Evidence paper

IDC inquiry on investment for development

The UK's strategy towards development finance institutions

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Introduction and context

The emergence of the Sustainable Development Goals (SDGs) marked a change in development debates. Not only do the SDGs aim to promote an integrated approach to economic, social and environmental development, they place emphasis on a development model where the private and public sectors have complementary roles to play in supporting inclusive and sustainable growth. They also represent a major shift in the international community's strategy to achieve these Goals by recognising the central role of the private sector. Private investment and innovation are major drivers of productivity, inclusive economic growth and job creation, which are key ingredients to tackle poverty. More than nine in ten jobs are created in the private sector in the global south.

Low- and middle-income countries (L&MICs) face unparalleled challenges to their future growth and development. Covid-19 and climate change have combined to reverse years of development progress and have created extraordinary challenges, made much worse by the impact of the war in Ukraine. In 2021, the SDG financing gap stood at $3.9 trillion in 2021, 56% increase from the pre-Covid estimate of $2.5 trillion. A need that far exceeds global aid budgets. Mobilising private investment will be critical and is the only way to generate the sufficient scale of capital that is required.

DFI investment (including that made by BII) plays a critical role in this. It is different from traditional aid investment thus BII's objectives and its theories of change are different from UK traditional aid but so too are the impacts. The UK government has set a clear priority on mobilising investment in its international development strategy to help L&MICs growth their economies sustainably. In this context, the question of interest is therefore one about economy, effectiveness and efficiency, ultimately does BII deliver value for money in the pursuit of this goal?

There is no doubt that BII plays a critical role in contributing to this agenda. It is a successful, respected, unique and stand out bilateral DFI. It has a long track record in supporting business in the global south to grow, has created thousands of jobs, thereby supporting economic growth and has generated tax revenue which governments can use to fund public goods and social investment. In 2021 its investments supported approximately 938,360 jobs.

It is especially valued for its focus on challenging geographies (e.g., South Asia and Africa), high risk investment through the deployment of scare equity capital and the development of its high risk catalyst portfolio. It has also been on a transformational journey since 2012 and again in 2017 with a much sharper focus on better understanding, managing and communicating the impact of its investments. It can improve on this and indeed must improve in this area. This will be essential for BII to better articulate and communicate its value for money and for stakeholders to better appreciate the value of BII as tool of government development policy.

This submission offers reflections in five areas based on ODI's latest research as follows:

1) Mobilisation of private finance
2) BII funding
3) Transparency and accountability
4) Intermediated investment and due diligence
5) Fighting and adapting to climate change

Relevant research has been hyperlinked in the submission.

1 Mobilisation of private finance

IDC question: What are the British Investment Partnerships (BIPs) and what are their objectives? What role does British International Investment (BII) play within them?

Covid-19 has reversed years of development progress and dramatically increased development needs, widening the SDG financing gap. Given already stretched aid budgets, DFIs including BII are under increased pressure to materially scale the mobilisation of private finance, to help fill this larger financing gap.

Objective of BIPs is the mobilisation of private finance but the UK government has a fragmented approach.

According to the UK Government's strategy for international development (IDS) published in May 2022, BIPs comprise at least seven[1] different institutions/platforms/ initiatives. The objective of which is to mobilise up to £8 billion of UK-backed financing a year by 2025 including from the private sector. Although the exact amount of private capital is not specified overall, there is a clear thrust and intention in the IDS that the vast majority of this is the mobilisation of private capital rather than public capital. It also states that that these partnerships will be characterised by "high standards, transparency and reliability".

There is no explicit quantitative mobilisation target for each BIP (including BII). There is also no clear division of labour between the 7 BIPs, with overlapping approaches, instruments and target investors and no mention of any coordination mechanism between the BIPs. This suggests a lack of coherence in approach, which is most likely to reduce the effectiveness of efforts.

[1] British International Investment (BII), Clean Green Initiative 'Just Energy Transition Partnerships', British Support for Infrastructure Project, The Mobilising Institutional Capital Through Listed Product Structures (MOBILIST) initiative, Private Infrastructure Development Group (PIDG), provision of UK Guarantees and UK Export Finance.

BII is not currently set up to pursue a mobilisation at scale agenda.

