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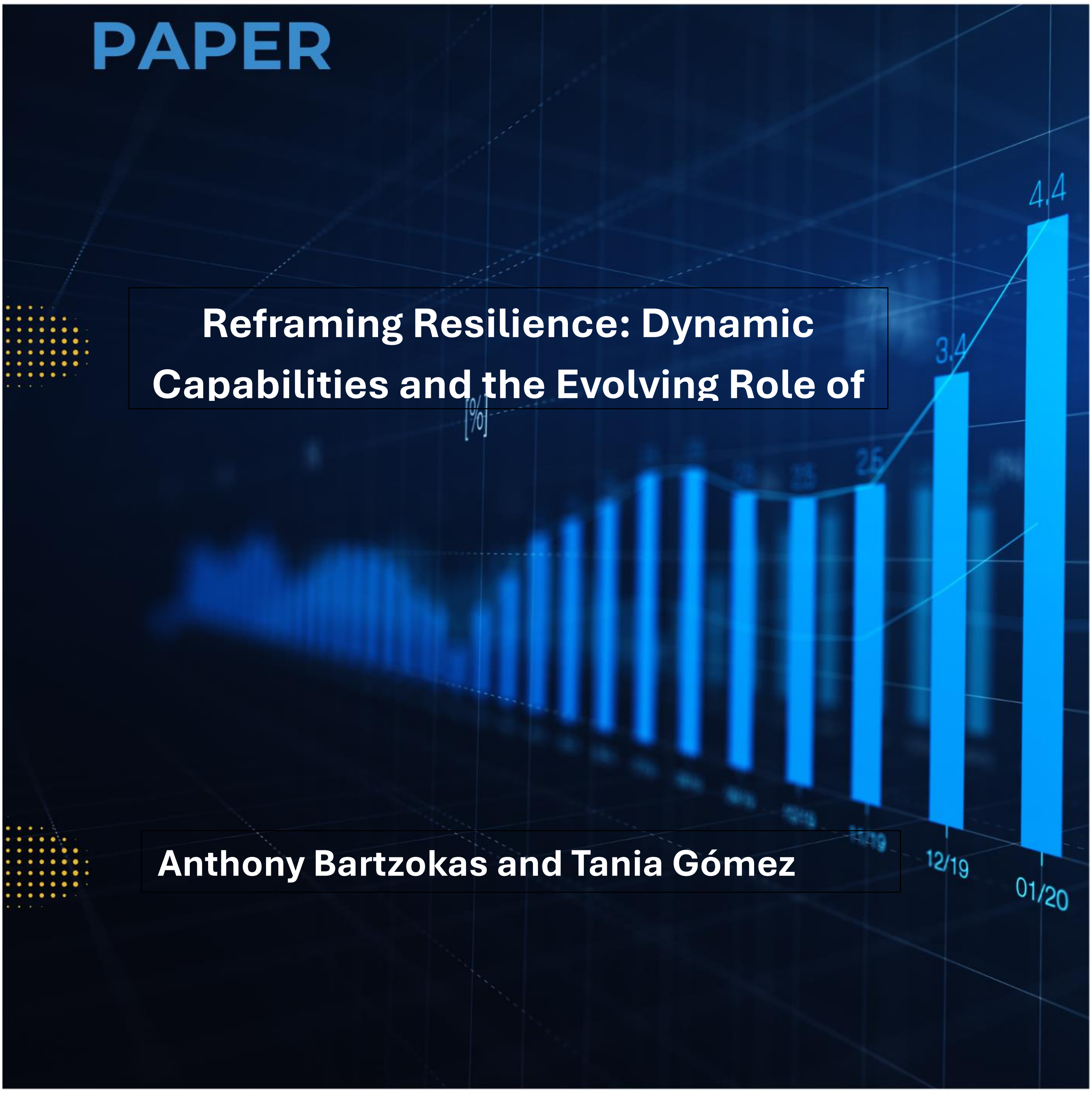

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Reframing Resilience: Dynamic Capabilities and the Evolving Role of International Financial Institutions

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ABSTRACT

This paper examines how International Financial Institutions (IFIs) can adapt to an era defined by geopolitical fragmentation and the erosion of multilateralism by harnessing their dynamic capabilities—specifically, their capacities to sense, seize, and transform in response to systemic shifts. Drawing on a Dynamic Capabilities Framework (DCF), we conceptualize IFIs resilience as a global public good, fundamental to sustaining development finance amid evolving global challenges. We propose a novel taxonomy that links the core elements of IFI business models to their institutional micro-foundations, and we identify two key mechanisms for amplifying impact: (i) the co-design of blended finance initiatives with the private sector, and (ii) the diffusion of institutional capabilities to Development Finance Institutions (DFIs) in the Global South. Our analysis positions IFIs as agents of systemic learning and knowledge transfer, underscoring the pivotal role of endogenous institutional reform in fostering resilient, sovereign financial architectures aligned with the Sustainable Development Goals.

Keywords: International Financial Institutions, Dynamic Capabilities Framework, Blended Finance, Institutional Diffusion, Local Currency Financing.

JEL Classification: F35, G23, O16, H81, O19.

1. Introduction

The global financial and geopolitical environment has grown increasingly volatile, placing significant strain on International Financial Institutions (IFIs) and challenging their capacity to respond effectively. This paper introduces a Dynamic Capabilities Framework (DCF) to advance our understanding of how IFIs adapt, evolve, and maintain relevance within this shifting landscape.

The introductory section outlines the systemic importance of IFIs, examines their foundational governance structures, and explores the structural pressures that threaten their legitimacy and effectiveness. It also situates the discussion within the broader reform agenda, highlighting the central debates that shape the future trajectory of these institutions.

1.1. The Systemic Importance of IFIs

International Financial Institutions such as the World Bank Group, the African Development Bank (AfDB), and the Asian Development Bank (ADB) are indispensable pillars of the world economy as these institutions can address global capital market failures and macroeconomic stability (Léon, 2025; Ocampo, 2025). Their role extends far beyond merely lending capital. IFIs are critical actors in global economic development and stability, specializing in providing long-term, patient, non-cyclical capital to developing and emerging economies, as well as their ability to crowd in private (impact) investment through blended finance instruments, risk-sharing mechanisms, and catalytic partnerships that enhance market confidence and leverage sustainable development outcomes. They provide essential countercyclical support during financial crises, preventing development setbacks (Leipziger, 2011). MDB lending to developing countries has grown significantly, acting as a crucial complement to private and bilateral finance, with annual lending volume rising substantially since the early 2000s (UN General Assembly, 2025).

