 of private investment in LICs (the average global amount mobilised per dollar is $USD 0.75).[6] While blended finance can help foster innovation at the early stages of projects, data suggests that DFIs "are primarily using less risky senior debt rather than instruments that are more risk appreciative to take on early-stage or 'pioneer' risk, such as subordinated debt, equity, risk-sharing facilities, guarantees or grants."[7] Given the advantages and disadvantages outlined in Figure Five[8], DFIs must assess the 'appropriateness' of blended finance on a purpose-driven, case-by-case basis.

1 *Collier; Kriticos; Logan; and, Sacchetto, (2021)*

2 *OECD Development policy papers, 'financing for stability in the post 2015 Era', OECD publishing, February 2018 N°10, page 12.*

3 *UNDP, 'financing the SDGs in the least development countries (LDCs): diversifying the financing tool-box and managing vulnerability', May 2016, page 9.*

4 *Ibid.*

5 *OECD Development policy papers, (February 2018), page 29.*

6 *Attridge, Samantha, 'blended finance in the poorest countries, the need for a better approach', ODI, Research reports, April 2019.*

7 *Attridge, Samantha, (April 2019) page 11.*

8 *This table is based on analysis of interviews and the following references: Paul Collier, Sebastian Kriticos, Sarah Logan, and Camilla Sacchetto, 'Strengthening development finance in fragile contexts, Policy paper, IGC, State Fragility Initiative, 2021; Adapt IFC's approach, risk appetite, instruments, and metrics of success to the context of FCS countries; OECD Development policy papers, 'financing for stability in the post 2015 Era', OECD publishing, February 2018 N°10; UNDP, Financing the SDGs in the least development countries (LDCs): diversifying the financing tool-box and managing vulnerability, May 2016; Collier, Paul; Gregory Neil; and, Ragoussis, Alessandros, 'pioneering firms in Fragile and Conflict-Affected States, why and how development finance Institutions should support them', Policy Research Working Paper 8874, World Bank Group, March 2019; ODI, Blended finance in the poorest countries, the need for a better approach, Samantha Attridge and Lars Engen, April 2019; Saldinger, Adva, 'Blended finance taskforce launches action plan, calls on MDBs to step up leadership', Devex, 20 April 2018, Snyders, Greg; and, Currey, Braden, 'Opinion: development funders – ghere's how to leverage blended finance to meet the SDGs', Devex, 29 March 2018.*

Figure 5: Pros and cons of blended finance in FCS

Pros	Cons
• Lowers investing risks & investment on commercial terms.	• Shifts risks from private to public sector
• Facilitates and requires collaboration between diverse stakeholders towards shared ends, particularly for social/development impacts.	• Collaboration is complex, time-consuming, difficult to structure for public benefit, requires a set of skills and tools yet to be honed.
• Enables DFIs to reach new clients, markets, models and 'riskier' projects.	• Fails to alter underlying market fundamentals/ conditions.
• Catalyses private sector investments and job creation.	• Can promote financially unviable projects; send false market signals.
• Helps mobilise/'crowd in' additional private sector financing.	• Provides unfair advantages to international investors and risks crowding out domestic investors.
• Allows client-specific risks to be addressed through TA.	• Effectively 'ties aid' which contradicts the aid effectiveness commitments.
• Enables financing of large, potentially catalytic projects, such as those around infrastructure.	• Risks skewing aid away from its core agenda, from social sectors and much needed grants
• Reduces the costs of investments.	• Untransparent nature of subsidising the private sector (particularly due to lack of data).
• Can be used to leverage benefits across different sectors.	• Requires tailored and full-time staffing capacities at country/regional level – which many DFIs lack.

Combining loans with equity can help manage risk and increase impact with clients

Lending is the dominant *modus operandi* for most DFIs but it is not the most effective when it comes to mobilization ratios.[9] Despite the strong benefits, particularly in FCS, equity remains a neglected financial tool. While equity requires: a longer-time horizon; a different staff skillset; and, a highly diverse portfolio, equity comes with many benefits which are clearly aligned with the catalytic role that DFIs aspire to play in FCS. And, if DFIs can move towards a model in which they have greater field presence, then balancing more equity with loans becomes a more realistic strategy. Equity, after all: enables investees to take a longer-time horizon; provides a strong and positive signal to other investors; and, allows for a more hands-on approach.[10] While this exposes DFIs to greater reputational and financial risks, it is important to recognise that loans also come with risk: the risk of defaulting. As stated by Collier, "the focus on debt provision is the sort of delusional strategy for pretending you don't have risks, when risk is the essence of working in FCS and you must accept it; by choosing debt over equity, you have not got away from risk you have just transformed it into a default risk. And, if you have that kind of downside,

9 *Lee, Nancy; and, Sami, Asad, 'Still lending (mostly) after all these years', Center for Global Development, February 2019.*

10 *Collier; Kriticos; Logan; and, Sacchetto, (2021) page 14.*

you also want the upside."[11] DFIs are beginning to transition to a greater mix of such tools: CDC, for example, has decided to invest more in equity, because it offers "a greater degree of engagement and support to companies and therefore can achieve more impact."[12] IFC also tends to focus on equity with an eight-year average holding, which is vital in order to account for macroeconomic trends and exchange rate fluctuations; the IFC portfolio has outperformed the S&P 500 index over the same period by 15 percent.[13] The exact mix of direct equity, debt, intermediated equity and grants will depend on the context, the investee and the expected benefits and potential risks, and must be tailored.

Towards innovative "bond-based best practice solutions to address issues of scale"?[14]

Bonds are increasingly being explored as potentially innovative tools for FCS. Bonds are generally linked to a specific outcome or level of performance which, unlike subsidies which reduce the costs, are designed to increase the returns.[15] This can be a highly effective way to motivate performance *and* crowd-in investment. Green and social bonds for example are growing in popularity, particularly amongst multilateral development banks and corporates; in 2014 and 2015, EIB issued US$ 11.6 billion, the World Bank US$ 8.5 billion and KfW US$ 4 billion.[16] "Blue bonds" have also emerged as a similar tool for Small Island Developing States and countries with large coastal areas. Moreover, UNDP has been exploring the possible benefits of adopting GDP-indexation for LDC's external debt and, in 2017, the ICRC issued a Humanitarian Impact Bond, raising CHF 26 million to support services for people with disabilities in FCS.[17] The question is now being asked whether 'peace bonds' can "do for financing peace and development outcomes, what green bonds did for climate change adaptation financing?"[18] Given the size of investments required in FCS - if DFIs are able to come together to collaborate - 'peace bonds' could well be an innovative and transformative financial tool which merits further exploration. To avoid some of the pitfalls of other bonds, it would be important to develop necessary standards and criteria for selecting projects, funds and assets for FCS[19], particularly oriented around 'do no harm' and peace-positive impacts. There are concerns, however, that Peace Bonds risk further increasing the high indebtedness of FCS, particularly in the wake of the devastating effects of the Covid-19 pandemic.

A wide range of complementary financial tools can be used in FCS

The below represents only a small selection of the various tools that can be used in FCS to manage risk and increase development impacts.

- **Equity investments** are increasingly being used to incentivize investment in perceived "riskier" sectors/contexts. The OECD estimated that over US$ 21 billion was mobilised between 2014 and 2021, with 15 per cent in low-income countries[20]. In recent years, philanthropic investors have emerged as partners for 'riskier', equity investments.[21]
- **Credit guarantees** are used to direct investments to risky sectors such as SMEs to encourage financial institutions to lend to that sector, but it tends to have high transactions costs, and must be accompanied by TA to be effective.

11 *Collier, Paul, University of Oxford, Phone interview, May 2021.*

12 *The Commonwealth Development Corporation (CDC Group), 'Investing to transform lives, strategic frameworks 2017-2121', CDC: the UK's development finance institution, June 2017.*

13 *Lankes, Hans Peter, 'How a mandate for impact in emerging markets helped the IFC outperform the S&P 500', IFC, September 2020.*

14 *International Dialogue on Peacebuilding & Statebuilding, Ibid, page 22.*

15 *Barder, Owen and Talbot, Theodorem, 'Guarantees, Subsidies, or Paying for Success? Choosing the right instrument to catalyse private investment in developing countries', Center for Global Development, 2015, page 9.*

16 *UNDP, Financing the SDGs in the least development countries (LDCs): Diversifying the Financing Tool-box and Managing Vulnerability, May 2016.*

17 *International Dialogue on Peacebuilding & Statebuilding, (2016), page 18.*

18 *Ibid.*

19 *Ibid.*

20 *UNDP (2016), page 37.*

21 *Ibid.*

- **Local currency financing** is an effective method for reaching SMEs and financial intermediaries in FCS. Local currency financing can "create more liquidity in the real economy, improve access to finance at reasonable cost, enable loan maturities to be extended and thereby improve the creditworthiness of projects that generate only local currency income."[22] The associated risks are best met with TA and capacity-building from partners.
- **Counter-cyclical lending contracts (CCLs)** are one of many tools designed to help manage risk and vulnerability. Under CCLs, it is agreed "ex-ante that debt service will automatically be allowed to fall, or become zero, in periods when external shocks hit the country."[23] While traditionally used for countries, not private sector entities, such models could prove pertinent to explore further for FCS if the development impacts of preventing business 'collapse' merit it.

Additionality must be multi-faceted

Financial additionality is considered vital in order to avoid market distortions that run counter to development priorities and to ensure scarce public resources are not being mis-deployed to projects that were not in need of DFI support. Additionality, however, can be difficult to prove due to the problem of counterfactuals and, it is argued, given the dearth of investments in FCS most investments are likely to be financially additional regardless.[24] Other forms of additionality, however, are much easier to prove. First, development additionality is a more measurable factor to take into consideration when deciding investments. Second, CDC now also uses the term "value additionality", defined as "providing value beyond our capital, which the market is not providing" such as specific forms of TA or capacity-building.[25] This strategy is based on the belief that "it takes more than money to grow a viable business and achieve development outcome."[26] Lastly, investments of a catalytic nature i.e. investments that attract other forms of capital are also a significantly more measurable indicator, particularly if other capital can be secured on commercial terms.

