Investment for Development: the UK's strategy towards development finance institutions

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Summary: British Investment International (BII)—the UK's private-sector investment institution—will play a greater role as the UK sets out to rebalance its international development activities. Under the lead of the UK's Foreign, Commonwealth, and Development Office (FCDO), the UK will strengthen its bilateral cooperation with partner countries, hoping to make available a mix of grants, loans, insurance, and expertise. BII's investments will align with these goals by developing productive capacity in partner countries in a sustainable and inclusive way. While the financial model of development finance institutions like BII is attractive, our analysis also shows that there is scope for BII to be more transparent in terms of its governance, investment allocations, and development results.

About the authors: We have long-standing expertise in conducting research on foreign aid and international development organizations. Our primary research interest is to understand under which conditions these organizations are effective in promoting the Sustainable Development Goals worldwide. To that end, we collect large-N data and perform statistical analyses.

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

1. BIPs reflect the UK's new approach to overseas development that focuses on mobilising investment into private businesses abroad
2. They are partnerships because they involve collaboration between the UK government with businesses, sovereign wealth funds, private investors, international organisations, and civil society
3. BII is the lead institution for third-party funding mobilisation, whose role is to stimulate private-sector investment into businesses that would not otherwise be forthcoming due to risk considerations
4. The UK Aid Strategy mentions other partners that will contribute to the new "UK offer" for developing countries. The strategy blends investment (e.g., Private Infrastructure Development Group (PIDG)), finance (e.g., UK Export Finance (UKEF)), and technical assistance (e.g., Foreign Commonwealth and Development Office (FCDO)).
5. BII provides the financing needed to deliver the BIP interventions. Without BII, private-sector investors might be very reluctant to invest due to concerns over the risk of these investments

How does the BII's strategy align with the FCDO's development agenda?

6. BII's strategy 2022-26 includes three objectives—productivity, sustainability, and inclusivity. These objectives are reflected in BII's operational focus on financing digital transformations, investing in green infrastructure and climate mitigation (30 percent of new finance to be targeted to this goal), and boosting finance for women (25 percent of new finance to qualify for this goal).

7. FCDO's development agenda emphasises three key areas—girls' education and women's rights, saving lives (through technology and insurance mechanisms), climate change, and global health (all new aid must align with Paris Agreement).
8. The substantive goals of both strategies are similar, reflecting a desire to champion UK strengths (like financial innovation) and UK commitments to climate change and gender equality
9. BII's strategy and FCDO's agenda are also consistent on how they will achieve their objectives. BII will work primarily at the country level. BII can work in all countries, but in line with the UK Aid Strategy, focal regions are Africa, the Indo-Pacific, and (to a lesser degree) the Caribbean (insofar as it is relevant to climate change). BII will only intervene where it can contribute to development, which involves responding to the local context, providing long-term ("patient") and flexible capital, and providing additional expertise and technical assistance by leveraging the in-country network of UK institutions such as UK embassies, FCDO, and UKEF (see UK Aid Strategy).
10. FCDO's approach will be more bilateral than ever before: "By 2025, FCDO intends to spend around three-quarters of its funding allocated at the 2021 Spending Review through country and bilateral programmes." (UK Aid Strategy, p. 22). The UK Aid Strategy emphasises the need for partnerships, but these will be organised more around specific countries and sectoral platforms rather than supporting the multilateral system more generally. The UK Aid Strategy also mentions the need to target specific regions, including Africa, the Indo-Pacific, and Small Island Developing States (SIDS). Aid will be reserved for lower-middle income countries and fragile states, given that those have the greatest needs and promise the greatest impact.
11. The UK Aid Strategy recognises the potential to enhance impact by providing more than just aid, working across government and mobilising private finance and insurance (through BII, UKEF). Here the BII's and FCDO's messages are consistent as they emphasise the role of partnership and interlocking support.

How does BII's strategic outlook compare with that of other comparable overseas institutions?

12. Other development finance institutions (DFIs) include KfW (German Development Bank), IFU (Danish Investment Fund for Developing Countries), and Norfund (Norwegian DFI).
13. We took a closer look at IFU, who are about to publish their strategic plan for 2022-26 (the current framework covering 2017-21 is available here). IFU is similar to BII in their governance arrangements: It is wholly owned by the Danish government, overseen by the Danish ministry for development cooperation, and with a mandate to promote sustainable development and green transitions (https://www.edfi.eu/member/ifu/).
14. IFU operates an SDG Fund and an Infrastructure Investment Fund, besides a couple more targeted investment funds, such as the Danish Climate Investment Fund, established already in 2014. Overall, the sectoral profile of investments between both DFIs is similar. Regarding regional allocations, IFU focuses on Africa, followed by Asia, with only a small and negligible remainder going to Latin America (https://www.ifu.dk/en/impact/).
15. IFU's statutes are somewhat more prescriptive or explicit as to IFU's contribution to Danish development priorities. Nevertheless, IFU's activities are integral to the government's efforts toward the Sustainable Development Goals. By statute, 50 percent of IFU's investments must be made in countries with GNI per capita below 80 percent of the upper limit of the lower-middle income bracket.
16. Since its inception in 1967, IFU has made 1,325 investments, totalling GBP 22 billion (including mobilised finance). With an annual investment of GBP 100 million in 2021, IFU is