Mobilising private finance at a much larger scale will require a step change in the current approach of the UK government including BII. On average during the period 2018 to 2020 the UK government mobilised approximately £1 billion ($1.3 billion[2]) per annum according to the most recent data from the OECD, with BII mobilising about 50% of this (£0.5 billion)[3] according to the OECD figures. Current overall levels of mobilisation will need to increase eight fold to meet this ambition, implying some bold changes to approach but the strategy lacks coherence and is fragmented across government.

BII is assigned an important role in contributing to this target for the UK government. In BII's new technical strategy it recognises how vital it is to mobilise private capital. However, no target has been set for BII in the IDS nor in BII's new strategy which was co-developed with FCDO and launched last year for the period 2022 to 2026. Lack of SMART targets in this area undermine the ability to hold BII to account.

DFIs like BII can and must play a critical role in mobilising private finance in support of the SDGs and Paris agreement, however, BII is not currently set up to pursue a mobilisation at scale goal. Its focus to date has been more on demonstration and market creation investment in more difficult markets rather than the mobilisation of commercial capital at scale. In 2012, BII's investment geography narrowed to focus on more difficult investment markets. During the period 2012 to 2021 BII was only allowed by FCDO to invest in Africa and South Asia. With the exception of Norfund, BII's geographic focus was unique amongst bilateral DFIs whose portfolios are generally more diversified across regions. This was a distinguishing feature of BII and a value add in a crowded DFI landscape. In these more challenging markets, it is challenging to mobilise commercial private investment at scale, at least in the short term. BII's investment theory was focused on the kind of investment that could establish the conditions for much greater commercial mobilisation down the line.

This is reflected in BII's low leverage ratio which ODI's latest research estimates that on average during 2018 to 2020 BII mobilised 40 cents for every dollar it invested. It is, however, important to put this into context. BII is not alone here, several pieces[4] of ODI research estimate low leverage ratios for most bilateral DFIs and MDBs and the system overall. For example, ODI's most recent research on this estimated that in 2018, bilateral DFIs mobilised 84 cents for every dollar they invested. The DFI and MDB system more broadly has been slow to respond to this agenda and

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[2] Average per annum 2018 to 2020.

[3] It is important to note that this figure differs from the figures reported by BII in their 2021 Annual Report, underscoring the huge transparency issue in the publication of mobilization data.

[4] Blended finance in the poorest countries: the need for a better approach | ODI: Think change; Development finance institutions: the need for bold action to invest better | ODI: Think change

develop effective approaches that can mobilise private capital at the scale that is needed.

A change in approach is needed.

Materially stepping up BII's mobilisation will require a shift in approach. Much of BII's mobilisation is focused at the transaction level. It does not focus on mobilisation at the balance sheet/institution level. For example, BII does not manage third party capital like FMO, BII does not issue debt in the capital markets like FMO and BII does not use concessional capital (e.g., blended finance) to invest in the junior tranches of structured investment products/vehicles. These kind of approaches have greater potential to mobilise private capital at scale than investment in individual transactions.

Stepping up mobilisation efforts and developing new approaches will most likely require BII to access and use concessional pots of capital (e.g., blended finance). This will enable BII to take subordinated positions or issue guarantees within structured products/vehicles which have the objective of mobilising private capital at a larger scale. It is not clear where BII will source these pots from. Currently, FMO and Proparco manage pots of externally provided concessional capital (from their governments, from EU concessional resources or from international concessional climate funds such as the green climate fund etc. BII can look to these but any funding from the UK government to support BII in this area will most likely be counted as aid by FCDO.

2 BII funding

IDC question: How is BII's budget determined? How does the budget inform BII's programme of work and to what extent can BII scale up or scale down on its investment activity?

BII's portfolio has grown significantly recently, which has been funded by aid.

BII periodically benefits from capital injections from the UK government which enable BII to step up its annual investment levels. During the period 2017 to 2021 BII received significant capital injections totalling £2.8 billion during 2017 to 2021. These capital injections have been counted as aid and have enabled BII to grow its portfolio significantly over the period.

In its new technical strategy 2022 to 2026, BII identifies it will need new capital to continue to increase its investment capacity. However, the ability to continue this kind of growth will be constrained by the tight fiscal position of the UK government. There is therefore a need to explore other ways to fund much needed increases in investment capacity.