22 *UNDP (2016), page 39.*

23 *UNDP (2016), page 47.*

24 *Collier; Kriticos; Logan; and, Sacchetto, (2021), page 22.*

25 *The Commonwealth Development Corporation (June 2017), page 26.*

26 *Ibid, page 27.*

Figure 6: DFIs, fragility strategies and conflict-sensitivity capacities

Based on publicly available information, our analysis indicates that only a minority of DFIs have elaborated or are in the process of elaborating a strategy specifically for engaging in fragile states (8 out of 22 analysed, including Asian Development Bank, CDC, European Investment Bank, International Finance Corporation; Islamic Development Bank, World Bank, Proparco and FMO). This important finding suggests that most DFIs, therefore, are not necessarily tailoring their investments in a meaningful way to the dynamics and specificities of FCS, undermining opportunities to work in more strategic and collaborative ways – and fully cognizant of the risks and opportunities. Publicly available information suggests that even less pay attention to and/or have the capacity to ensure their investments adhere to the principles of conflict-sensitivity: only three DFIs appear to explicitly incorporate conflict-sensitivity into their work at the time of the analysis. It should also be noted that none of these conflict-sensitivity strategies are applied at the decision-making stage i.e. conflict-sensitivity is applied once an investment decision has already been taken, it is not used as the basis for making the decision of which investments to make. As a result, there is a strong risk that investments on the part of DFIs can feed into rather than address the drivers of conflict; without conflict-sensitivity assessments and strategies these institutions lack the tools to ensure their investments 'do no harm'.

6

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What are the most important non-financial tools that should be used in FCS?

What are the most important non-financial tools that should be used in FCS?

"Shareholders" must start asking the right question

The literature indicates that shareholders are asking the wrong questions: the question should not be '*how can we do more transactions in FCS*'? This leads to technical responses around the need for more capital and/or blended finance, for example,[1] and minimizes attention on the more important question of what positive impacts (and how) DFIs can have in FCS. The question should therefore be: *how can we have more positive impacts in FCS with responsible investments?* This leads to a different kind of response that combines both technical and non-technical aspects. It is also a question that focuses on the imperative of 'do no harm': it you are doing harm, it is impossible to do good in FCS - which is, after all, the mandate of a DFI. IT must be sequential (i.e. 'do no harm' before trying to 'do good'). Focusing on the volume of investments on the one hand, and the number of jobs created on the other – without considering (other positive and negative) impacts - risks feeding into instability and increasing inequalities, impacting the most vulnerable and increasing rather than diminishing their chances of 'being left behind.' The goal must be to increase positive impact on lives and livelihoods of people living in FCS.

Use OECD-UNDP Impact Standards for Financing Sustainable Development to define success

Through this lens it is easy to understand that a successful project is not one that creates jobs, fosters market creation, and generates tax revenues. A successful investment creates jobs, markets and revenues alone in a manner that addresses conflict fault-lines and societal divisions – by understanding, incorporating, and actively managing political, economic, social and/or environmental dynamics when selecting countries, sub-regions, sectors, investees and partners. Despite the lack of causal evidence on the relationship between private investment and peace, we know that in FCS the private sector can fuel grievance and exacerbate tensions; "the negative impact of private sector operations on fragility is often the result of large inflows of resources into highly resource-scarce environments, with local actors vying for control of these resources."[2] Similarly, while evidence

1 *Interview nine*

2 *Collier; Kriticos; Logan; and, Sacchetto, (2021), page 19.*

of the relationship between job creation and stability is relatively weak, there is some evidence that a lack of employment opportunities for youth poses a particular risk,[3] especially due to the persistent "youth bulge" in many FCS. Similarly, women's economic empowerment through their participation in the formal workforce is essential for the achievement of gender equality and has significant impacts on growth. Realigning the meaning of success will mean re-aligning incentive structures and the skillset of staff in FCS. To support efforts to focus on positive impact, the OECD and UNDP – after extensive consultations – in May 2021 launched 'Impact Standards for Financing Sustainable Development.'[4] The Standards allow DFIs and private sector partners to design impact management systems in line with international standards focused on: designing an impact strategy; adopting an impact management approach; fostering transparency and accountability; and, ensuring effective governance systems.

Heightened human rights due diligence is a requirement in FCS

As stated at the beginning of this analysis, engagement in FCS cannot be business as usual. In July 2020, the United Nations Working Group on the issue of human rights, transnational corporations and other business enterprises issued its report on *'Business, Human Rights and Conflict-affected Regions: Towards Heightened Action'* – building upon the Guiding Principles for Business and Human Rights. The report states clearly that since the risk of human rights abuses is heightened in FCS, due diligence by business should be heightened accordingly. The report moreover argues that "activities linking businesses to conflict are often not perceived as salient human rights issues and therefore might be ignored or under-prioritized in standard human rights impact assessments."[5] In FCS, business actors are never 'neutral' and their presence can never be without impact: human rights due diligence must, therefore, be complemented by a conflict-sensitive approach. For undertaking enhanced due diligence in FCS there are multiple tools that can leveraged.[6]

Analysis, proactive engagement and conflict-sensitivity: Critical tools for FCS

The below table, Figure Seven[7] outlines three critical tools for working in FCS. Each of these tools will not only help manage reputational and financial risks to the investor, they will also enhance the development impacts of the investments being made.

3 *Datzberger, Simone; and, Denison, Mike, 'private sector development in Fragile States', ESP PEAKS, September 2013.*

4 *OECD, UNDP, 'OECD-UNDP impact standards for financing Sustainable Development', OECD Publishing, Paris, 2021.*

5 *United Nations, General Assembly, seventy-fifth session, Item 72 (b) of the provisional agenda*, 'Promotion and protection of human rights: human rights questions, including alternative approaches for improving the effective enjoyment of human rights and fundamental freedoms', A/75/212, 21 July 2020.*

6 *Footnote 42 of https://undocs.org/en/A/75/212: See also: International Alert, 'Human Rights Due Diligence in Conflict-Affected Settings: Guidance for Extractives Industries', London, 2018; Geneva Centre for Security Sector Governance (DCAF) and ICRC, 'addressing security and Human Rights challenges in complex environments toolkit, 2017; Swisspeace, 'enhanced Human Rights due diligence in Conflict-affected and high-risk areas', 2016; United Nations Development Group, 'conducting a conflict and development analysis, 2016; Shift, 'Human Rights due diligence in high risk circumstances', New York, 2015; Corporate Engagement Program-CDA Collaborative Learning Projects, Prospectors and Developers Association of Canada and World Vision Canada, 'preventing conflict In exploration', 2012.*

7 *The contents of this table are based on an analysis of the interviews and the following sources: Independent Commission for Aid Impact, 'CDC's investments in low-income and Fragile states', ICAI, 2019; Penh, Borany, 'New convergences in poverty reduction, conflict and state fragility: what business should know', Journal of Business Ethics, Vol. 89, No. 4, pp. 512-528, 2009; Datzberger, Simone and Denison, Mike, 'private sector development in Fragile States', ESP PEAKS, 2013; Collier, Paul; Kriticos, Sebastian; Logan, Sarah, and Sacchetto, Camilla, 'strengthening development finance in Fragile Contexts', Policy paper, IGC, State Fragility Initiative, 22 March 2021; Liu, Chaoying and Harwit, Emil, 'The effectiveness of private sector development interventions in Fragile and Conflict - affected Situations: Evidence from evaluations', Development Impact Department, IFC, World Bank Group, November 2016; Findev Blog, 'can financial services promote stability in Fragile States?', 21 march 2017. The Commonwealth Development Corporation (CDC Group), 'Investing to transform lives', strategic frameworks 2017-2021, CDC: the UK's development finance institution; International Finance Corporation (IFC), 'understanding DFIs' private sector engagement in african Fragile and Conflict-Affected Situations', December 2018; van Dorp, Mark and Smits, Marcel, 'the social impact of business in Fragile and Conflict-affected Settings: contributing to the SDGs and reducing local ESG risks by using Human Security and positive peace', Knowledge Platform Security & Rule of Law, 2020; International Dialogue on Peacebuilding & Statebuilding, How to scale up responsible investment and promote Sustainable Peace in fragile environments, 2016; International Finance Corporation (IFC), 'better ESG reporting, A key to strengthening capital markets', October 2018; Chua, Han, Teng, et al, 'sustainable finance: looking farther', Chapter 6, IMF, October 2019; Covalence, PeaceNexus, 'Peacebuilding Business Index methodology – measuring business contributions to peacebuilding in fragile countries, January 2019; Korwatanasakul, Upalat, 'Environmental, Social and Governace investment: concepts, prospects and the policy landscape in Eds Nemoto, Naoko; and, Morgan, J. Peter, 'ESG investment, opportunities and risks for Asia', Asian Development Bank Institute, 2020; Government of the Netherlands, 'Guidelines conflict sensitive private sector development, Ministerie van Buitenlandse Zaken, 2019; Amadiegwu, Amara; Kihiu, Maya; Simon, Manuel, 'mobilising the private sector for peace and reconciliation', The Graduate Institute of International and Development Studies, the World Economic Forum, 2020; https://undocs.org/en/A/75/212.*