much smaller than BII (with about GBP 1.5 billion per year). These financial commitments are possible with a relatively modest capital base of DKK 100 million (GBP 10 million), expected to increase to DKK 1,000 million in 2022-26 (which requires parliamentary approval).

How effective are the governance structure and internal oversight mechanisms of BII (e.g., oversight over direct investments, fund investments, BII controlled companies)?

17. Assessing the effectiveness of institutional structures is difficult for two reasons: first, there are many definitions of effectiveness, and they cannot be completely objective ("effectiveness for whom?"); second, it is difficult to attribute results to these specific governance structures, especially given that data on internal operations that would be required to perform the analysis are unavailable.
18. Our approach to analysing effectiveness is to review the governance structure and internal oversight mechanisms and then make informed judgments about their adequacy.
19. BII's governance consists of an Executive Board, an Executive Committee, and an Investment Committee. The Executive Board guides the overall strategy and consists of people with private-sector expertise, regional experts, and development experts. The Executive Committee, led by the CEO, is responsible for the operational decision-making at BII. The Investment Committee makes investment decisions. It is made up of senior BII officials and external experts. This structure mirrors the setup of other DFIs and multilateral development banks and therefore seems fit for purpose. However, the publicly-available information is insufficient to provide more detailed assessments. For example, how are eminent persons chosen? How is a potential confluence of interests through overlaps or alignments between the Executive Board and the Investment Committee avoided?
20. BII's only shareholder is FCDO. This is advantageous because it allows BII to focus on its public mission and take risks that private shareholders might not be willing to take.
21. BII's website provides limited information on BII's project governance. The focus seems to be on screening for the most viable projects to minimise the later need for project management and oversight. BII staff appraises potential projects using an impact scoring based on BII's strategic objectives and the investees' environmental, social, and governance (ESG) systems and practices (see BII website). The Investment Committee deliberates on project proposals and takes the ultimate investment decision. Following the investment decision, BII "work[s] with investees to put in place steps identified before the investment to ensure the company or fund is aligned with our standards. These may include an environmental policy and implementation strategy, a business integrity plan, a governance structure, or a strategy to enhance development impact." BII also asserts to "monitor the portfolio on a regular basis," assessing "how the company is performing against a range of criteria, including achievement of milestones, risk management, valuation movements, development impact, and environmental, social and governance performance." (see BII website). From this description, it is unclear who monitors, how often, and to what effects.

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?

22. Speaking of budgets in the context of DFIs is somewhat misleading because DFIs are catalysts that mobilise investments much larger than their own contribution.
23. As a DFI, BII is entirely self-financed. Projects achieve a modest financial return that covers administrative expenses. BII posits that a financial return of 2 percent (before costs) is sufficient to ensure its financial viability, which is plausible.

24. The size of BII's investment budget depends on three factors. The first is its shareholder capital, which the UK parliament fully controls. Current capitalisation levels were legislated in the Commonwealth Development Corporation Act in 2017. Capital subscriptions can be either paid-in contributions or guarantees by the UK government. A second determinant is the risk profile of its investments. To maintain financial viability, BII must balance the risks it takes through its investments. More investments that involve higher risks, longer time horizons, and lower investment income require BII to have a stronger capital base, thus limiting future investments. BII is also subject to unforeseen risks, such as exchange rate fluctuations, which may reduce the profits on its investments.
25. BII could diversify its shareholder base to scale up its operations. In the case of Denmark, IFU can leverage contributions from Denmark's pension funds. A similar option could be available to the UK, which should maintain complete public shareholding control.

How are the decisions of BII's management scrutinised? What transparency is there over BII's performance monitoring and reporting?