The IFI model leverages relatively small amounts of paid-in capital from member countries to issue highly rated bonds in international markets. This allows them to borrow cheaply and then lend at favourable, below-market rates for resource-intensive infrastructure, health, and education projects (Marodon R., et. al, 2025). Their function is not just financial; they are vital knowledge brokers and catalysts for developing international standards in areas like financial regulation, public financial management, and environmental and social safeguards (IMF, 2001).

The unique role of IFIs in sustainable development has been emphasized in the literature. A mission-oriented approach has been proposed to enable development banks to drive systemic transformation aligned with the Sustainable Development Goals (Mazzucato, 2023), while the establishment of an IFI framework aimed at scaling institutional capacity through policy alignment, capital reform, and global coordination has also been underscored (Riaño et al., 2021)

Their client service-oriented model however is diversified in response to country funding needs by income group: For low-income countries, concessional and below-market financing remains a central priority, reflecting the critical need for affordable and predictable capital to advance development objectives and maintain debt sustainability. By contrast, non-concessional borrowers tend to place greater value on technical assistance, policy dialogue, and knowledge transfer, viewing IFIs as strategic partners in institutional strengthening and policy reform rather than as primary sources of finance (Prizzon and Zeka, 2025). This distinction illustrates the evolving role of IFIs, which are increasingly required to balance their traditional financial intermediation function with their advisory and catalytic roles. It also highlights the need for IFIs to develop diversified capabilities—combining financial innovation, policy expertise, and knowledge management—to remain effective across diverse client segments and development contexts.

1.2. Governance Structure and the Legitimization Crisis

The foundational governance of the IFIs, established largely after World War II, is rooted in a shareholding model that currently faces a profound crisis of legitimacy in terms of structure and voting power. IFIs are supranational institutions where member countries subscribe to a specified number of shares, which directly determines their voting rights and thus their influence (European Parliament, 2024). Governance is vested in a Board of Governors (typically finance ministers), who delegate daily operational decision-making (e.g., project approval) to a resident Board of Directors. While this model grants them the legal backing of sovereign states, it is the root of the ongoing debate over fairness.

Over the past several decades, global economic gravity has shifted toward emerging and developing economies (notably China, India, Brazil, Indonesia, and others). These economies now account for a much larger share of global GDP, trade, and investment flows. Academic analyses—Humphrey, 2016 and 2019; Klingebiel et al,.2025; Mazzucato, 2023—argue that IFI governance has not kept pace with these transformations. The persistence of voting power asymmetries means that countries whose economic weight has grown significantly remain underrepresented in decision-making structures. Conversely, traditional lenders such as the United States have restricted their financial support and distanced themselves from the UN SDG agenda (Tooze, 2025) This misalignment between current economic realities and institutional governance structures fuels the ongoing "crisis of legitimacy." Scholars often frame this as a "governance lag" (Humphrey, 2019; Brookings Institution, 2024), where universal commitments of the SDGs target should evolve to more realistic, context-sensitive frameworks that recognise the intersection of power, development, and geopolitics (Tooze, 2025).

The geopolitical landscape is characterized by the erosion of multilateral consensus (UNOSSC, 2025) on the 2024 UN "Pact for the Future", and the collapse of the discourse on the scale up of international funds for development. The fracturing of cooperation and the rise of protectionism challenge the donor architecture (as noted in the original policy brief) where the International Financial Architecture governance reform is framed by geopolitical tensions and donor retrenchment (eg. US and China). This environment, which necessitates a reconfiguration of political consensus (Klingebiel, 2025), is pushing IFIs to work more closely "as a system" and coordinate their efforts to maintain relevance amidst rising global uncertainty (World Bank, 2024).

The voting power remains heavily weighted toward the original, wealthy donor nations, primarily the United States and major European countries. Despite the growing economic power and rising financial needs of the Global South, the allocation of voice and influence has failed to keep pace. This geopolitical asymmetry restricts developing countries' access to affordable global finance and is often seen as an imposition of external policy views rather than promoting true country ownership (European

Parliament, 2024). Reforms that change the allocation of voice and voting rights in institutions like the IMF and World Bank are now considered "critical" to enhancing their legitimacy and efficacy (Brookings Institution, 2024).

1.3. Emerging challenges and the Impetus for Reform

Structural shifts in the world economy have intensified the pressure on IFIs to reform their mandate and financial models, moving beyond their traditional country-specific approach and amplifying Global South voices. Recent data indicate that government demand for IFI support is projected to rise significantly over the coming decade. This anticipated increase reflects not only expanding development financing needs but also the enduring appeal of concessional and blended resources in an era of tightening fiscal space and volatile capital markets (Prizzon and Zeka, 2025). The ability of IFIs to provide affordable, long-term, and countercyclical financing—while maintaining a focus on large-scale, transformative investments—positions them as indispensable partners in addressing the global financing gap for the Sustainable Development Goals (SDGs). This trend underscores the need for IFIs to strengthen their financial innovation, policy coordination, and institutional agility to respond effectively to differentiated country demands and the evolving landscape of global development finance.

Today's challenges—including climate change, pandemics, digitalization, and demographic divergence—are global public goods issues that transcend national borders (IMF, 2021). The IFIs traditional model, which focused primarily on country-specific lending for poverty reduction, is now deemed "insufficient" to address these complex, multi-directional risks (Yellen, 2023). The World Bank's constrained ability to deploy timely capital for COVAX during the COVID-19 pandemic illustrated the critical gap in its mandate and financial framework (IFI Working Group, 2023). Furthermore, the globalization of financial markets and the increased prominence of non-bank financial institutions have accelerated the cross-border transmission of shocks, requiring the IMF to adapt its surveillance role to maintain global financial stability (BIS, 2025).

1.4. The Current Reform Debate

The resulting debates have coalesced into a comprehensive IFI Evolution Agenda, guided by the G20 Roadmap towards Better, Bigger, and More Effective IFIs (CEB, 2024).