Figure 7: Critical tools for working in FCS

BEST PRACTICE	KEY ACTION POINTS
1. **Analysis informed:** Make strategic investment decisions based on context analysis	
There are diverse tools and methodologies that can assist DFIs investing in FCS (Fragility assessment, Political Economy Analysis, Conflict Analysis etc.). There are three key areas to any analysis: first, identify the root causes of fragility/conflict based on country analysis and grievances; second, understand the main conflict actors, their interests and role in the conflict; third, understand where investments in such a context can have the most positive impact (by avoiding fuelling the conflict and/or by actively addressing key drivers of fragility, and based on the activities of other actors). Once a sector/area of intervention has been selected, it is then possible to undertake a much more granular analysis of how specific investees own 'footprint' may impact upon local- and national-level tensions and relationships, and how negative dynamics can be minimised, and positive ones maximised.	• Work with independent entities and civil society organisations with prior experience of working with DFIs/IFIs to support such exercises. • Ensure local knowledge and a (sub-) regional lens is reflected in the analysis. • Ensure analyses are tailored to operational needs of DFI to avoid the 'so what?' • Partner with other DFIs to maximise resources. • Foster awareness that context analysis improves financial and development success. **Key question 1:** Where and how (with which actors, sectors and in which regions of FCS and to who's benefit) can investments have the most positive developmental impacts? **Key question 2:** What will be the potential positive and negative interactions between the investments and the FCS?
2. **Proactively engage:** Foster upstream support to the Environmental, Social and Governance (ESG)/ Sustainable Development Goals (SDG) strategies on non-exclusionary basis	
There are no globally accepted ESG standards and the scope of ESG factors is very wide. However, it is well-recognised that adherence to common ESG standards help improve business performance and mitigate some of the risks of investing in FCS. Incorporating regular monitoring of key ESG criteria can help identify key issues where investees require additional support. Pro-active efforts, while more resource-intensive, are more responsible than negative and/or exclusionary screening practices since – without DFI engagement – such actors may be unlikely to change their practices at all. The potential promise of investment may be a turning point for certain actors with regards to ESG factors, with vastly beneficial impact. If investments are expected to contribute to the SDGs, providing support to MSMEs to ensure they are meeting these objectives and that such objectives can be measured will be beneficial.	• Ensure ESG standards are realistic for the context; understand most pertinent risks for context. • Avoid a priori exclusion of certain actors; work with partners to help businesses mitigate risks to the context through pro-active engagement. • Develop ESG 'critical', 'important' and 'supportive' criteria for context, focusing on risks to people and the context. • Work 'upstream' with clients to develop ESG/SDG strategies as part of a 'compliance journey' with clear milestones. • Help clients to understand the benefits of ESGs/SDGs for their operations to avoid 'box ticking' exercises.
3. **Conflict-sensitivity:** Ensure investment/TA assistance ''do no harm' before 'doing good'	
Conflict-sensitivity is an imperative in FSC. Conflict-sensitivity involves: a deep understanding of the context; an understanding of how investments (selected sector, clients and beneficiaries) interact with the context; the identification of clear measures to address adverse impacts and build upon opportunities to strengthen social cohesion and peace. Both IFC and EIB have started incorporating conflict sensitivity in their investment processes. EIB offers conflict-sensitivity guidance to IOs and established a Conflict Sensitivity Helpdesk in 2017. IFC's Conflict-affected States in Africa initiative has also used a fragility lens since 2015 and provides advisory services to identify how to address fragility issues. Do no harm is vital in FCS.	• Build in-house capacity in conflict-sensitivity/applying a conflict lens. • Work with other actors in any given context to understand how best to effect change. • Ensure consultations with key local stakeholders to foster more conflict-sensitive practices. • Focus on 'do no harm' before trying to have peace-positive impacts. • Develop conflict-sensitivity metrics to track impacts through the investment cycle. • Foster inter-DFI conflict-sensitivity learning in collaboration with conflict-sensitivity experts.

7

CONDITIONS FOR
SUCCESSFUL INVESTMENTS IN
FRAGILE AND CONFLICT-AFFECTED STATES

Looking ahead: Minimum standards, options and recommendations for DFIs operating in FCS

Looking ahead: Minimum standards, options and recommendations for DFIs operating in FCS

Overview

The findings of this study suggests that despite a growing willingness on the part of DFIs to engage in FCS, attention to development impacts of these investments – beyond the number of jobs created – is sub-optimal. Many DFIs aspire to contribute to the SDGs but not all have the kind of development-related indicators, monitoring and assessment mechanisms to understand whether these objectives are being consistently achieved. Moreover, impact assessments around DFI investments are not commonplace and nor is this information consistently shared when such impact assessments are undertaken.

Indeed, while many DFIs can point to the financial returns of their investments – as one might expect – not all are able to consistently support claims that their efforts have had a developmental impact broadly speaking, nor that they have made a meaningful contribution to the selected SDGs specifically. While it is reasonable to assume that such investments have made development contributions, there is not always enough monitoring of investments and, therefore, evidence to consistently support this assertion. Standardizing the development contributions DFIs aspire to have in FCS would also better enable partnerships on the basis of comparative advantage. Such criteria for selection and monitoring would enable DFIs to be more laser-focused on the development contributions of their investments – and therefore to be more selective about their investments - and to provide more targeted support to its clients to reach these ends.

In a similar spirit, there is little evidence to support the notion that all DFIs are consistently doing 'no harm' nor is there evidence to suggest whether investments are, in fact, positively contributing to peace. What is evident is that, as it stands, most DFIs do not undertake the type of context analyses required to understand the dynamics of political economy in FCS, including the interaction between formal and informal factors, actors and realms and nor do they all regularly conduct the type of enhanced due diligence required of actors operating in such contexts. What is missing, therefore, from most DFI approaches is a commitment to conflict-sensitivity.

Conflict-sensitivity is a process through which actors seek to minimise their negative and maximise their positive impacts on conflict – it is a three-phased approach designed to: first, understand the context in which an investment is undertaken through an analysis of current or potential conflicts; second, understand how investments interact with that context; and, third, to define and implement mitigation measures that address adverse impacts and build upon opportunities to strengthen social cohesion and peace. Bluntly put, conflict-sensitivity is there to ensure actors like DFIs work *on* the conflict or at least *around* it, but that they avoid – at all costs – becoming part *of* it. With 80% of the world's poor predicted to be living in FCS by 2030, conflict-sensitivity is increasingly an imperative, not an option.

Lastly, there is significant scope for DFIs to be much more 'strategic' in how they go about investing in FCS. Strategic investments are ones which, while meeting DFI requirements for financial returns, are most likely to have transformative development impacts. This does not necessarily require *more financing* for FCS it simply requires *different approaches for FCS*. There are key ways in which DFIs, generally speaking, could be more strategic about their investments. For example, based on in-depth country analyses and sector diagnostics, DFIs would be able to better identify the sectors most likely to have a transformative development impact in FCS; as a result, they could either select and/or support clients and/or initiatives focused on such sectors.

Another way in which DFIs could be more 'strategic' is through their use of partnerships, both with other DFIs, but also with the international community more broadly speaking, with NGOs and other business actors; such a plethora of actors is well-placed to: support DFIs in understanding the conflict; make context-informed investment decisions; monitor investments; help DFIs acquire critical skill-sets such as conflict-sensitivity; and, foster a pipeline of bankable/developmentally-oriented deals. Partnerships should be based on a 'common-sense' division of labour informed by comparative advantage, whilst ensuring that the benefit-cost ratio of transaction costs required for partnerships are paying off in terms of meaningful results on the ground.

Looking ahead

Investing for development is **complex endeavor** through which institutions take mitigated risks in order to realize both development impacts for the country in question and positive returns for the institution. In FCS contexts in particular, investment for development is characterized by: significant opportunities; high uncertainty; and, vast knowledge gaps that make both mitigating risks and reaching development impact complex exercises that require greater due diligence than in non-FCS contexts.

Research for this study suggests that, generally speaking, DFIs could make improvements to their working modalities in FCS along five key axis:

- First, more could be done to ensure that **risks** to DFIs are being managed *in equal measure* to the risks that DFI investments pose to the context in question through enhanced and more adapted due diligence measures.
- Second, **conflict-sensitivity** must be applied to all DFI investments on an ongoing basis, to ensure that investments have positive impacts or, at a minimum, 'do no harm'.
- Third, investments could be more **'strategic'** in order to maximise the potential for transformative impacts in FCS through a range of financial instruments and adapted investment modalities, including more targeted use of TA.
- Fourth, the use of **partnerships** is currently sub-optimal and could greatly improve the financial and non-financial additionality of investments.
- Lastly, these changes would require staffing and incentive structures and – to some extent –

cultural shifts at many DFIs/MDBs in order to support greater engagement in FCS with more sustained staff presence.

In order to address these concerns, this section elaborates:

A. Three **minimum standards** for investing in FCS
B. **Four investor profiles** that reflect DFI in-country choices with regards to conflict and development
C. Six **recommendations** to improve the impact of DFI investments in FCS

Figure 8: A summary of best practices/lessons learnt from key stakeholders interviewed

1 **Candid internal discussions about what it takes to do investment in FCS:** These candid discussions must take place within DFIs, with their management and shareholders, with clear understanding of the resources, skillset and time horizons required.

2 **Have realistic expectations of financial returns if impact is the priority outcome**: Goals must be adjusted and priorities aligned when it comes to working in FCS.

3 **Do meaningful analysis**: Do not invest in a context without doing an analysis first; maximize the resources invested in analysis by sharing with other DFIs and investors.

4 **Adapt all aspects of the investments to the country context**: There is no 'one size fits all' approach; only a deep understanding of the context will be able to inform the type of investments needed and the type of support needed to make them succeed.

5 **Align staff capacities and incentives**: A deal-maker is not necessary what you need; individuals must be motivated by the 'double' (or triple) bottom line. Incentive structures must then be adapted accordingly; it must be rewarding to work in FCS.

6 **Create a project pipeline:** Bankable projects do not "come knocking at the door." It takes a proactive approach of being on the ground and working with actors to foster the right kinds of projects in the right places.

7 **Ensure due diligence is conflict-sensitive:** Ensure that questions about how negative conflict impacts will be managed and positive ones encouraged are integrated into all aspects of the investment.