26. BII is managed by an Executive Committee that is headed by a CEO.
27. The Executive Board has a duty to fulfil its oversight role. However, unlike other financial institutions (like the International Monetary Fund), meeting memos are not publicly available.
28. BII reports on its activities through annual reports and information collated on its website, for instance, on the projects it invests in.
29. BII collects three types of information to track impact: a portfolio-level impact score, tailored sets of target indicators for its strategic objectives, and financial performance measures.
30. Five indicators measure BII's overall portfolio's impact: total number of jobs supported; annual employment growth; taxes paid (by investees); attributed carbon footprint; the amount of simultaneous mobilisation
31. BII's impact matrix also tracks indicators for its three specific objectives. For productivity, these include the amount of electricity produced (in GWh), loans provided by investees, and the number of people reached. For sustainability, BII tracks the portion of its investment portfolio targeting climate change, the emissions avoided, and the number of green jobs supported. For inclusivity, BII measures the number of low-income people reached. However, these metrics appear rather crude and not well-aligned with the strategy. For example, inclusivity mentions gender empowerment but does not contain any gender-specific indicator. Similarly, productivity, which is about doing more with less, is focused too much on "doing more" but neglects the input side.
32. In terms of financial performance, BII seeks to achieve a return of 2% over seven years on a rolling-average basis, gross of operating cost.
33. To what extent BII meets these performance criteria is not clear to outsiders. Performance indicators are available from 2016 to 2021, but only at an aggregated level. Project-level reporting is focused on listing the investments with recipients, sectors, and financial data. BII reports projects through a database on its website and the International Aid Transparency Initiative (IATI). However, the available data are incomplete and do not align with the aggregate figures from the project-level data. The number of projects reported in the two databases also differs. Especially the information on funding amounts and impact indicators are often missing at the project level. Therefore, it is challenging to assess BII's performance from the outside.
34. This level of transparency is far behind international standards monitored by organisations like Publish What You Fund (PWYF). Given that PWYF has recently started focusing more on

BII and its peers through the DFI transparency initiative, increased transparency will be crucial to safeguard BII's reputation among development finance institutions.

What criteria does BII use to determine investment decisions and how are financial returns balanced with achieving impact?

35. We distinguish between *de jure criteria* (as laid down in BII's strategies) and *de facto criteria* that could guide BII's investment decisions.
36. According to BII's strategy, BII invests where it can make a difference. BII focuses on where it can achieve development impacts that would not otherwise come about. BII claims that it is willing to take substantial risks in support of its mission (STRAT). In recent years, BII claims the balance between impact and financial returns has shifted toward impact and is expected to continue doing so, provided BII will be able to achieve a 2 percent gross return.
37. To identify investment opportunities, BII uses an Impact Dashboard in which staff score the expected impacts along the three strategic objectives. In addition, investments must satisfy the criteria laid out in the BII Investment Policy, which covers all countries, sectors, and modalities eligible for funding. This policy has few restrictions, notably that BII cannot invest in fossil fuels. Investments must also be in line with the BII Responsible Investment Policy, which requires all investees to comply with environmental and social standards (national laws, ILO core labour standards, and E&S systems, including a grievance mechanism) and business integrity (compliance with AML/CFT laws, BI systems, whistleblowing system; companies must also not engage in corruption, fraud, tax evasion, or sanctions busting). These standards are in line with those of other DFIs but may only meet the highest IFC standards on a case-by-case basis
38. More analysis is needed to establish to what extent BII's investments adhere to these policies. The reported data on BII's investments are insufficient to assess this issue comprehensively. For instance, even if BII invests in the DR Congo, a country that scores low on human rights indices, we cannot conclude that BII investments violate E&S and BI criteria because they may still have supported firms that meet these criteria in a generally difficult environment. More fine-grained data at the company level would be required to assess the de facto criteria guiding BII's investments.
39. That said, we performed a high-level analysis of BII's investment decisions using available data from BII's website. For facts and figures about BII's investment portfolio, please see the appendix. We are happy to provide more tailored analysis on request.

How do external events influence the investment decisions of BII (e.g., in response to the crises in Afghanistan and Ukraine, the depreciation of Sterling etc.)?

40. Theoretically, we can formulate expectations regarding how external shocks may influence BII's investment decisions. First and foremost, a deterioration in financial circumstances from the borrowers' perspective—for instance, due to an appreciation of the pound—will adversely affect BII's financial performance and thus potentially constrain its ability to take risks. These constraints could mean a shift in its investments toward more stable countries, which tend to be middle-income economies. We expect BII to move along the continuum between development impact and financial sustainability due to financial shocks.
41. In addition, political shocks may threaten the viability of ongoing investments and BII's ability for future investments. An example is the usurpation of power by unfriendly regimes such as the Taliban in Afghanistan.
42. Beyond these high-level points, we could conduct a more thorough quantitative analysis if we were given access to more comprehensive funding data.

What due diligence does BII undertake prior to making investment decisions and how does this compare with best practice?