1. "**Better**" (Operational and Mandate Reform): This focuses on enhancing efficiency and responsiveness. Key reforms include expanding the core mission to integrate global challenges (e.g., sustainability, resilience, inclusiveness) without diluting the focus on poverty (IFI Working Group, 2023), and strengthening country-level collaboration by harmonizing procurement and creating country-led platforms (World Bank, 2024).
2. "**Bigger**" (Financial Capacity Reform): This involves optimizing the use of existing capital. Following the G20 Capital Adequacy Framework (CAF) review, IFIs are exploring measures like greater clarity on callable capital, use of hybrid capital, and implementing financial policy revisions to unlock hundreds of billions of dollars in additional lending capacity (World Bank, 2024; UN General Assembly, 2025). The goal is to maximize lending while safeguarding credit ratings.
3. "**More Effective**" (Governance and Impact Reform): This addresses the legitimacy crisis. Proposals include strengthening the voice of developing countries on the Boards (Brookings Institution, 2024), increasing geographical diversity, and ensuring IFIs align incentive structures with the updated, broader vision (CEB, 2024). The call for agile contingency financing (UNOSSC, 2025) is central to this effectiveness mandate.

Addressing global financial challenges requires systemic reforms to the IFA, particularly through changes in IFIs governance, operations, and business models, as well as enhanced mechanisms to better leverage private finance. (Prizzon, 2025). A systemic approach to investigating the role of IFIS and their potential -in amplifying development impact must consider their governance structures, capital incentives, and decision-making dynamics.

This evolving context provides the backdrop for the present working paper, which argues that a pragmatic and timely route to reasserting the relevance of IFIs lies in pursuing an internally driven, endogenous reform agenda. Framed through the lens of the Dynamic Capabilities Framework, this approach offers a more feasible alternative given the protracted pace of reform in global geopolitical governance structures.

2. Theoretical Framework: Dynamic Capabilities for Institutional Resilience

To sustain competitive advantage and achieve their development mandate in a rapidly changing and uncertain environment, IFIs must possess more than just financial resources; they require dynamic capabilities for implementation of their mandate in a challenging external environment. Drawing on the adaptation of the Dynamic Capabilities Framework (DCF), proposed by Teece (2007), we suggest that IFI resilience rests on their capacity to sense, seize, and transform opportunities and threats.

DCF Component	Definition in IFI Context
Sensing	The ability to scan and evaluate changes in the global financial architecture, geopolitical risks, client country needs, and emerging technological opportunities (e.g., climate finance, digitalization).
Seizing	The ability to select, coordinate, and allocate resources (financial, human, and institutional knowledge) to capitalize on identified opportunities, often through the design and implementation of new financial instruments.
Transforming	The ability to continuously renew and reconfigure the organizational structure and core capabilities of the IFI to maintain competitive fitness and policy relevance.

Using the Dynamic Capabilities Framework helps shift attention from the basic functions of IFIs—such as loan disbursement and project management—to their more advanced, strategic processes. These dynamic capabilities support change and adaptation within organizations. They are defined as the ability to integrate, develop, and reorganize skills and resources in response to changing conditions (Teece et al., 1997). Unlike ordinary capabilities, dynamic capabilities focus on actively shaping or adjusting resources to meet new challenges (Helfat et al., 2007).

IFIs often struggle with bureaucratic inertia, donor-driven mandates, and political complexity. These factors impede the rapid reconfiguration of capabilities needed for SDG alignment. Dynamic capabilities offer a valuable lens for understanding how financial institutions, especially IFIs, can adapt to the challenges of sustainable development. While research on Dynamic Capabilities in the banking and financial sector has expanded- exploring critical endogenous and exogenous dimensions such as micro-foundation of dynamic capabilities (Helfta and Peteraf, 2015; Ambrosini and Bowman, 2009) regulatory and technological adaptations (Battisti and Deakins, 2017) or on global learning processes (Vahlne and Johnsson, 2017) this body of literature remains largely disconnected from the institutional realities, government structures and development mandates of IFIs. Bridging this gap is essential to advance theoretical understanding and to enable practical transformation within IFIs toward greater adaptability and alignment with the Sustainable Development Goals. Our value proposition is to extend the dynamic capabilities framework beyond the “firm-level” analysis typical of the private financial sector, toward a systemic and institutional perspective that captures how IFIs develop, coordinate, and diffuse capabilities across multiple governance levels. This approach situates IFIs not merely as financial intermediaries but as adaptive, learning-oriented institutions capable of transforming the global financial architecture through endogenous innovation and collective intelligence.

Unlike commercial banks, IFIs operate under multi-stakeholder governance structures and pursue development objectives beyond financial returns. Their operational complexity and mission orientation make them fertile ground for DC research. The literature offers limited insight into how IFIs build and sustain dynamic capabilities. Most studies focus on commercial entities, overlooking the strategic, political, and institutional dynamics that characterize IFIs.

3. The IFI Business Model: A Global Public Good by Design

The business model of IFIs is fundamentally different from that of commercial banks (Peitz, 2022). IFIs are designed to reduce systemic development risks and deliver value as providers of Global Public Goods, focusing on long-term impact and market stability rather than profit (Cole, 2009; Marois, 2022). These public banks typically aim to support economic development, financial inclusion, and access to credit in underserved areas—such as small and medium-sized enterprises (SMEs), infrastructure projects (Macfarlane & Mazzucato, 2018), and low-income households. Their role complements the commercial financial sector by: i) directing finance to priority sectors or regions; ii) strengthening the financial system by addressing gaps in credit supply and demand; iii) promoting economic stability through countercyclical interventions; and iv) raising standards by enforcing social and human rights safeguards. While they seek financial sustainability, profit maximization is not their primary goal.

A key challenge in the literature is how IFIs reconcile their need for financial solvency with their broader development mandate. This balance is essential to their role as providers of Global Public Goods, which requires long-term investment in areas that may not yield immediate commercial returns. IFIs achieve this through a unique financial architecture, advanced risk management systems, and the development of internal, non-tradable knowledge assets. These assets—conceptualized as Dynamic Capabilities—enable IFIs to adapt strategically, manage complexity, and deliver sustained impact in support of global development objectives.

3.1. The Leveraged Financial Model: Shareholder Capital and Market Nexus

The IFI financial structure is characterized by a market tested capacity to leverage limited shareholder capital into substantial financial resources for development.