8 **Community engagement is a must**: Ensure investments are meeting needs by engaging with communities, for as long as it takes.

9 **Build partnerships:** DFIs must overcome the hurdles to greater collaboration to succeed in FCS. Partnerships are also vital with actors across the peace-humanitarian-development nexus, including with civil society.

10 **Robust monitoring systems and adaptive programming:** Monitoring systems will best serve the objectives of the project if they occur throughout the project cycle, not just at the end. Monitoring should then inform project implementation – investees may require support to mitigate risks/maximize opportunities and ensure that the investment is having the desired impact. Remaining flexible is key.

11 **Take a long horizon and deploy capital patiently:** Engaging in FCS takes time. Selecting the right client takes time. Building a relationship of trust takes time. Working with that client to ensure positive impacts also takes time. It is vital to be patient.

12 **Have courage; and, accept failure:** Emerging from fragility takes courage on the part of those living in FCS; courage is therefore also required of those supporting them. Not all investments in FCS will succeed; but those that do will be transformative.

Three minimum standards for investing in FCS

The below minimum standards for operating in FCS must in be place before extending or beginning new investments in FCS. In line with one of the major findings of this study, the focus of the below recommendations is on ensuring 'do no harm': to DFIs; to the context in question; to the clients; and, to the end beneficiaries or other stakeholders.

1. Ensure clear strategic positioning in FCS

A comprehensive conceptual framework helps to give clarity and consistency in navigating FCS. Internally, DFIs should clarify, define and **agree upon key concepts** such as: depth of impact; definition of success and return; performance; minimum standards for 'do no harm'; and conflict-sensitivity. A shared understanding of what these concepts mean for each DFI in FCS will be necessary before moving forward.

Through this process, DFIs should **reframe the rationale** and narrative underpinning engagements in FCS as and where necessary. Given global trends and the link between poverty, development and peace, SDG 16 (on peace, justice and strong institutions) can be explicitly stated as a goal to which DFI investments contribute. Greater attention to SDG 16 does not represent mission creep. It simply acknowledges reality, in the form of a direct link between development and the possibility of stability/ peace. Including SDG 16 in the rationale and framing for DFIs has positive implications: deeper and more useful context analysis, better due diligence, and 'access' to a host of actors, networks and resources that can enrich DFI understanding of and engagement in FCS.

Under this clear(er) and unapologetic framing, and considering its strengths and assets, DFIs should solidify their strategic positioning in FCS around the following **key principles:**

- **Focus on *depth* of impact over investment *volume***: Invest in few countries but be bold in them, aiming for broad-based impact by investing in clients and sectors with high spillover potential and/or lowest harm potential; with a view to generating 'success stories', focus on FCS where there is a stronger likelihood of success first, before embarking on more 'difficult' contexts. Focus on depth of impact and finding successful ways of working rather than investment size.
- **Prioritize partnerships**: Prioritize partnerships from analysis to financing to monitoring, as a means to increase impact and build capacity (of partner and sector/industry). Seek collaboration not competition with other DFIs notably around context analysis, information sharing/risk management, and eco-system development. It is important to collaborate to create the conditions for healthy competition amongst commercial actors which entails having greater data transparency on DFI investments at country level.
- **Tailor measures of effectiveness to end goal:** Integrate realism into targets for rates of return: performance must be based on a wide-range of metrics – not only financial – and ultimately tailored to the end goal. As stated by Collier: "with skill and experience, once overheads are met by aid, modest positive returns on the portfolio might be possible, but that is not its purpose. The purpose is to ending up with companies that are self-sustaining, able to grow and be models for new entrants (local and foreign)" and which then has transformative impacts on the ability to break into regional and/or global supply chains which enable countries to escape fragility.[1]
- **Foster learning and transparency:** Commit to *global and local* knowledge generation and sharing of what worked and why, and what didn't and why.

1 Collier, Paul, email correspondence, 2 October 2021.

2. Invest in conflict-sensitivity analysis and strategies:

In line with this strategic approach, DFIs should invest in conflict-sensitivity analysis and conflict-sensitivity strategies. This entails four key phases:

a. **Understand the context** through an analysis of current or potential conflicts. This analysis should include formal and informal elements of the below:
   - Drivers and triggers of violence (including at sub-national level, in location of investment/ investees;
   - History and nature of sources of exclusion and inequalities (including in sector under consideration);
   - Sources and drivers of legitimacy;
   - Sources, means and cultural norms of wealth/asset generation, distribution and sustainment (including which sectors have highest development and transformation potential);
   - Power dynamics between political, business and social actors (generally and in specific sectors); and,
   - Real governance structures and practices (generally and in specific sectors).

b. **Understand how investments** (selected sector, clients and beneficiaries, operations, value and supply-chains) interact with the context (including with power actors);

c. **Define and implement mitigation measures** that address adverse impacts and build upon opportunities to strengthen social cohesion and peace.

d. **Undertake conflict-sensitivity monitoring**: Conflict-sensitivity, is not a one-off event; FCS are not static but *constantly evolving contexts*. As the context changes, so will the interaction effects between investment decisions/processes and that context. This requires monitoring of the contextual changes and interaction effects and ongoing adaptation.

3. Extend investment-specific due diligence

A broader and deeper context analysis should underpin individual investment due diligence process, which could be strengthened by answering key questions; broadening the consulted stakeholders; enhancing KYC; and improving ESG due diligence:

Key questions to answer:

- Do we understand the country situation, conflict dynamics, risks and opportunities?
- What is the development challenge/development potential that relates to the DFI's mission?
- What is the maximum development impact we can realistically have?
- Do we seek a more ambitious impact (see four investor profiles below) and what is the pathway for that impact through this investment?
- What are other investors doing in the country/sector, why, and would our investment add to their investment (from development impact) perspective?
- Do we understand why others have failed or had success?
- What are opportunities for collaboration?
- What are red lines/minimum conditions for us to get in/stay in (regulatory framework, etc.)?
- How do we ensure that our investment considers and responds to potential harm (at a minimum)?
- What don't we know/what are the knowledge gaps, what does it mean in terms of partnership opportunities, the design of our investments and our risk management approach?
- What is the best use of TA - when and at what level - to maximize sustainable impact?
- Depending on our investment approach (see below), which actors will have influence on the outcome of the investments? Do they support or oppose our approach? What needs to be done prior to investment to secure their buy in?

Broaden the consulted stakeholders

- Expand the diversity of stakeholders consulted as part of more standard due diligence processes;
- Stress-test the investment proposal with non-DFI partners (DFIs could co-create a network of "stress-testers", with some having country, development, gender and/or conflict-sensitivity expertise).

Enhance KYC

Ensure that elements of reputational risk analysis (risks to DFIs) always include:

- Financial risks
- Programming risks
- Legal risks
- Integrity risks

Enhance ESG due diligence

In each review, include clear and specific conflict, gender and climate impact questions to assess for potential positive and negative impacts:

- Could the investment have an impact on gender dynamics? And how?
- Could the investment have an impact on the environment? How?
- Could the investment have an impact on source of conflict and conflict dynamics?

B. Four investor profiles for investing in FCS

With these 'basics' in place, TrustWorks has identified four scenarios or DFI 'options' for FCS mapped according to two dimensions, and which build upon the key findings of this study:

- **Approach to conflict:** This dimension reflects the willingness and/or strategic choice of the DFI towards conflict ranging from managing the risk of 'doing harm' to positively impacting fragility and conflict.
- **Approach to development:** This dimension reflects the focus of the DFI on development impact when making investment decisions ranging from seeking narrow development impacts to transformative development impacts.

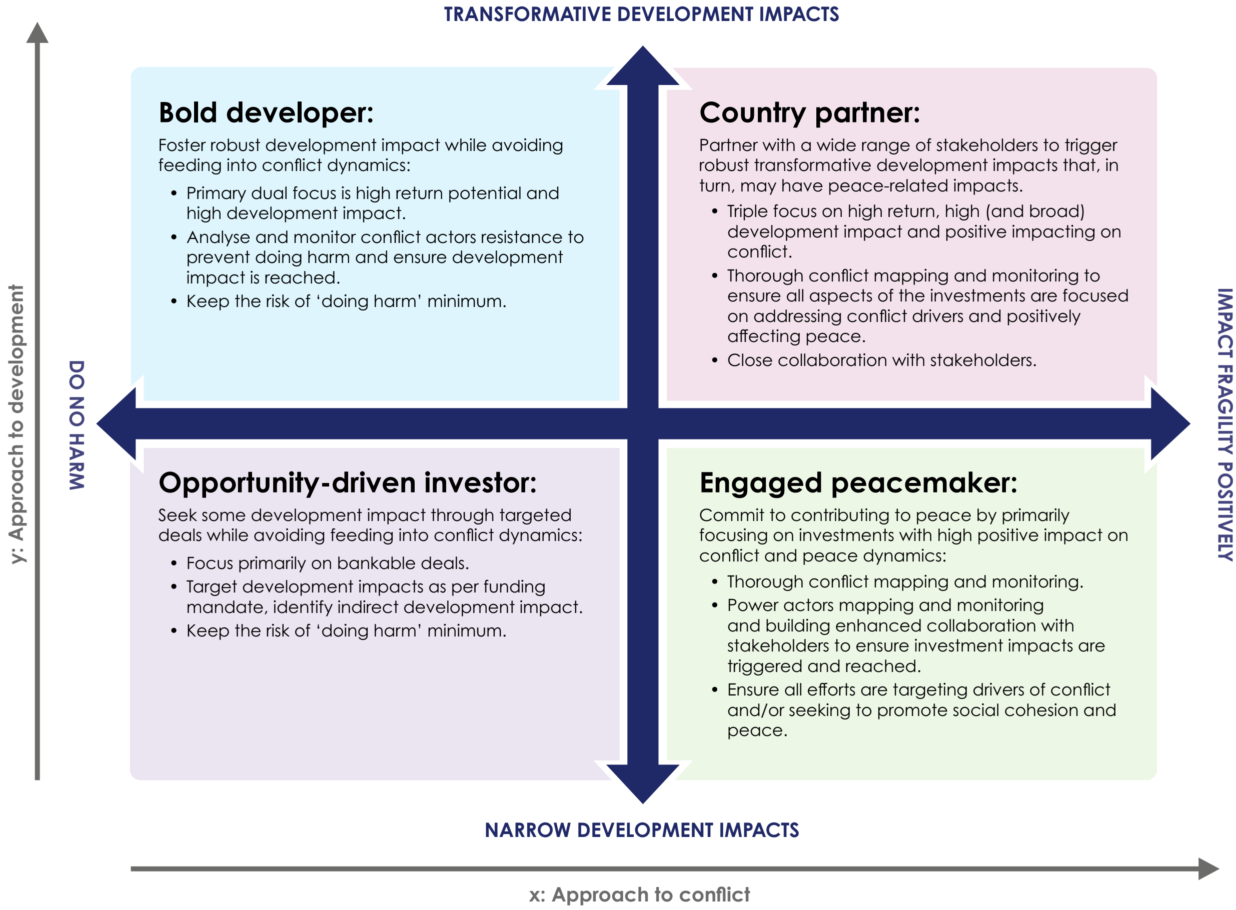
The crossing of these dimensions results in four investor profiles summarized in Figure Nine below.
Opting for one of the investor profiles is either a matter of choice or a necessity which depends on:

- the country-specific levels of uncertainty/knowledge gaps;
- possible approaches to address these;
- 'windows of opportunity' within the FCS in question[2]; leadership changes, for example, within the FCS in question may create space and potential for change.

Regardless of the profile selected, it is important recognize that if the government in the country in question lacks the will or capacity to forge a realistic pathway out of fragility, it will be challenging to make meaningful progress.

2 Collier, Paul, email correspondence, 2 October 2021.

Figure 9: Four investor profiles in FCS



C. Tailoring DFIs approach to the FCS context

The below recommendations can then be adapted, depending on the investor profile selected; it is important to note that costs associated with many of the below activities, such as creating a pipeline of investments, for example, should be treated as overheads to be financed by aid budgets – they should not be loaded into the investment.[3] These aid investments are likely to have catalytic impacts and should be prioritised accordingly. A summary of potential options for adapting these recommendations to each of the four profiles is provided at the end of these recommendations.

4. Harness the power of partnerships

To achieve an 'as deep as possible' understanding in a context of high uncertainty and vast knowledge gaps, DFIs should consider a combination partnerships and local presence.

- Develop a minimum level of information-sharing based on the commitment and investments of DFIs at a country and sector-specific level in order to enhance data transparency and foster greater levels of collaboration.
- Partnerships to pool the generation of and/or access context analysis (with other DFIs, or directly with local entities, with UN through the RC office in country).
- Explore different types of partnerships to different HQ- and country-ends (see below table, 'the role of partnerships).

3 Collier, Paul, private correspondence, 2 October 2021.

Figure 10: The role of partnerships

Key partner	Headquarters	Field-level	Points for DFIs to consider
DFIs/IFIs	• Pooled financing for high-risk investments. • Exchange of lessons learnt on FCS.	• Joint context analysis. • Strategic use of TA. • Pooled risk management. • Advocacy for policies/ regulations. • Pooled efforts to create 'pipeline' of bankable deals through SME development programmes.	• What is the concerned DFI's value-added compared to other DFIs and how can this be leveraged to better collaborate? • What role can the specific DFI play to catalyze and 'pioneer' greater collaboration between DFIs?
UN, OECD, NGOs, academics	• Secondments to bolster conflict-sensitivity expertise. • Exchange of lessons learnt on do no harm and conflict-sensitivity in FSC.	• Political economy/conflict analysis baseline. • Effective stakeholder engagement. • Third party monitoring, particularly of conflict-sensitivity dynamics. • Creating a 'pipeline' of bankable deals through SME development programmes.	• How can the specific DFI leverage partnerships with other institutions to build internal capacity on key issues such as conflict-sensitivity (e.g. through secondments, trainings, other)? • Do current country analyses incorporate the work of other actors and how can this be improved in a way that the DFI in question can then build upon in-country? • Could the DFI be working more effectively with other development actors, and across the 'nexus'?
MFA and embassies	• Collaboration on strategic country selection. • Exchange of best practices.	• Coherence on development approach in FCS. • Physical and political access.	• To what extent are specific DFI engagements aligned with country-specific MFA strategies and how can this be improved? • To what extent are embassy-level analyses useful and can they be adapted to better suit DFI needs?
Private sector	• Exchange of lessons learnt on sectoral/supply chain needs and dynamics in FCS.	• Mentoring of SMEs. • Intel on sector/supply chain needs and dynamics.	• To what extent does the private sector in-country inform the choice of sector? • Is there a role for Chambers of Commerce in supporting DFI strategies?

5. Leverage Technical Assistance (TA)

TA should be a key enabler for DFI approaches in FCS. TA enables DFIs to act across three complementary levels:

- **Investee-level TA:** To support compliance with investment requirements and/or achieve the goals defined for the investment. Partnerships and local presence assist in the diversification of the breadth/depth of the TA provided at this level.
- **Sector-level TA:** To contribute to creating sector fundamentals and capabilities (regulation, technology; infrastructure, competencies, competitive landscape to name just a few) fostering sector-wide impact and preparing the ground for higher impact by and through the sector. Partnerships and local presence can assist with this strategy.
- **Country-level TA:** To identify and support relevant government programmes that are consistent with the DFI strategy for that country. A combined, coordinated and syndicated approach with partners and country presence are essential at this level.

6. Adapt investment modalities

The investment modalities should be adapted to the FCS context. To the extent possible given the DFI strategy and profile for the country, **instruments** (type, pricing, currency, term)**, conditionalities** and **non-financial targets** should be adapted to increase the chances of success of the goals of investment, closely monitored and complemented with TA to support the client reaching them, if relevant.

- **Instruments** should be tailored to the investee to allow a maximum flexibility and commitment – within DFI risk strategy and guidelines – to increase the chances of the investment leading to the intended impact. The well-balanced adaptation of instrument type (including innovative instruments such as bonds), pricing, currency and terms are highly encouraged and, in some contexts, necessary. While there is no one size fits-all adaptation to recommend, possible adaptations may include a preference for:
    - Development bonds over equity
    - Equity over debt
    - Local currency funding over foreign currency funding
    - Longer horizon investment to shorter horizon investment.
- **Conditionalities** should be extended to include specific and measurable goals for the investment that relate to development and/or that the client commits to in the investment agreement. These conditionalities must then be monitored – together with the other covenants – closely across the investment lifecycle.
- **Non-financial targets relating to ESG** should be included in the investment setup not only from the perspective of the DFI in question (the DFIs own compliance with Responsible Investment Principles for example), but also from the stakeholder perspective (country, investee, end beneficiaries). Investees should be incentivized to implement these ESG requirements and implementation should be closely monitored and support provided as and where necessary.

7. Develop FCS relevant staffing modalities and skillsets of IOs

DFIs should consider the *expansion of investment officer profiles and skill-sets* (new recruits, and/or training of existing staff), to include:

- Political economy analysis
- Conflict-sensitivity
- Broader risk management skills
- Understanding dimensions of doing business in high security risk environments
- Outreach and networking skills

In general, highly experienced staff are required, who are proactive, "entrepreneurial, passionate, and able to weather the ups and downs of such markets." Moreover, DFIs may wish to consider adapting staff modalities, including:

- Increase physical access (including in some cases, through regional units rather country-based teams); given that many DFIs have limited resources for vast geographical expansion, this recommendation also speaks to the need to target strategic investments in a few countries rather than expand the portfolio geographically.
- Adapting incentive structures, to better link incentives not only to volume of investments, but also to level of development impact.

8. Invest in granular data for objective and up to date monitoring of fragility

- Collect and curate granular data about a selected number of fragility attributes (using a combination of advanced analytics procedures and country expert insights) about violent incidents, actors and their relationships, socio-economic, humanitarian factors, etc.
- Collaborate with other DFIs and actors, especially those with local presence, to enrich the fragility monitoring dataset with factual and objective data.
- Quantify in objective and data-driven manner the country's fragility.

Generate data-driven insights in the form of fragility maps and conflict actors' mapping to feed into investment and monitoring process, in line with the chosen scenario.