43. BII's website documents the process through which BII scrutinises new investments. This process involves three stages: project initiation, project appraisal, and Board approval.
44. BII's process for project initiation: "A prospective deal might be brought to our attention by a sponsor, third party contact, or through direct outreach from British International Investment. If it is initially seen as viable, the deal team, which includes specialists from our investment and impact teams, conducts further research to decide whether it should be put before our Investment Committee."
45. BII's process for project appraisal: "The deal team works closely with the potential investee to carry out due diligence and deal structuring, examine how the prospective investment meets our criteria, and understand the opportunities for impact. This includes producing an 'Impact Dashboard' which articulates the development impact that we expect." BII's deal teams evaluate the investment against BII's strategic impact objectives using an "Impact Score". In addition, BII assesses investees' environmental, social, and governance systems and practices and their commitment to making improvements and adhering to industry good practices. BII claims to "look for opportunities to maximise impact, with a particular focus on our priorities of ESG, gender equality, climate change and business integrity."

What current investments does BII hold?

46. In 2021, BII invested over GBP 1.87 billion and increased its investment portfolio to GBP 8.1 billion in assets under management.
47. Geographic distribution of BII's portfolio as of 2021: A plurality of BII's investments was in Africa (57%), followed by South Asia (34%), and other regions (9%), notably the Caribbean. The top 10 countries in which BII was invested were India (28%), Nigeria (7%), Kenya (5%), Egypt (5%), Morocco, Bangladesh, Pakistan, Ghana, South Africa, and Cameroon (all below 5%). The low percentages indicate a high geographic dispersion, which is advantageous from a risk perspective. New commitments in 2021 were even more focused on Africa (72%)
48. Sector distribution of BII's portfolio as of 2021: Priority sectors are financial services (34%), infrastructure and climate (25%), and health (7%). New commitments in 2021 focused on infrastructure (40%), financial services (26%), technology and telecoms (11%), and food and agriculture (10%).
49. BII's mode of engagement as of 2021 comprised direct equity (35%), intermediated equity (33%), debt (30%), and guarantees (2%). Data on new commitments in 2021 showed a further reduction in intermediated equity (22%) and an increase in guarantees (5%). These numbers differ from BII's publicly available project data, which is dominated by intermediated investments.

How effectively does BII manage funds following its initial investment?

50. Effectiveness should be assessed in terms of development impacts and financial sustainability.
51. Regarding financial sustainability, BII's fund management seems effective as BII has not suffered losses that would have undermined financial sustainability.
52. In terms of development impacts, effectiveness is much harder to evaluate. Even if development-related metrics such as jobs created or electric capacity built have increased in the countries in which BII has invested, this is not necessarily evidence of effectiveness. BII

might have selected projects that would have achieved these objectives regardless of BII's investment. BII's contribution is difficult to ascertain in the absence of counterfactual data.

53. BII could partner with academics or research institutes to more rigorously evaluate its operations. Although there are limits to undertaking randomised control trials, which would involve selecting firms for support at random, this could be a useful approach.
54. For most of its activities, quasi-experimental methods using observational data should be used to understand development impacts. More transparency about the (sub-national) location of their investments—over as long a time period as possible—would be required to make a rigorous data-based assessment of this impact.

How does BII evaluate the impact of its investments?

55. BII evaluates its investments against indicators mapping onto its three strategic objectives: productivity, sustainability, and inclusivity.
56. Productivity indicators: the amount of electricity produced (in GWh), loans provided by investees, and the number of people reached (or the number of jobs created).
57. Sustainability indicators: Amount of emissions avoided and the number of green jobs supported.
58. Inclusivity indicators: Number of low-income people reached
59. Not all indicators may be relevant in a given investment. It is, therefore unclear how BII chooses the relevant indicators that provide the basis for performance measurement at the project level.
60. BII also monitors results at the portfolio level, for instance, the share of investments relevant to climate change and gender equality. Regarding financial results, BII seeks to achieve a 2 percent gross return before costs on a rolling seven-year average basis.
61. Again, it could benefit the assessment of BII impacts if they were more transparent about their evaluations. For example, they could follow peer institutions, like the German KfW, in publishing the results of their evaluations online.

Appendix

Here we provide analysis of BII data from two publicly available sources on the BII website:

- BII data on *companies* (1530 entries, 1991-2022)
- BII data on *fund investments* (237 entries, 2003-2022)

Companies

The data list 1531 investments in companies, although confusingly, it also seems to entail some intermediated investments (that should only be reported in the *Investment funds* dataset). The data include information on company names, region, country, and sector of investees. However, funding data are missing for 1382 out of 1531 entries. Therefore, we decided to count the investments here because coverage for counts approaches the reported aggregate figures.