Initial Capital and Market Leverage: The IFI model begins with capital subscriptions from sovereign shareholders, primarily consisting of a small percentage of paid-in capital and a much larger percentage of callable capital. The paid-in capital forms the core equity, but the crucial mechanism for scale is the use of the callable capital, backed by highly rated sovereign governments, to secure a Triple-A (or equivalent) credit rating in international capital markets (CEB, 2024; World Bank, 2024; Marodon R., et. al, 2025). This rating allows IFIs to borrow at extremely low rates (the cheapest segment of the market) and on-lend to developing countries at favourable, below-market rates. Literature confirms this model is self-financing: IFIs leverage, for example, approximately $150 billion in paid-in capital to support over $1.4 trillion in development assets (CEB, 2024).

The Organic Growth Debate: This financial structure addresses the debate on expansion: growth is neither purely organic (reinvesting profits) nor purely based on shareholder injections. Instead, it is an organically leveraged model. IFIs secure expansion by demonstrating superior asset quality, risk management and countercyclical performance to maintain market confidence and preserve their Triple-A credit ratings, which then allows them to *borrow* more, thus scaling their operations far beyond what their immediate equity base would permit (Humphrey, 2016, 2019).

However, this organically leveraged model faces a set of systemic constraints that limit its developmental effectiveness and responsiveness. Among these are conservative capital adequacy frameworks and risk management practices modelled after commercial banking standards, which prioritize capital preservation and ratings stability over developmental leverage. IFIs financial policies—shaped by shareholder governance structures dominated by high-income creditor nations—often enforce tight lending-to-capital ratios and restrictive provisioning rules. As a result, IFIs underutilize their balance sheets, lending significantly below their potential capacity (Finance in Common 2020. These prudential constraints not only limit their ability to respond to crises with agility but also inhibit their role as catalysts of systemic transformation in developing economies.

Recent analytical reviews, including the G20-commissioned Independent Review of IFIs Capital Adequacy Frameworks (CAF), have underscored the need for a paradigm shift from static, backward-looking capital metrics to risk-sensitive and dynamic approaches that better reflect IFIs preferred creditor status, diversified portfolios, and historical default performance (G20, 2024; White and McHugh, 2024) Implementing such reforms—through clearer treatment of callable capital, the use of hybrid instruments, and the recalibration of internal risk buffers—could unlock hundreds of billions of dollars in additional lending capacity without compromising financial integrity or creditworthiness. In effect, a more dynamic capital adequacy framework would align financial prudence with developmental ambition, enabling IFIs to deploy their balance sheets more efficiently in pursuit of global public goods such as climate resilience, digital infrastructure, and inclusive growth (S&P Global Ratings, 2024).

3.2. Pricing, Purpose, and 'Additionality'

Loan pricing by IFIs is not primarily guided by the pursuit of profit maximization through widening spreads. Rather, it reflects a strategic orientation toward developmental additionality—ensuring that financial products and services contribute substantively to inclusive and sustainable development outcomes in client countries. At the same time, IFIs must safeguard their financial integrity, which entails maintaining creditworthiness, managing risk prudently, and ensuring long-term operational sustainability. This dual mandate—balancing developmental impact with financial soundness—is central to the pricing frameworks adopted by IFIs. A clear illustration of this approach can be found in the African Development Bank Group's 2025 strategic framework, which articulates how pricing mechanisms are aligned with both developmental objectives and institutional financial discipline (African Development Bank Group, 2025). The following analysis examines how this dual mandate is operationalised in practice, exploring the mechanisms, pricing instruments, and institutional strategies through which IFIs balance developmental objectives with financial sustainability.

Non-Commercial Pricing: Loan pricing includes administrative costs and a market-based cost of funds (the rate at which the IFI borrows) but often incorporates a deliberate development discount or concessional element. The margin earned above costs is strictly retained to cover operational expenses, build reserves (further supporting their credit rating), and subsidize concessional windows (IMF, 2001). This pricing strategy allows them to provide the long-term, patient, non-cyclical capital that commercial finance avoids, particularly for projects with extended gestation periods and public good benefits (Marodon R., et. al, 2025).

Additionality as a Justification: The concept of additionality is central to the MDB value proposition. It ensures that IFIs only intervene where private capital is unwilling or unable to, due to high perceived risk, market failures, or the absence of a market (such as in policy reform or fragile states). Their pricing and products (e.g., guarantees, blended finance) are structured to mobilize private capital and address the "missing middle" of development finance, rather than displacing commercial actors (Convergence, 2023).

Project Preparation and Risk-Sharing Facilities. Recognizing that many infrastructure and development projects in low- and middle-income countries struggle to reach financial close due to inadequate preparation, weak institutional capacity, or unclear risk profiles, IFIs have increasingly invested in Project Preparation Facilities (PPFs). These facilities offer early-stage technical assistance, feasibility assessments, and support in project structuring—critical inputs that enhance the quality, credibility, and **bankability** of proposed investments. A bankable project is one that meets the financial, legal, and technical standards required by commercial lenders and investors, including clear revenue models, risk mitigation strategies, and robust governance frameworks. By improving bankability, PPFs help bridge the gap between public sector ambition and private sector requirements, thereby facilitating the mobilisation of private capital at later stages. Complementing these efforts are risk-sharing mechanisms—such as co-financing platforms, syndicated loans, and guarantee schemes—developed in coordination with other Development Finance Institutions (DFIs) and private lenders. These instruments distribute risk across multiple actors, reduce exposure concentration, and enhance resilience within the development finance ecosystem (Finance in Common, 2020).

Despite these advances, empirical evidence reveals persistent structural limitations in private capital mobilization. The “mobilization rate” of private finance in IFI-supported projects remains modest, particularly in low-income and fragile states. Studies indicate that the majority of blended finance flows continue to target middle-income countries where risk-adjusted returns are more attractive, thereby leaving the poorest economies underserved (IIF Policy Paper, 2025; White and McHugh, 2024)

Furthermore, Regional and National Development Banks can offer more geopolitical alignment, local ownership, and flexibility in financing terms, contributing to a more pluralistic development finance landscape. Public Development Banks (PDBs) are increasingly critical in implementing national development strategies and crowding private capital, by leveraging lending frameworks. Through concessional assistance, blended finance mechanisms, guarantee schemes, sustainability-linked bonds, and co-lending or co-financing platforms, PDBs can de-risk investment environments and enhance the flow of capital toward projects with high developmental impact. These instruments function as *financial multipliers*: they absorb early-stage or political risks that deter private financiers, thereby enabling private participation at scale. For instance, first-loss tranches or subordinated debt structures offered by PDBs create a layered-risk framework in which private investors—occupying senior tranches—gain confidence through enhanced protection against default or volatility (DEval, 2020; Convergence, 2023).