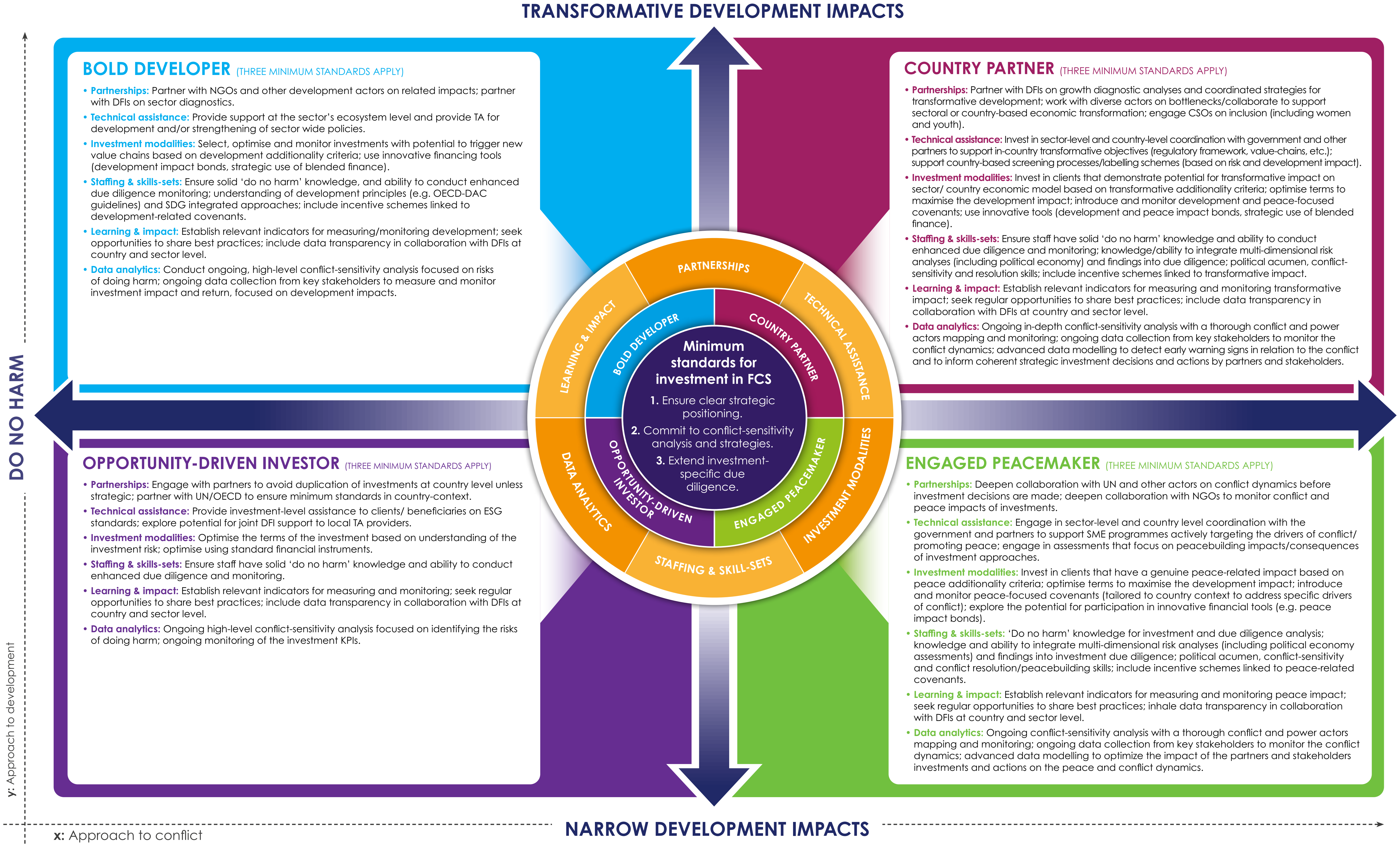
9. Invest in institutional learning and impact assessments

- Investing in FCS requires taking a 'learning by doing' approach, and ensuring such learning is then integrated regularly into new/ongoing investments and approaches.
- In addition to regular reflection exercises, impact assessments are required to understand whether the investments are having any unintended consequences on the one hand, and to understand the impact they are having on the client, the beneficiaries and the SDGs on the other.

Figure 11: Summary – Adapting key recommendations to the investor profile

Thematic area	Opportunity-driven investor	Bold developer	Engaged peacemaker	Country partner
Partnerships	▶ Avoid duplication of investments at country-level with other DFIs unless strategic (e.g. if combination of support enables investment to reach scale). ▶ Ensure partnerships with UN and OECD on 'do no harm' as per minimum standards.	▶ Partner with NGOs around development-related impacts (analysis, advocacy, monitoring, assessing impact). ▶ Partner with other DFIs on sector diagnostics to understand how to invest in sectors that have the greatest development potential.	▶ Deepen collaboration with UN and other actors on understanding conflict dynamics, sources of conflict before investment decisions are made. ▶ Deepen collaboration with NGOs to monitor conflict and peace impacts of investments.	▶ Partner with other DFIs to undertake growth diagnostic analyses and to elaborate coordinated strategies to foster and support transformative change. ▶ Work with networks of international, national and local actors to address bottlenecks and collaborate to support sectoral, or country-based economic transformation. ▶ Engage CSOs to ensure a focus on most marginalised through the lens of inclusion (including women and youth).
Technical Assistance	▶ Provide investment-level assistance to clients on ESG measures, and support clients to assist beneficiaries where relevant with ESG-related support. ▶ Explore with other DFIs potential for joint support/development of local TA providers to catalyse/sustain investments.	▶ Provide support to institutions at the sector's eco-system level (e.g. credit bureaus for financial industry, MFI associations). ▶ Provide TA for development and/or strengthening of sector wide policies and strategies in key investments sectors.	▶ Engage in sector-level and country level coordination with the government and other relevant partners to support SME programmes (and others) that actively target the drivers of conflict or promote peace. ▶ Engage in assessments/analyses that focus on peacebuilding impacts/consequences of various investment approaches.	▶ Invest in sector-level and country-level coordination with the govt and other relevant partners to support programmes consistent with in-country transformative objectives (regulatory framework, regulations, value-chains, etc.). ▶ Support the development of country-based screening processes/ labelling schemes (based on risk *and* development impact) in partnership with other international actors.
Investment modalities	▶ Focus on investees that 'do no harm'. ▶ Optimize the terms of the investment based on an assessment of stand-alone risk of the investment. ▶ Choose the usual financial instruments (loan, equity) that fits the investee needs and optimize risk/return.	▶ Select investees who have the potential to trigger new value chains (champions) based on development additionality criteria. ▶ Optimize the terms to maximize the development impact while having an optimal risk/return and introduce and monitor development focused covenants and KPIs. For example, focus on equity over debt, local over foreign currency funding, long-term horizons over short-term. ▶ Introduce innovative financial tools such as development impact bonds, and strategic use of blended finance.	▶ Invest in clients that have a genuine peace-related impact based on peace additionality criteria. ▶ Optimize the terms to maximize the development impact while having an optimal risk/return and introduce and monitor peace-focused covenants and KPIs (tailored to the specific country context to focus on addressing the specific drivers of conflict in the given country context). ▶ Explore the potential for participation in innovative financial tools such as peace impact bonds.	▶ Invest in clients that demonstrate the potential to have a transformative impact on sector dynamics and even country economic model, including 'pioneering firms/sectors' (based on transformative criteria). ▶ Optimize the terms to maximize the development impact while having an optimal risk/return and introduce and monitor development and peace focused covenants and KPIs. For example, focus on equity over debt, local over foreign currency, long-term horizons over short term horizons. ▶ Use innovative tools such as development impact bonds, participation in peace impact bonds and strategic use of blended finance.
Staffing modalities and skill-set	▶ 'Do no harm' knowledge for investment and due diligence analysis.	▶ Do no harm knowledge for investment and due diligence analysis. ▶ Understanding of development principles (e.g. OECD/DAC guidelines); ▶ Understanding of relevant SDG frameworks (e.g. SDG financing instruments) and SDG integrated approaches (e.g. how developments in one sector/SDG impact other sectors/SDGs). ▶ Include incentive schemes linked to financial & development-related covenants.	▶ 'Do no harm' knowledge for investment and due diligence analysis. ▶ Knowledge and ability to integrate multi-dimensional risk analyses (including political economy assessments) and findings into investment due diligence. ▶ Political acumen, conflict-sensitivity and conflict resolution/ peacebuilding skills. ▶ Include incentive schemes linked to peace-related covenants.	▶ Do no harm knowledge for investment and due diligence analysis. ▶ Knowledge and ability to integrate multi-dimensional risk analyses (including political economy assessments) and findings into investment due diligence. ▶ Political acumen, conflict-sensitivity and conflict resolution skills. ▶ Include incentive schemes linked to country/sector-wide transformative impact of investment.
Learning and impact	▶ Establish relevant indicators for measuring and monitoring. ▶ Seek and engage in opportunities to share what works and what doesn't in relation to investment approach. ▶ Enhance data transparency in collaboration with DFIs at a country and sector-level.	▶ Establish relevant indicators for measuring and monitoring development. ▶ Seek and engage in opportunities to share what works and what doesn't in relation to investment approach. ▶ Enhance data transparency in collaboration with DFIs at a country and sector-level.	▶ Establish relevant indicators for measuring and monitoring peace. ▶ Seek and engage in opportunities to share what works and what doesn't in relation to investment approach. ▶ Enhance data transparency in collaboration with DFIs at a country and sector-level.	▶ Establish relevant indicators for measuring and monitoring transformative impact. ▶ Seek and engage in opportunities to share what works and what doesn't in relation to investment approach. ▶ Enhance data transparency in collaboration with DFIs at a country and sector-level.
Data analytics	▶ Ongoing high level conflict-sensitivity analysis focusing on identifying the risks of doing harm. ▶ Ongoing monitoring of the investment KPIs	▶ Ongoing high level conflict-sensitivity analysis focusing on identifying the risks of doing harm. ▶ Ongoing data collection from partners and stakeholders to measure and monitor the investment impact and return, particularly focused on development.	▶ Ongoing in depth conflict-sensitivity analysis with a thorough conflict and power actors mapping and monitoring. ▶ Ongoing data collection (from partners, including the government/ state and stakeholders) and its processing to monitor the conflict. ▶ Advanced data modelling to detect early warning signs in relation to the conflict and to inform coherent and strategic investment decisions and actions by the partners and stakeholders.	▶ Ongoing conflict-sensitivity analysis with a thorough conflict and power actors mapping and monitoring. ▶ Ongoing data collection (from partners, including the government/ state stakeholders) and its processing to monitor the investment impact. ▶ Advanced data modelling to optimize the impact of the partners and stakeholders investments and actions on the peace and conflict dynamics.