Figure A1: Number of company investments (1991-2022)

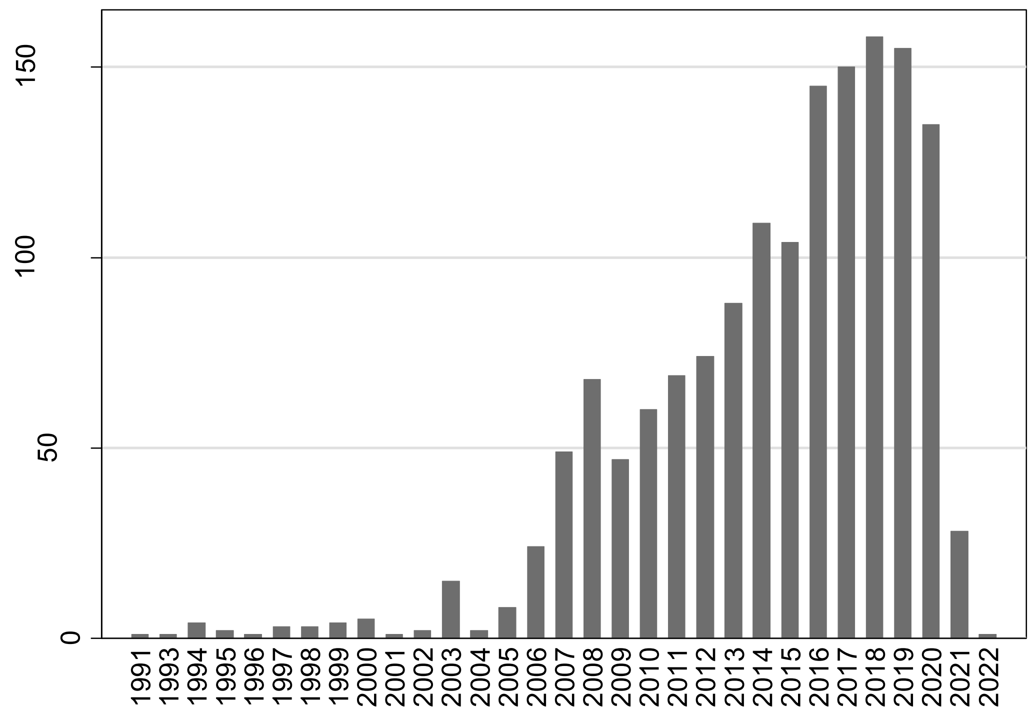


Figure A2: Types of investments

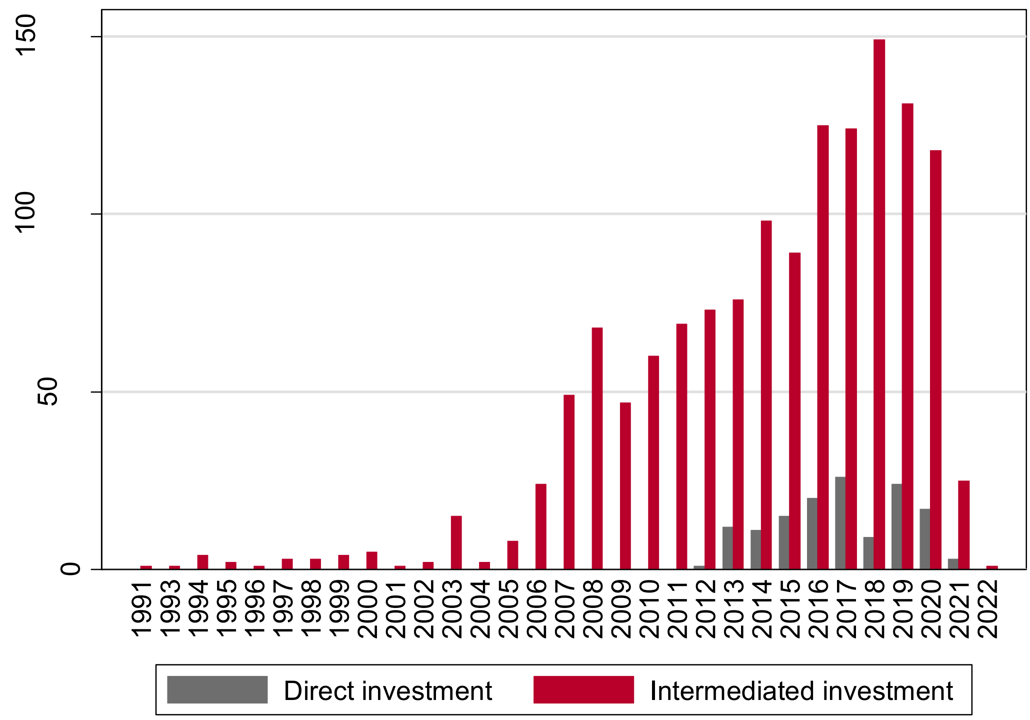


Figure A3: Number of investments in countries (1990-2022) with at least 3 projects