Equally important is the local embeddedness of PDBs, which provides them with a distinct comparative advantage in navigating national and regional market dynamics. Their deep contextual knowledge, currency-matching capabilities, and proximity to clients enable them to address informational asymmetries that often distort risk assessments by international investors. This proximity facilitates more accurate project appraisal and the tailoring of financing solutions to local needs. By offering financing in local currency, PDBs help mitigate one of the most significant sources of financial vulnerability in developing economies—exchange rate volatility. Crucially, the operational linkages between IFIs and PDBs also create scope for the diffusion of advanced financial engineering tools and institutional practices. Through technical assistance, joint initiatives, and capacity-building programmes, IFIs support PDBs in adopting more sophisticated risk assessment methodologies, blended finance instruments, and project structuring techniques. This transfer of expertise enhances the ability of local institutions to originate and support **bankable projects**—those that meet the financial, legal, and operational standards required to attract commercial investment—thereby strengthening the overall development finance architecture (Horrocks et al., 2025).

3.3. Policy-Based Lending and the Dual Role of Risk Mitigation

The business model of IFIs is closely tied to their capacity for non-financial risk mitigation, particularly in high-risk environments where traditional forms of collateral—such as physical assets—are either unavailable or insufficient. In such contexts, IFIs leverage their institutional credibility, policy dialogue, and technical expertise to reduce perceived risks and enhance project viability. This ability to mitigate risk through non-financial means—such as regulatory engagement and governance support—is a defining feature of their value proposition, especially in fragile or frontier markets.

Conditionality as Collateral Substitute: For sovereign lending, IFIs cannot utilize traditional collateral. Instead, they employ loan conditionality—known as policy-based lending or Development Policy Lending (DPL)—as a crucial risk mitigation strategy (SAIS Perspectives, 2019). These conditions serve as a substitute for collateral and a powerful governance screening tool, ensuring that loan disbursements are tied to verifiable policy reforms (e.g., public financial management, environmental safeguards). By requiring country commitment and co-ownership of reforms, IFIs reduce the fiduciary risk and the risk of policy reversal, thereby enhancing the likelihood of loan repayment and project success. Technical assistance and policy advice provided by IFIs are expected to remain in steady demand across client countries. However, governments increasingly emphasize the importance of support that is timely, demand-driven, and context-specific, reflecting a preference for engagement that aligns closely with national priorities and institutional realities (Prizzon and Zeka, 2025). This shift highlights a growing expectation for IFIs to move beyond standardized interventions toward more adaptive and responsive models of technical cooperation. It also underscores the strategic importance of strengthening IFIs in-country presence, knowledge systems, and feedback mechanisms to ensure that advisory services effectively translate into locally owned and implementable policy solutions.

Scaling Risk-Sharing Instruments: A core service of the IFI business model is the use of sophisticated financial instruments to absorb non-commercial risks that deter the private sector (Climate Policy Initiative, 2023). This includes:

- Guarantees: Issuing political risk guarantees (e.g., MIGA) to encourage foreign direct investment or guarantees on commercial loans/bonds to lower private capital costs.
- Local Currency Finance: Deploying local currency instruments and hedging facilities to mitigate currency mismatch risks—a key deterrent for long-term investors in developing economies (UN, 2024).

IFIs have traditionally provided loans in hard currencies such as the U.S. dollar or the euro, reflecting their own funding sources and the preferences of global investors. However, this practice exposes borrower countries to exchange rate volatility, especially when local currencies depreciate against foreign denominations. Such mismatches can significantly increase debt service burdens, exacerbate fiscal pressures, and heighten systemic vulnerabilities during external shocks (Horrocks *et al.*, 2025; Klingebiel, Pérez-Pineda y Berensmann, 2025)

To mitigate these risks, several IFIs have begun expanding the use of local currency instruments and hedging facilities, enabling borrowers to service debt in domestic currency while maintaining investor confidence. Initiatives such as The Currency Exchange Fund (TCX) and regional programs by the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD) have shown how currency risk mitigation tools can unlock long-term domestic lending for sectors such as microfinance, housing, and clean energy (OECD, 2025; UN, 2024). Local currency lending also promotes the development of domestic capital markets, fostering financial sovereignty and reducing dependency on volatile external flows (White Rose Research Online, 2023). Nonetheless, the availability of local currency instruments remains limited due to structural constraints—such as shallow domestic markets, insufficient hedging capacity, and conservative MDB balance sheet policies—which curtail the scaling of such innovations (Horrocks *et al.*, 2025).

Institutional Agility and Countercyclical Role. Despite their expertise in risk management, IFIs face institutional rigidity that hinders their ability to act swiftly during crises. Disbursement processes remain slow and bureaucratic, constrained by extensive due diligence and board approval procedures that can delay financing when it is most urgently needed

(Finance in Common, 2020). As a result, IFIs often fail to play a fully countercyclical role—injecting liquidity when private capital retreats during downturns or crises. During the COVID-19 pandemic, for example, the delay in mobilizing large-scale capital for global health initiatives such as COVAX illustrated the limitations of existing IFIs instruments and approval cycles (IFI Working Group, 2023). Unlike central banks or sovereign governments, IFIs do not serve as lenders of last resort, and their operational mandates often restrict the rapid redeployment of capital across regions or sectors (BIS, 2025).

Reforming this institutional architecture is critical to enabling IFIs to respond more effectively to systemic shocks—whether pandemics, climate events, or commodity price collapses. Recent reform agendas, including the G20 "Better, Bigger, More Effective IFIs" roadmap, call for greater flexibility in capital adequacy frameworks, streamlined approval processes, and stronger coordination with regional and national development banks to accelerate crisis response (CEB, 2024; Brookings Institution, 2024). Such measures would enhance IFIs ability to act as stabilizing anchors in times of turbulence, while maintaining their creditworthiness and developmental impact.

In sum, scaling up risk-sharing and local currency instruments represents not only a financial innovation but also a manifestation of IFIs dynamic capabilities—specifically their ability to *seize* and *transform* in response to emerging risks. By recalibrating risk frameworks, leveraging hybrid instruments, and deepening collaboration with domestic financial actors, IFIs can expand their catalytic capacity to deliver sustainable and inclusive development in a volatile global environment.