Figure 12: A DFI model for successful investments in FCS



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Annex 1: Examples of how DFIs characterise fragility (based on publicly available materials)

Examples of different definitions and approaches to fragility		
DFIs/IFIs/MDBs	**Definition/understanding of fragility**	**Specifics about the approach in FCS**
International Finance Corporation (IFC)	Fragile and conflict-affected economies often exhibit several common characteristics, such as social conflict and excluded groups, poor institutions and services, inadequate infrastructure and government and firm capabilities, environmental and social issues, limited and undiversified private sectors, and low levels of trade and per capita income. While building trust, security, and strong institutions is critical to helping these countries advance and gain stability, the role of the private sector throughout the development process is increasingly seen as essential, as recognized in the g7+ New Deal for Engagement in Fragile States.	The Seven Principles in Action: IFC's Solutions in FCS **1.** Be conflict sensitive every step of the way **2.** Avoid the dilemma of choosing between short and long-term impacts. **3.** Act fast during conflict-to-peace transitions and remain engaged during setbacks. **4.** Commit more than financial resources. **5.** Stick to standards, but be flexible on the timing. **6.** Support new players and innovate **7.** Keep markets open to international trade and investment
World Bank Group (WBG)	Rather than a definition, the World Bank uses a Fragility, Conflict and Violence (FCV) typology. This typology will need to be an expanded and differentiated approach to defining FCV that appropriately captures diverse settings across the income spectrum, and that spans regional, national and individual dimensions. Within the current Harmonized List of Fragile Situations, there is a need to distinguish situations of very different nature, scope and intensity, with a view to tailoring and prioritizing WBG approaches and responses to different FCV contexts: • Countries with high levels of institutional and social fragility, identified based on publicly available indicators that measure the quality of policy and institutions and manifestations of fragility. • Countries affected by violent conflict, identified based on a threshold number of conflict-related deaths relative to the population. This category includes two sub-categories based on the intensity of violence: countries in high-intensity conflict and countries in medium-intensity conflict.	To carry out the Fragility, Conflict and Violence Strategy, the WBG has set out 23 measures to strengthen its effectiveness in FCV settings, organized into four categories: - Policies, Processes & Practices, for example: • Articulate how the WBG will operate in humanitarian crises, in refugee and forced-displacement situations, and when dealing with security and military actors, particularly in insecure environments, and update Operational Policy (OP) 2.30 on Development Cooperation and Conflict accordingly. • Simplify and streamline IFC and MIGA processes to more nimbly address FCV challenges, including streamlining the processing of small loans. - Programming, for example: • Ensure that country partnership frameworks and operations in FCV settings systematically address the key drivers of fragility and sources of resilience. • Promote the use of portfolio reviews, conflict filters, and peace lenses in FCV settings to support Bank teams in ensuring that portfolios and operations identify and address fragility drivers and conflict risks, particularly in countries with pockets of fragility. - Partnerships, for example: • Operationalize and deepen partnerships with multilateral development banks (MDBs) at the country level on areas of focus in the FCV agenda, including through more regular joint trainings and joint diagnostics. - Personnel, for example: • Increase on-the-ground presence by deploying more professional staff to fragile and conflict-affected situations, as well as nearby locations. Implementation of the strategy occurs at four levels to ensure that the WBG adapts its approach to the distinct nature of FCV settings: **1.** Through the 23 operational measures outlined in the strategy; **2.** through corporate strategies, initiatives, and commitments where FCV is prioritized, such as the IDA19 Replenishment, the IBRD and IFC Capital Increase package, the FY20-22 HR Strategy, and MIGA's FY21-23 Strategy; **3.** Through FCV country and regional programs; and through analytics and operations in FCV impacted countries, and **4.** Through analytics and operations in FCV-impacted countries.
European Investment Bank (EIB)	Fragility is characterized by unstable institutions and poor governance, which result in weak political, fiscal, security and service delivery functions. Fragile states are either unable or unwilling to fulfil these core functions for the majority of, or for specific sections of society. They are also more likely to experience violent conflict. The link between conflict and fragility is clear. To understand conflict's causes and drivers, one has to consider the overall institutional framework of the country. Fragility of both institutions and societies are key risk factors for conflict. Fragility and conflict have been identified as critical development challenges, both for low- and middle-income countries, and they represent a major trap for developing countries. Fragility is about more than just conflict. A country doesn't need to experience an outright violent conflict to be deemed fragile. To understand how fragile a country is, the European Investment Bank relies on specialized sources, such as the Organization for Economic Co-operation and Development. Its 2020 States of Fragility report lists 57 fragile states. The European Investment Bank has planned or active operations in 39 of them. Other relevant sources include the World Bank's Harmonized List of Fragile Situations, and the Global Peace Index.	To strengthen the effectiveness of EIB's development interventions and maximize positive impact on peace, the Bank has developed a conflict sensitive approach. The European Investment Bank's conflict sensitive approach aims to: - reduce the risk of the conflict and fragility derailing the project, - avoid the risk of conflict being exacerbated by the project and, - contribute to conflict prevention and peacebuilding efforts through its investments. Conflict sensitivity refers to the awareness of risks related to conflict, but also of the impact the project can have on the conflict itself – both in positive and negative terms. Public and private investors need to understand that their investments don't happen in a vacuum. Their financing can tilt the potential conflict one way or another. They can have a positive influence by contributing to conflict prevention and stabilization. They can also unintentionally aggravate the conflict.

Examples of different definitions and approaches to fragility		
DFIs/IFIs/MDBs	**Definition/understanding of fragility**	**Specifics about the approach in FCS**
Islamic Development Bank (IDB)	According IDB, fragility is the combination of exposure to risk and an insufficient coping capacity of the state, system and or communities to manage, absorb or mitigate those risks (drawing on OECD definitions). Fragility can lead to negative outcomes that include violence, the breakdown of institutions, displacement, humanitarian crisis or other emergencies. It encompasses the inability of states to fulfil responsibilities as sovereign entities due to lack of capacity.	In their Fragility and Resilience Policy (2019), the IDB outlines their objectives in FCS which is to address fragility, conflict and resilience by: strengthening institutions, building resilience and contributing to social cohesion and social development in member countries. The strategy has four pillar: • Investing in prevention • Transitioning from relief to development • Supporting recovery and resilience • Mobilizing resources for resilience
African Development Bank (AFDB)	Fragility comes about where pressures become too great for countries to manage within the political process, creating the risk of conflict and outbreak of violence— the most extreme manifestation of fragility— whether interstate or civil war, ethnic or tribal conflict, widespread criminality or violence within the family. Countries that lack robust institutions, diversified economies and inclusive political systems are the most vulnerable. In the most acute cases, violence has the effect both of magnifying the underlying pressures and eroding the institutions needed to manage them, creating a fragility trap from which it is very difficult to escape. Fragility is an imbalance between the strains and challenges (internal and external) faced by a state and society and their ability to manage them.3 At the extreme, fragility is expressed as conflict or collapse of state functions. Viewing fragility as a condition and not a category of countries recognizes that it can affect countries, regions, or areas within countries, middle-income countries as well as low-income countries. Correspondingly, fragility has multiple manifestations that span a wide range of situations, from mild or transitional instability to prolonged violent conflict. Fragility is thus the opposite side of the coin to state resilience, which is the ability of the state to manage such strains through effective institutions, processes and capacities that build legitimacy and societal cohesion. For AFDB, fragility does not respect national boundaries. Natural resource pressures and other drivers of fragility often extend across borders while conflicts in one country can affect neighboring countries and inflame entire regions, as can be seen in the Mano River region in West Africa, the Horn of Africa and the Great Lakes region. An estimated 80% of the cost of conflict—in foregone economic growth—is borne by neighboring countries, with growth about 0.6% a year lower per neighbor.	Addressing Fragility and Building Resilience in Africa- The AfDB Group Strategy 2014–2019 (no revised strategy identified at time of research) According AFDB, the drivers of fragility can be categorized into four dimensions: economic, social, political and environmental, all usually involving exclusion and inequality. At the core of social drivers of fragility is a demand by individuals or groups in a society for inclusion and access to services, resources, opportunities, rights or identity that lead to grievances, social tensions, rebellions and violence. Political drivers may include the limited - participation or voice of certain groups, or state capture by some elites that threaten to deprive other elites or segments of society, which can manifest itself in a loss of legitimacy of institutions or breakdown of political settlements. Environmental pressures and climate change may lead to humanitarian disasters and competition over scarce natural resources such as water or pasture; countries or communities affected by geographic insularity, such as island states and isolated areas within a state, are particularly vulnerable in this regard. Large and growing economic inequalities, economic capture of the state by a small group, or the inability of the society to provide jobs, particularly for youth, are prominent economic drivers. Although these drivers of fragility exist to varying degrees in almost all countries, it is the state's and society's capacity to address and mitigate the effects that also differentiates the levels of fragility. Based on the Bank's understanding of the key drivers of fragility, three areas of particular strategic importance for building resilience stand out where the Bank should focus its engagement. These are the need to: • strengthen state capacity and support effective institutions; • promote resilient societies through inclusive and equitable access to employment, basic services and shared benefits from natural resource endowments; and, enhance the Bank's convening role for a deeper policy dialogue, partnerships and advocacy around issues of fragility. **Gender Strategy 2021- 2025: The African Development Bank wants to create more opportunities for women in key sectors of the continent:** • In its new gender strategy for the period 2021-2025, released on February 3, 2021, the African Development Bank unveils its gender vision for the next five years. The pan-African development institution plans to "transform the continent's key sectors into accessible terrains of opportunity, where women, girls, men and boys, regardless of their background, enjoy equal access to and control over productive resources and are provided with the infrastructure and support services to thrive." • The Bank's strategy is to strengthen gender equality and the empowerment of women and girls in its five priority areas, the "High 5". It intends to mainstream gender in all country and regional operations. It will also strive to classify 100% of its public sector operations using the Gender Marker System (GMS). • Priority will also be given to interventions aimed at strengthening gender equality and the empowerment of women and girls by selectively focusing on areas where the Bank can demonstrate concrete comparative advantage and value added. The Bank will therefore continue to invest in generating country-specific gender data and knowledge to improve its understanding of country-specific constraints. • In addition, the Bank intends to leverage its convening power in the post-Covid-19 recovery process which has disproportionately affected women, girls and youth. Thus, with the support of key partners such as financial institutions, central banks, civil society organizations (CSOs), among others, it will help regional member countries to better rebuild and overcome structural obstacles. To this end, it intends to support the • Financing of short- and long-term gender-sensitive interventions that place women at the center of the action as key drivers of socio-economic recovery. • The Bank launched the Affirmative Finance Action for Women in Africa (AFAWA) initiative in May 2016 to close the US$42 billion financing gap for women in Africa. Over the next few years, the institution plans to release up to $5 billion in financing as part of the implementation of this women's initiative. • The African Development Bank has also committed to building the capacity of financial institutions operating on the continent to focus more on the niche of women-owned small and medium enterprises. It also intends to help them tailor their products and services to the types of businesses run by women and girls.