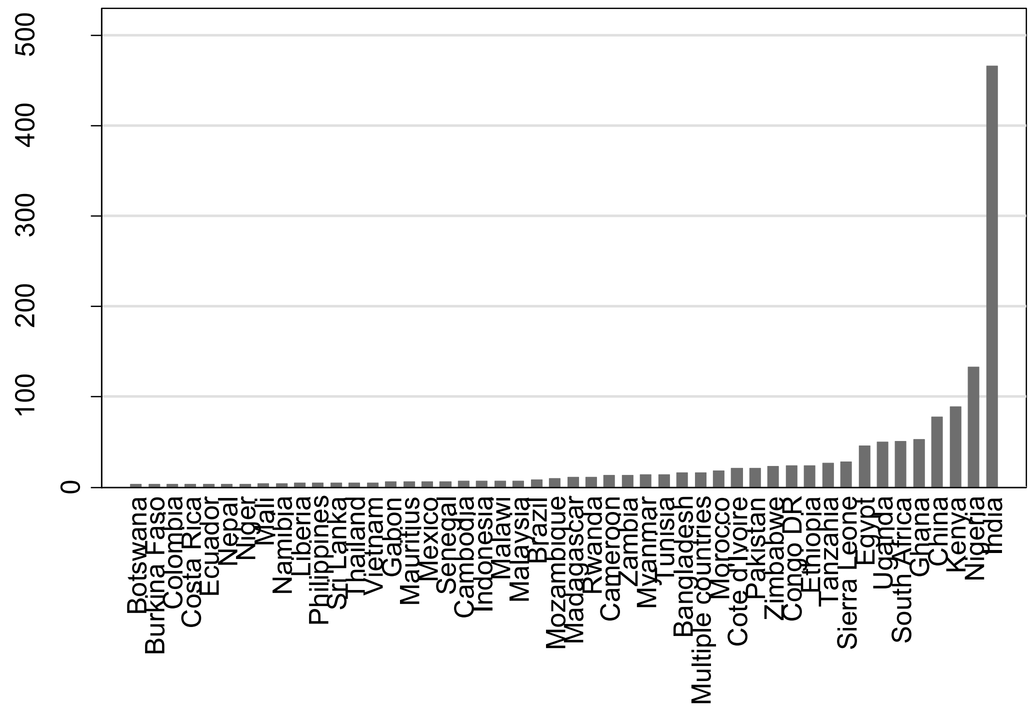


Figure A4: Number of investments in countries (1990-2022) by investment type and at least 3 projects