Debt funding of BII should be explored considering ballooning SDG and green financing gaps and a constrained UK aid budget.

In our new study we examined the business models of bilateral DFIs including BII. We conclude that BII can potentially increase its investment capacity without immediate recourse to new capital which would be counted as aid. One area that could be considered by the UK government is the issuance of bonds in the capital markets. Only a few bilateral DFIs do this currently. By way of illustration and working on a very prudent assumption of just 1x leverage of BII's net debt-to-equity ratio, ODI estimates that BII could have mobilised debt funding into its balance sheet to fund at least $8 billion of additional investments in 2020. Investment capacity could potentially be boosted at no extra cost to taxpayer, and it would reduce the amount of financial support from the government currently counted as aid, which could be spent on other aid priorities.

We believe that the UK government should explore the risks and opportunities of allowing BII to issue debt in the capital markets (albeit not targeting a AAA credit rating which would require BII to manage its capital in an extremely risk-averse way). In our study, we find good examples of institutions focused on development finance who operate with lower credit ratings than AAA and who have comparatively higher levels of risk in their portfolios and report comparable if not higher returns than a number of the DFIs that we study. It is possible, therefore.

Further, debt financing of BII could allow for a more effective use of a scarce concessional resource. Debt funding could potentially fund BII's near commercial investment and part of the aid saved could be allocated to fund/seed pots of concessional that can take really high risk investment (e.g., catalyst portfolio type of investment); fund critical pipeline and market development work, and fund junior positions in in structured vehicles/products to mobilise private capital at a greater scale.

3 Transparency and accountability

IDC question: how are the decisions of BII's management scrutinised? What transparency is there over BII's performance monitoring and reporting?

Huge lack of transparency undermines accountability and effective policy making.

Transparency is a huge issue. On the one hand it hinders BII's ability to clearly articulate its story, demonstrate its impact and its value for money for the taxpayer. On the other it hinders accountability and analysis which can better inform government policy making and allocation of aid.

BII ranks poorly in Publish What You Fund's DFI transparency index, ranking 12th position out of 21 non-sovereign DFIs with a score of 26.5 out of 100. To put into context, BII is again not alone. Transparency for all bilateral DFIs and MDBs focused on mobilising private capital is sorely lacking, with the highest score at 54.4 out of 100 for the IFC. Big gaps include project level ESG and accountability disclosure, project level financial disclosure and project level impact disclosure.

This lack of transparency and disclosure means it is very difficult to understand of public and aid money invested in and by BII.

Future UK government support should be conditional on improvements in transparency.

Any future support by the UK government should be tied to targeted improvement in all components of the DFI transparency index. Hard won gains in transparency with the aid effectiveness agenda have been lost when aid has been channelled this way. Aid channelled this way must be subject to the same transparency requirements as traditional aid.

4 Intermediated investment and due diligence

IDC question: what due diligence does BII undertake prior to making investment decisions and how does this compare with best practice?

Intermediated investment has a role to play – if got right.

Intermediated investment is beneficial, but it comes with attendant risks that must be managed. Due diligence and transparency are critical.

On the plus side intermediated investment will usually have a higher mobilisation effect that direct investment in a project or company. For example, investment in a fund not only mobilises private investment into the fund, but it also mobilises private investment at the project or company level when the fund invests at this level. ‘Fund-of-fund’ structures can have even greater mobilisation potential as this structure also mobilises private investment in the ‘fund-of-funds’, which then mobilise private investment into the funds it invests in, and these funds in turn mobilise more equity and debt investment at the project level.

It also allows DFIs to extend their reach. The ticket size of DFI investment is typically large and means that it is not well suited to reach micro, small and medium enterprises (MSME’s), who play a crucial role in many economies in the global south, where they represent a large portion of country’s gross domestic product (GDP). Local financial intermediaries are arguably also better placed to price risk and have networks which can extend the reach of DFI investment.

The challenge is the extent to which BII can control how and where their investment is channelled; as well as understand the impact of intermediated investment.

BII has a policy on responsible investment, but it is unclear how this is applied to intermediated investment.