Examples of different definitions and approaches to fragility		
DFIs/IFIs/MDBs	**Definition/understanding of fragility**	**Specifics about the approach in FCS**
Asian Development Bank (ADB)	Fragility is a state with weak capacity to carry out the basic functions of governing a population and its territory, that lacks the ability or political will to develop mutually constructive and reinforcing relations with society, or that is affected by other specific vulnerabilities, such as for small states.	Fragile and Conflict-Affected Situations and Small Island Developing States Strategy (Dec. 2020) is designed to leverage ADB's longstanding engagement in FCAS and SIDS to building the FCAS and SIDS approach. ABD uses conflict-sensitive approaches in their country strategies and operations. Which means that ADB will: • continue efforts to make country strategies and plans for all FCAS countries more fragility- and conflict-sensitive, • strengthen human resources for FCAS operations, • seek to augment financial resources for FCAS operations, • adopt differentiated business processes for FCAS operations and develop a more appropriate risk framework, • develop an institutional strengthening framework for FCAS DMCs, and • refine its approach to identifying FCAS DMCs.
BIO Belgium Investment Company for Developing Countries / Belgium	BIO invests in Least Developed Countries, Low Income Countries, and Lower-middle Income Countries (i.e. the OECD's DAC-list). BIO can also invest in upper middle-income countries and pays particular attention to the partner countries of the Belgian Development Cooperation and to less developed countries. While they do not appear to reference 'fragility' directly, they do have an SDG 'Frontier Fund', dedicated to combining impact and returns in select countries (many of which are located in FCS, particularly in Africa).	Strategy 2019-2024: BIO's strategic directions take 4 dimensions into account: • the client, • the geographical framework, • priority sectors and, • sustainability. Africa: The portfolio of investments focuses on the diversification of the economies, the creation of local champions, the development of infrastructure and the deepening of financial inclusion. End of 2018, Africa accounted for circa 50% of their outstanding portfolio. Should read: Some local liaison offices have been opened - for example in the Democratic Republic of Congo, Mozambique and Nigeria - as these countries have the size and dynamism for a scalable formal private sector and play a catalytic role in their respective subregions with entrepreneurs expanding business outside their borders.
CDC/United Kingdom	While CDC participates actively in the Fragility Forum, they do not have a specific 'fragility' definition or strategy. They tend to categorize the low-income countries they invest in in terms of "investment difficulty" and those listed in the "most difficult" and "difficult" categories tend to be FCS.	Since 2012, CDC's plans reflect a progressive focus on low-income and fragile states. CDC's strategy for 2012-16 was to invest exclusively in Africa and South Asia, with an aspiration to shift CDC's capital to more challenging regions over time. The more recent strategic framework, covering the period 2017-21, commits CDC to increasing the volume of its investments in poorer and more fragile countries and regions, where its "capital is most needed". DFID's 2015 and 2017 business cases for new investment in CDC also reaffirm CDC's commitment to investing in fragile and conflict-affected countries. A recent study also showed that a much higher proportion of CDC's investments have been in fragile and conflict-affected countries (43%) compared with other leading DFIs. The French DFI, Proparco, is the second-most active in fragile countries, at 28%.
KfW Development Bank (Germany)	While peacebuilding as a prerequisite for sustainable development has been a core concern of the international community since the last century, the concept of fragility has only been established since the turn of the millennium. In general, those states are classified as fragile if their institutional regulations show clear deficits in the areas of monopoly of force, capacity and / or legitimacy and which therefore have a high potential for conflict escalation. On behalf of and with funds from the Federal Government, KfW Development Bank is committed to a wide range of short- to long-term measures to contain fragility and promote peace.	KfW Development Bank implements a steadily growing number of projects in contexts of fragility. As of December 31, 2019, the 'FFF portfolio' with a volume of EUR 19.0 billion represented a share of 35% in the total current FC portfolio of EUR 54.3 billion. The "PFD Portfolio" is composed of three interrelated fields: (1) Involvement in states which OECD/DAC (2018) has classed as "fragile" (2) Use of funds for projects with a concrete link to the topic of "forced displacement" (3) Measures which aim to promote peace and/or reduce fragility (FS1/FS2) In this domain, KfW focuses on four key topics: crisis prevention and strengthening resilience; from emergency aid to reconstruction and peacebuilding; support in escape contexts; and, prevention of violence and crime.
Finnfund (Finish Fund for Industrial Cooperation LTD) / Finland	FinnFund does not appear to use a specific definition of fragility.	Fragile states are at the core of development financiers' (DFIs) mission to alleviate poverty. According to Finnfund, it is more cost-effective to fund the private sector through DFIs than through governments. • Create a series of transformational pilot programmes to increase effective collaboration of such institutions in selected countries: • Work together to identify ways to streamline their processes for investments in the private sector of economies affected by fragility and conflict and Continue their efforts to identify appropriate uses for concessionary capital that can be blended with commercial capital to achieve development impact.

Examples of different definitions and approaches to fragility		
DFIs/IFIs/MDBs	**Definition/understanding of fragility**	**Specifics about the approach in FCS**
PROPARCO – Société de Promotion et de Participation pour la Coopération Économique – France	Proparco is a major actor in the development aid of fragile countries, even if they do not have a specific definition of 'fragility' per se. According to Proparco, in fragile countries, the creation of private sector jobs is a way out of the crisis. The support of local entrepreneurs by development finance institutions (DFIs) must go beyond the role of financing investment. Their action aims in particular to co-coordinate the action of donors, to support the value chain as a whole and to tackle the factors that hinder entrepreneurship.	Proparco is convinced, like Paul Collier, who published an article on their website, that employment and a fair distribution of wealth strengthen the resilience of societies and limit the occurrence of crisis situations. However, given the stakes, this contribution and the impacts obtained deserve to be scaled up. New approaches adapted to these specific environments must be imagined, in addition to the products that DFIs traditionally offer. The reflection is still ongoing, but despite proposals, DFIs are confronted with difficulties related to the economic environment of these countries and to the constraints of their own business model. Fragile states often have small, fragmented markets which suffer from logistical disruptions and a lack of skilled labour, with often very complex regulatory systems and frequent political interventions in the economic sphere. For Proparco, the success of its interventions in fragile states is therefore based on improving the business environment and creating value chains on the one hand, and on adapting the DFIs' business model to create specifically adapted investment capacities on the other. The strategy consists of: - an integrated sectoral approach in the most fragile areas and actions to foster the emergence of markets in border countries (mainly in Africa, the Middle East and Haiti), - A "DFI pack" that responds to local needs in order to develop tools and new approaches for DFIs, with the aim of creating new spaces for collaboration, - Support for the necessary dialogue between the state and the sector-specific actors, with support from public development banks and DFIs in order to promote good public governance, which is essential for investment, - Strengthening or creating subsidiaries, particularly through the role of public development bank
SIFEM – Swiss Investment Fund for Emerging Markets / Switzerland	SIFEM invests in developing and emerging countries, i.e. countries whose GNI per capita is below a set threshold (USD 7,065 per capita in 2021) as defined by the International Bank for Reconstruction and Development - which is part of the World Bank Group. While like most other DFIs they participate in the Fragility Forum they do not have a specific strategy dedicated to FCS, but many FCS fall under their strategy on developing and emerging countries.	SIFEM is an important instrument for fostering private sector development in developing and emerging countries, complementary to other measures of the economic development assistance; • SIFEM promotes sustainable and inclusive growth in developing and emerging countries as well as their integration into the global economic system; • SIFEM focuses on the creation and maintenance of more and better jobs as well as on the improvement of working conditions and skills, recognising that more and better jobs are the main driver of poverty reduction in developing and emerging countries, along with social inclusion, and that they offer an alternative to irregular migration. In this way, SIFEM helps to fight the root causes of irregular migration and contributes towards the mandate of Parliament to strategically link international cooperation with the migration issue; • SIFEM promotes the development of sustainable businesses in developing and emerging countries, based on internationally recognised environmental, social, and governance standards; • SIFEM contributes to strengthening the resilience of these countries, inter alia against climate change.
Swedfund – The Swedish Development Finance institution - Sweden	Swedfund has the same goal as Sweden's international aid generally – to create opportunities for people living in poverty and under oppression to improve their living conditions. Many of the countries in which Swedfund invests are FCS but they do not have a strategy specific to FCS.	By investing in shares and funds and providing loans. Swedfund works actively with regard to women's empowerment, climate, human rights and digitalisation. Swedfund's operations are constantly evolving and we play a vital role in Swedish development cooperation, not least as a catalyst for developing the private sector and implementing Agenda 2030. They have chosen to have a geographical focus on sub-Saharan Africa and the poorest countries in Asia. Approximately 58% of Swedfund's investments take place in sub-Saharan Africa. They focus our investments and which are particularly important for achieving the goal of reducing poverty, including, energy & climate, financial inclusion, in order to increase the proportion of SMEs and promote entrepreneurship, as well as health. Climate and women's empowerment are two thematic areas that permeate what they do, regardless of the choice of instrument, geography or sector.

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Conditions for successful investments in fragile and conflict-affected states

A TrustWorks-led project in partnership with NIRAS
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