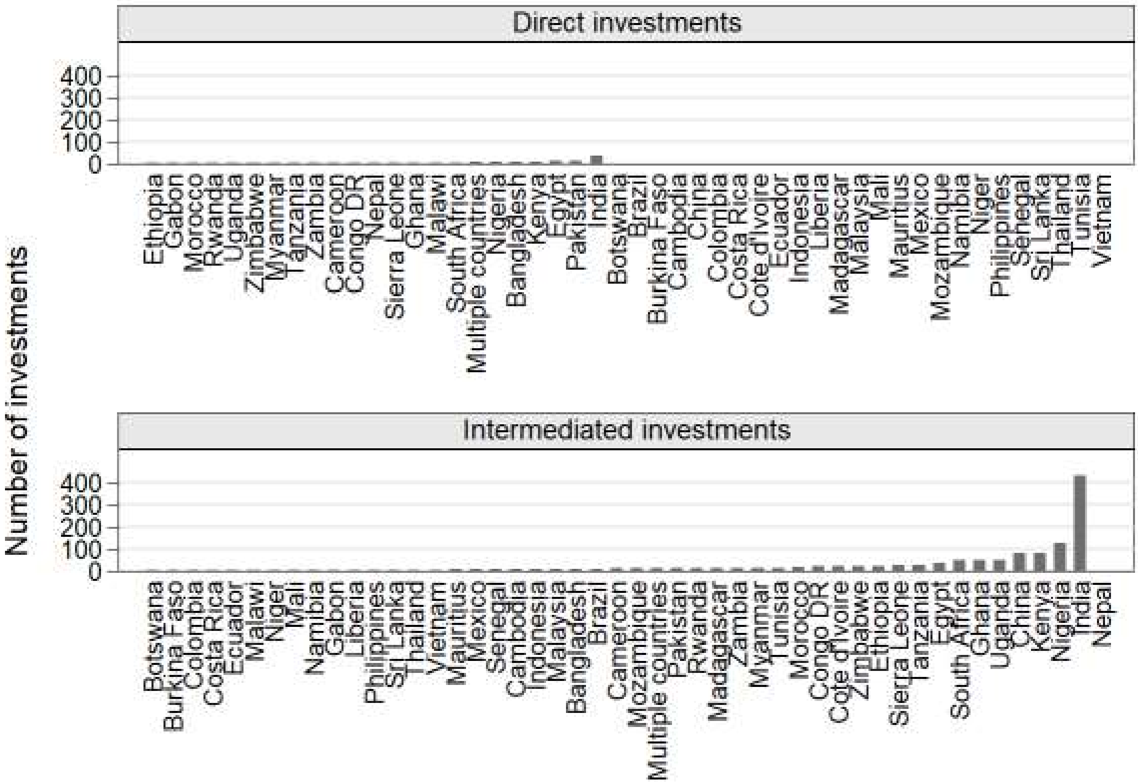


Figure A5: Breakdown of investments (1990-2022) by sectors with at least 3 projects

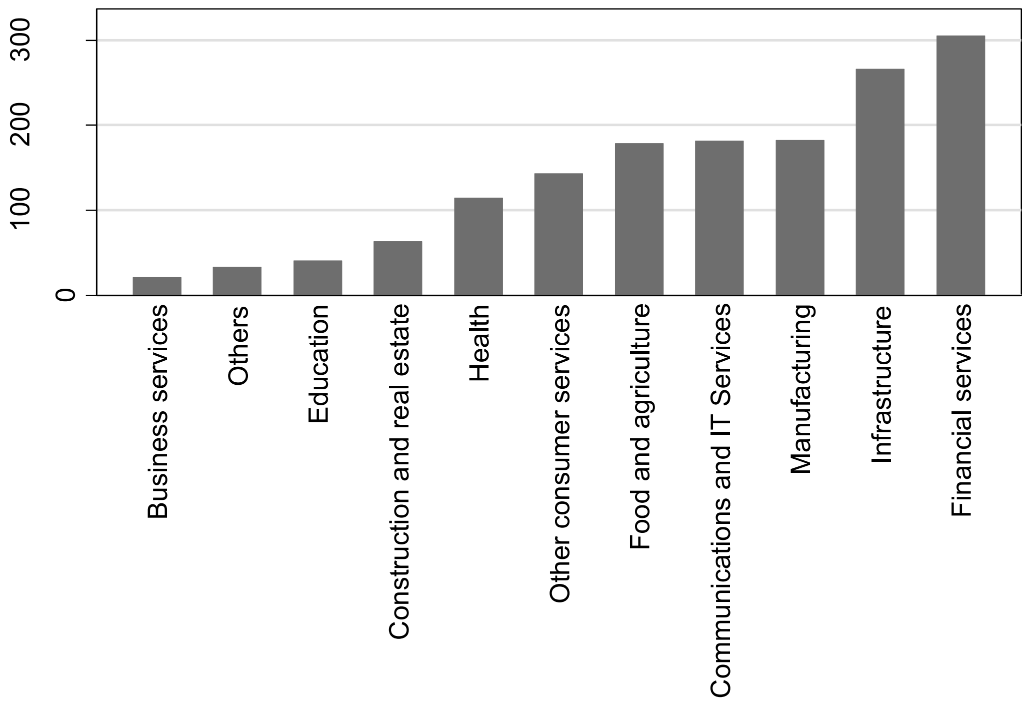
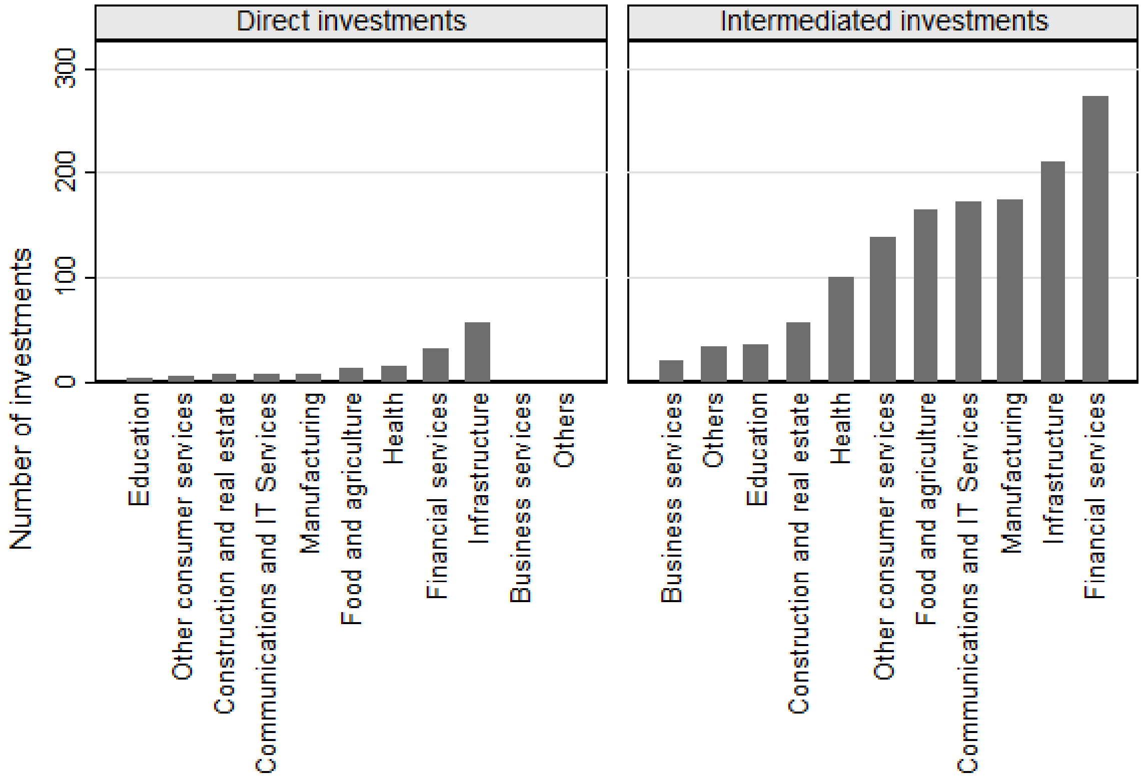