3.4 Dynamic Capabilities: A Salient Asset in IFI Business Models

The sustainability and scalability of the IFIs business model—characterised by its risk-tolerant and leveraged nature—do not rest solely on conventional financial metrics such as balance sheet strength or the backing of callable capital. Rather, they depend fundamentally on the institution's internally accumulated assets: the specialised expertise, institutional knowledge, and operational processes that shape its approach to financial deployment and risk management. These intangible capabilities enable IFIs to operate effectively in complex environments, structure innovative financing solutions, and maintain credibility across diverse stakeholder landscapes.

This forms the critical nexus between the IFIs financial reality and its strategic mandate. The ability to structure complex blended finance deals, design context-specific policy conditions, and manage a vast portfolio of sovereign risk is a manifestation of superior organizational learning. Therefore, the most valuable endogenous asset of an IFI is its Dynamic Capability: the high-order processes that enable it to systematically sense emerging global risks (e.g., climate change), seize opportunities by designing new instruments (e.g., pandemic bonds), and transform its own operational model (e.g., Capital Adequacy Framework reforms) to remain relevant in a turbulent global environment (Teece, 2007). This capacity for purposeful, strategic change is what allows the MDB model to function as a resilient Global Public Good.

Dynamic capabilities offer a valuable lens for understanding how financial institutions, especially IFIs, can adapt to the challenges of sustainable development. Although research on DCFs in banking is expanding, it remains largely disconnected from the realities and mandates of IFIs. Bridging this gap can support both theoretical advancement and practical transformation toward SDG achievement.

Literature on Private Banking sector DC offers important insights for analysis and transfer knowledge that could be scalable to DFIs:

- Recent scholarship emphasizes the micro-foundations of DCs, such as individual routines, leadership, learning processes, and organizational culture, as the building blocks of higher-order capabilities (Helfat y Peteraf, 2015); Ambrosini and Bowman, 2009). These elements are critical in knowledge-intensive sectors like banking and finance.

- Financial institutions face constant regulatory and technological changes. Studies such as Battisti & Deakins (2017) illustrate how small financial firms develop adaptive and absorptive capabilities to navigate external shocks. Strategic renewal, often under conditions of uncertainty, is a recurrent theme in this sector. (Kindström, Kowalkowski y Sandberg, 2013) document how modular service innovations and digital platforms have become central to value creation in banking. These innovations necessitate dynamic capabilities related to IT integration, customer engagement, and rapid scaling.

- International banks build capabilities through global learning across geographies. (Vahlne y Jonsson, 2017) demonstrate that internationalization capabilities evolve through feedback loops from diverse market contexts. This is especially relevant for IFIs operating in diverse developing environments.

4. Leveraging Dynamic Capabilities

The institutional assets accumulated by IFIs—particularly their codified expertise and reputational capital—serve as key manifestations of the Dynamic Capabilities Framework. These intangible resources generate significant impact multipliers through two strategic channels: the mobilisation of external capital and the transfer of institutional knowledge. By leveraging their credibility, technical know-how, and operational experience, IFIs not only attract private and public co-financing but also disseminate advanced financial practices, governance standards, and risk management tools to local development banks and partner institutions. This diffusion of capabilities strengthens the broader development finance ecosystem and enhances the effectiveness of financial interventions in complex environments. To unpack these strategic channels further, it is useful to examine how dynamic capabilities are operationalised across different institutional settings and how they contribute to scaling development impact beyond the confines of the IFI itself.

4.1. Joint Initiatives with the Private Sector: The Limits of Blended Finance

The seizing capability of IFIs—their ability to design and implement new financial instruments—is critical in structuring blended finance and attracting private capital to close the estimated $4 trillion SDG financing gap (Convergence, 2023). Blended finance is defined as the strategic use of concessional finance (grants, or low-interest loans from public or philanthropic sources) to mobilize additional commercial finance toward sustainable development (OECD, 2025; World Economic Forum, 2015). Research by the OECD (2025) has demonstrated the potential of blended finance to de-risk investments and achieve development outcomes at scale.

For example, blended finance can facilitate investment in renewable energy projects in sub-Saharan Africa, where upfront capital costs often serve as a barrier to development.

While the market has seen growth, especially in climate finance, its overall impact is still insufficient to meet the World Bank's "billions to trillions" goal (World Bank, 2015).

Analysis of blended finance flows indicates targeted progress, particularly in certain regions and sectors:

- **Regional Concentration:** Sub-Saharan Africa consistently remains the most common destination for blended finance flows (Convergence, 2023). However, Low-Income Countries (LICs) as a group receive a disproportionately low share of private funds mobilized by Development Finance Institutions, receiving only 7.6% of such funds between 2012 and 2019 (Lykke Lauridsen & Sierra-Escalante, 2021).
- **Sectoral Success:** The Energy/Climate sector (particularly renewable energy) and Financial Services consistently receive the largest share of blended capital (DEval, 2020). Following a recent surge in focus, the climate blended finance market saw its highest annual financing total in 2023 (World Bank Group & Convergence, 2024). Furthermore, the Agriculture sector, particularly climate-smart agriculture, has witnessed increased momentum (Convergence, 2023).

Despite positive sectoral and regional trends, academic literature points to structural impediments that have severely restrained the transition from "billions to trillions" (McHugh, 2021; ODI, 2018). This limitation highlights constraints on the IFI's capacity to *scale* their "seizing" capability:

1. **Low Mobilization Ratios and Volume**: Annual blended finance flows have averaged approximately $9 billion, which is nowhere near the scale required for the 2030 Agenda (Convergence, 2023). Furthermore, mobilization ratios (private capital mobilized per dollar of public concessional finance) are often low, particularly in the poorest countries, suggesting that the public "bang for the public

buck" is less efficient than proponents hoped (LSE, 2021; ODI, 2018).

2. **Lack of Standardization and Fragmentation**: Most blended finance projects are developed individually, often requiring a lengthy and costly incubation period as nearly every instrument is designed from scratch ("lack of a standardized blended finance playbook") (LSE, 2021; Lykke Lauridsen & Sierra-Escalante, 2021). This fragmentation creates assets too small and complex for large institutional investors, hindering rapid replication and scaling (LSE, 2021).

3. **Project Pipeline and Technical Capacity**: Developing and emerging markets often lack the technical knowledge and capacity to design genuinely *investable* projects that meet private sector standards (Lykke Lauridsen & Sierra-Escalante, 2021). This issue is compounded by upstream barriers such as weak and unstable policies and regulatory environments, which fundamentally shrink the space for private investment (LSE, 2021). Addressing this requires shifting from donor dependency to building endogenous capacity within client countries (Lykke Lauridsen & Sierra-Escalante, 2021).