It is not always clear what level of due diligence BII undertakes prior to making investment decisions, and therefore how it compares with best practice. There are three reasons for this, as set out in BII’s Policy on Responsible Investment (PRI) (April 2022):

1. BII applies two sets of environmental and social (E&S) standards: (a) 'core' E&S and business integrity (B)I requirements that apply to every Investee, and; (b) 'risk-specific' E&S and BI requirements that apply to certain Investees only. However, it is not clear if or when 'risk-specific' E&S requirements are applied (Section 2.2.2).

2. The document suggests that E&S and BI requirements (whether core or risk-specific) may not be applied to portfolio companies when making an Investment via a financial institution or private equity fund. Instead, BII places a requirement on the intermediary to develop processes, capacity and governance systems to implement appropriate standards in their portfolios (Section 2.1.1).

3. In addition, the document suggests that E&S and BI requirements (whether core or risk-specific) may not be applied where BII co-invests with other financial institutions (Section 4.2).

Since many of BII's investments are made via intermediaries or together with co-investors, it is not clear whether even the core E&S and BI requirements apply. This is concerning since the core E&S and BI requirements set out in the PRI reflect basic minimum legal requirements that any investor would adhere to, such as compliance with national E&S laws, the use of child labour (as an ILO core labour standard) or banning the use of capital to fund excluded activities. The policy could therefore be improved to ensure that these core E&S and BI requirements are applied to all investments that BII makes, regardless of whether those investments are made via an intermediary or together with co-investors.

There is a risk that applying core E&S and BI requirements to all of BII's investments will result in fewer investments being made via intermediaries or with co-investors. This could stifle investment in some of the most impactful projects and locations (such as Fragile and Conflict Affected States), which are often completed via intermediaries or with co-investors. We recognise that completing core due diligence on all investments carries with it additional transaction costs. However, we believe that doing so is necessary to mitigate core risks within BII's portfolio. However, few specific exceptions could be granted, for instance where BII invests in a financial intermediary that lends to individuals or SMEs. However, we believe that due diligence of core E&S and BI risks should be carried out for larger portfolio companies held via a private equity fund.

The risk-specific E&S and BI standards listed in the Annex of the PRI largely reflect best-practice for investing responsibly in emerging markets by following the IFC Performance Standards. However, it is not clear when these risk-specific standards are applied to the due diligence of investments. It should also be noted that the last update of the IFC Performance Standards was in 2012, and that although an update is due very soon it might be worth replacing them with more up-to-date guidance on managing risk-specific E&S and BI issues. BII could also provide aggregated data on how many times due diligence on the different risk-specific E&S and BI issues was completed across its investment portfolio.

BII's internal capacity and governance system for assessing E&S and BI risks compares very well with other development banks. BII has a large and experienced internal E&S and BI team as well as a legal team that act as first lines of defence. In addition, BII carries out Risk and Compliance (second line) and Internal Audit functions (third line). However, these teams would need to be expanded to provide enough capacity to meet not just core, but risk-specific E&S and BI requirements for its investments, especially where co-investors and intermediaries are involved.

5 Fighting and adapting to climate change

In its new strategy BII is allowed to invest in climate finance in the Indo-Pacific and Caribbean region. This relaxation in BII's investment geographies means that BII will be able to invest in less challenging investment markets with a greater potential to mobilise commercial finance than its more restricted geographies during the period 2012 to 2021. This will also have the benefit of diversifying BII's portfolio with benefits for risk management and potentially profitability However, there is a risk that investment is skewed towards low hanging fruits (e.g., established renewable energy technologies) in more established markets, where there is a very real risk of too many DFIs chasing too few projects.

There is a risk that BII will miss out on catalysing significant impact opportunities associated with the transition to a low-carbon, climate-resilient global economy. To maximise its impact and also realise significant commercial returns while fulfilling the principle of additionality, BII will need to shift its investments from low-hanging fruit in established renewable technologies and low-carbon transport to more nascent opportunities in harder-to-abate sectors, such as steel, cement and chemicals. BII can be a pioneering force in ensuring that new technologies that would support these sectors to transition to net-zero are tried, tested and eventually scaled-up to become commercially viable for institutional investors.

BII already supports such pioneering efforts in off-grid renewables through its Catalyst Portfolio (e.g. Gridworks). However, it could complement its five existing Catalyst Strategies with a Strategy that focusses specifically on hard-to-abate sectors. More detail on transition finance opportunities is outlined in recent ODI research for EDFI.