4. **Risk Mismatches and Complexity**: While concessional capital is used to de-risk investments, the complex financial structures required to demonstrate *additionality* can sometimes paradoxically reduce the overall pool of available financing (McHugh, 2021). Furthermore, the market structure and governance processes of IFIs can sometimes conflict with the requirements of private sector banks (McHugh, 2021). The IFIs' role as a trusted neutral broker in policy dialogue (World Bank, 2023) is crucial to bridging this culture and risk gap (Mirova, 2025).

4.2. Targeted Diffusion to local DFIs

The transforming capability of IFIs extends beyond internal institutional renewal to encompass the strategic diffusion of high-order financial instruments and codified expertise to local and regional Development Finance Institutions and public banks in the Global South. This transfer is essential for building resilient, sovereign financial architectures that are less dependent on fragmented and externally driven donor systems (Klingebiel, Pérez-Pineda & Berensmann, 2025). Enhancing the financial capacity of local development banks is a critical component of this agenda. By equipping these institutions with the advanced financial engineering tools, risk assessment methodologies, and operational practices accumulated within IFIs, the development finance ecosystem becomes more robust, adaptive, and capable of originating and managing complex, bankable projects. This not only improves the effectiveness of local financial institutions but also strengthens their ability to mobilise domestic and international capital, manage risk, and contribute to long-term development outcomes. Achieving this requires a bottom-up reform agenda that reinforces IFI impact through practical, demonstrable benefits of public–private sector transforming capabilities (Bartzokas, 2023).

In this context, innovative financial instruments—such as blended finance mechanisms, guarantee schemes, and public–private partnerships (PPPs)—serve as powerful tools for mobilizing private capital. These instruments not only attract additional investment toward development objectives but also facilitate the transfer of knowledge, practices, and technical expertise from the private sector to Development Finance Institutions. IFIs deploy sophisticated financial instruments to address market failures and achieve development impact (Mirza & Leon, 2025), including:

- **Guarantees and Risk Mitigation**: Guarantees are a primary tool for mitigating specific risks (e.g., political risk, credit risk) to encourage Foreign Direct Investment (FDI) and lower commercial financing costs (DEval, 2020). Guarantee schemes are financial instruments that protect private investors from potential losses, thereby increasing their willingness to invest in high-risk regions. Sovereign guarantees, in particular, have proven to be effective in securing investments for climate-resilient infrastructure projects. These guarantees help mitigate risks associated with natural disasters, political instability, or fluctuating market conditions. A notable example is the Green Climate Fund's Risk Reduction Facility, which uses guarantees to leverage private finance for climate adaptation projects in vulnerable countries. These financial tools play a critical role in attracting investment into countries that might otherwise be overlooked due to perceived risks.

- **Local Currency (LC) Financing**: This instrument is crucial for mitigating currency mismatch risks—a key deterrent for long-term investors in developing economies—by providing hedging facilities or directly lending in local currency (White Rose Research Online, 2023). Scaling LC-denominated activities unlocks the long-term financing necessary for infrastructure and climate projects (White Rose Research Online, 2023). Development finance institutions and multilateral banks can play a pivotal role by offering currency risk mitigation tools, such as currency swaps, hedging instruments, and partial credit guarantees. These instruments lower the risk premium associated with lending in local currency, making it more attractive for both international investors and domestic financial institutions. Initiatives like TCX (The Currency Exchange Fund) have demonstrated the potential to provide effective hedging solutions that enable local currency financing for sectors such as clean energy, housing, and microfinance.
- **Subordinated and Junior Capital.** One of the key ways IFIs enable private-sector participation in development finance is by assuming the riskiest positions in a project's capital structure—often referred to as subordinated or junior capital. These are the first-loss layers of financing, meaning that if a project underperforms or incurs losses, the IFIs investment absorbs the initial impact before other investors are affected. By taking on this risk, IFIs effectively shield senior creditors—typically private-sector lenders or institutional investors—from early losses, making the overall investment proposition more attractive and viable. This approach is particularly important in high-risk or frontier markets, where commercial investors might otherwise be unwilling to engage. In doing so, IFIs play a catalytic role: their willingness to bear greater risk helps unlock additional financing from private sources, thereby expanding the scale and reach of development projects that would not proceed without such support (DEval, 2020).
- **Public-private partnerships (PPPs)** are another effective mechanism for pooling resources from both public and private

sectors for large-scale development projects. By sharing both the risks and rewards of development, PPPs create the necessary financial space for addressing urgent climate and development challenges. One of the most prominent examples of a successful PPP is the Africa Renewable Energy Initiative, which seeks to harness Africa's renewable energy potential through joint investments from both the public and private sectors. By combining resources and expertise, PPPs can unlock large-scale investments and ensure that critical infrastructure projects, such as renewable energy grids or climate-resilient urban development, are delivered at scale.

- **Green debt relief** is an innovative approach that could be integrated into debt restructuring frameworks to support countries facing mounting debt burdens. Green debt relief involves the restructuring of debt obligations in a manner that simultaneously addresses fiscal challenges while promoting investments in climate resilience and sustainable development. This concept has gained traction in recent years through debt-for-climate swaps, where a portion of a country's debt is forgiven in exchange for commitments to invest in climate-resilient infrastructure or environmental conservation. A prominent example is Barbados' debt-for-climate swap agreement with the United Kingdom, which allowed the country to reduce its debt burden while simultaneously committing to fund climate adaptation projects. Such arrangements free up fiscal space, enabling countries to direct more resources toward urgent development goals, particularly those related to climate action (IMF, 2023; Steele, P., Patel, S., & MacDonald, M., 2023.

Academic reviews confirm that these instruments, alongside technical assistance, are expected not only to enable investment but also to increase its developmental impact by fostering local market viability and supporting high-impact projects (non-financial additionality) (Mirza & Leon, 2025).

The successful adoption of complex IFI instruments and standards by local DFIs hinges on the recipient institution's endogenous capabilities, ensuring that the transfer leads to self-sustaining change rather than donor dependency (Lykke Lauridsen & Sierra-Escalante, 2021; UNIDO, 2023). The necessary conditions for efficient institutional diffusion are:

1. **High Absorptive Capacity:** Local DFIs must possess the internal knowledge base, technical skills, and organizational structure (their endogenous absorptive capacity) to understand, adapt, and integrate complex IFI instruments (e.g., impact measurement methodologies, risk models) (UNIDO, 2023). This process involves *institutional learning* and the ability to convert external knowledge into internal practice (IMF, 2008). The Finance in Common initiative, launched in 2020, has created a global network of over 500 PDBs that collectively manage more than $23 trillion in assets. Scaling up platforms such as the Finance in Common Summit is critical to fostering institutional learning, enhancing policy coherence, and deepening cooperation among PDBs and other stakeholders. These platforms serve as vital convening spaces where institutions can share knowledge, exchange best practices, and collectively reflect on their role in aligning financial flows with the Sustainable Development Goals (SDGs) and the Paris Agreement.

2. **Alignment and Flexibility:** While harmonization efforts on metrics and principles (e.g., impact management and measurement, or IMM) are valuable for comparability, the literature stresses that a single, rigid framework is not useful (OECD, 2021). Effective transfer requires flexibility to tailor instruments to the different contexts, geographies, and specific national priorities of the local DFI (OECD, 2021).

   Institutionalizing cooperation would involve establishing formal mechanisms for policy alignment, mutual accountability, and strategic collaboration. This can be achieved by strengthening SDG alignment frameworks, ensuring that all participating institutions are not only mainstreaming the SDGs into their operations but also measuring and reporting their impact against clearly defined metrics. Such alignment would help bridge the gap between global development goals and the operational realities of national and subnational development banks.

3. **Governance and Autonomy**: The local DFI must possess sufficient organizational and technical autonomy to translate national policy directives into operational procedures and financial instruments without undue political interference (UNIDO, 2023).

Sound governance, coupled with a strong capital base, is necessary for the DFI to pursue the consistent, long-term, and risk-intensive engagement characteristic of development finance (UNIDO, 2023).

By bringing these institutions together in platforms such as Finance in Common the convergence of development finance around common principles such as sustainable investment, inclusive growth, and climate action is enabled. However, to maximize its potential, this initiative must evolve from an annual dialogue forum into a more structured and institutionalized mechanism for long-term coordination and transfer knowledge learning.

4. **Demonstration Effect**: The transfer is often facilitated by an indirect mobilization effect, where IFIs and DFIs demonstrate the viability of investing in specific private sector segments, absorbing first-mover costs and reducing risks for local players (Mirza & Leon, 2025). The long-term impact rests on the local institutions internalizing this demonstration effect and adapting the successful models. Moreover, advancing transparency standards across these institutions is essential for building trust, improving impact assessment, and facilitating capital mobilization—particularly from private investors who require greater visibility into the social and environmental outcomes of development finance. Developing a shared taxonomy for sustainable finance, harmonized reporting systems, and common Environmental, Social, and Governance criteria would help ensure consistency and comparability across institutions.

Finally, scaling up platforms or networks such as Finance in Common would contribute to a more inclusive and coordinated global development finance ecosystem. It would enhance synergies among multilateral, regional, and national development banks, and position PDBs as strategic enablers of public-private financing for sustainable development. As development challenges become increasingly interconnected—ranging from climate change to inequality to pandemic preparedness—a robust, institutionalized platforms can play a transformative role in ensuring that finance is not only available but also aligned, accountable, and impactful.

Greater coordination and cooperation among IFIs)—particularly at the country level and in shared priority areas—has the potential to generate outcomes that exceed the sum of individual institutional efforts (Prizzon and Zeka, 2025). Enhanced collaboration can improve complementarity, reduce duplication, and deliver more coherent support to client governments. However, realizing such synergies remains complex and resource-intensive. Coordination often entails both direct costs, such as administrative and transaction burdens, and indirect opportunity costs arising from misaligned institutional incentives. IFIs continue to be assessed primarily on their individual performance metrics and portfolio outcomes, which can discourage joint operations and limit collective impact. Addressing these structural disincentives is therefore essential to transforming coordination from an ad hoc exercise into a systemic capability, enabling IFIs to act as a coherent network rather than as isolated entities within the global development finance architecture.

5. Conclusion and Agenda for Future Empirical Research

The path to a resilient global financial architecture requires a strategic deployment of IFI dynamic capabilities.

The focus on IFI endogenous assets provides a pragmatic pathway to impact, especially given the perceived "stagnation" of traditional development cooperation, such as Official Development Assistance, which necessitates a "reconfiguration" of political consensus (Klingebiel, 2025). These internal reforms and operational shifts are necessary to support the strengthening of the global financial architecture ahead of key discussions like the Fourth International Conference on Financing for Development (FfD4).

These measures collectively contribute to the building of resilient financial architectures that are less dependent on external capital, more aligned with local development priorities, and better equipped to withstand global financial shocks (Klingebiel, Pérez-Pineda & Berensmann, 2025). Specifically, in light of the global financing gap and debt issues, IFIs must support more agile contingency financing and move towards more inclusive and representative governance models (UNOSSC, 2025). Furthermore, the scaling up of local currency-denominated activities is essential, as it mitigates currency mismatch risks and unlocks the long-term financing necessary for critical areas such as climate action, infrastructure, and social investment—all vital for achieving the SDGs.

Future empirical research should aim to quantify the specific impact multipliers generated by the dynamic capabilities of IFIs, with particular emphasis on the following areas:

Reputational Enhancement Effects: Conduct empirical studies to assess how the adoption of IFI operational standards—particularly codified capabilities—contributes to reduced borrowing costs (e.g., lower spreads) in blended finance transactions across emerging markets.

Accumulation of Intangible Assets: Investigate the tacit processes and operational mechanisms through which IFIs adapt to global transformations, develop and deploy innovative financial instruments, internalize and disseminate institutional knowledge, and coordinate multi-level actions across global, regional, and national domains.

Institutional Diffusion Dynamics: Utilize panel data econometrics to examine the correlation between IFI-led technical assistance programs and measurable improvements in institutional quality—such as governance indicators, non-performing loan ratios, and regulatory effectiveness—among Development Finance Institutions in the Global South.

Local Currency Mobilization: Undertake econometric analysis to evaluate the effectiveness of IFI-issued local currency-denominated instruments in extending the tenor and increasing the volume of domestic private sector investment, particularly in climate-resilient infrastructure projects as a follow up of recent research on loan syndications.

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