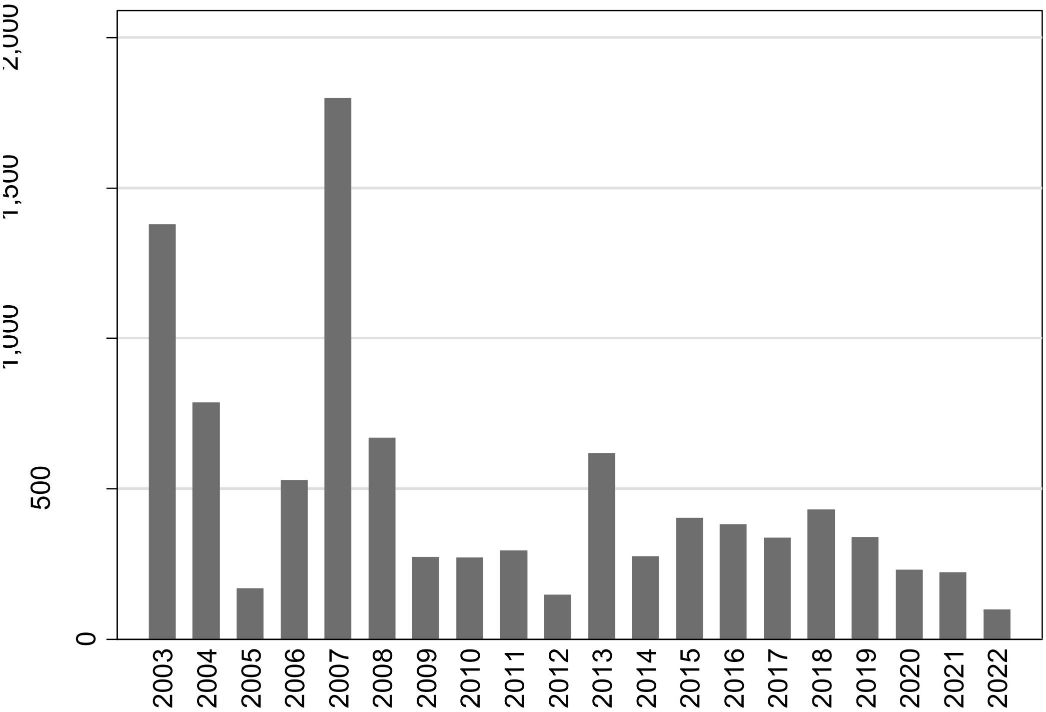
Figure A6: Sector breakdown by investment type (1990-2022)



<u>Fund investments</u>

This dataset includes a list of intermediated investments, which are investments made through financial vehicles. The data provide information on regions, countries, sectors, and funding amounts (with gaps though).

Figure A7. Annual amount of investment (2003-2022)



The data seem to indicate a lower incidence of intermediated investments in recent years. However, it is not clear if this is a genuine drop or if the data are incomplete. The BII website indicates a total funding commitment of GBP 1.87 billion in 2021 (or over US$ 2 billion).

Figure A8: Number of intermediated investments (2003-2022)

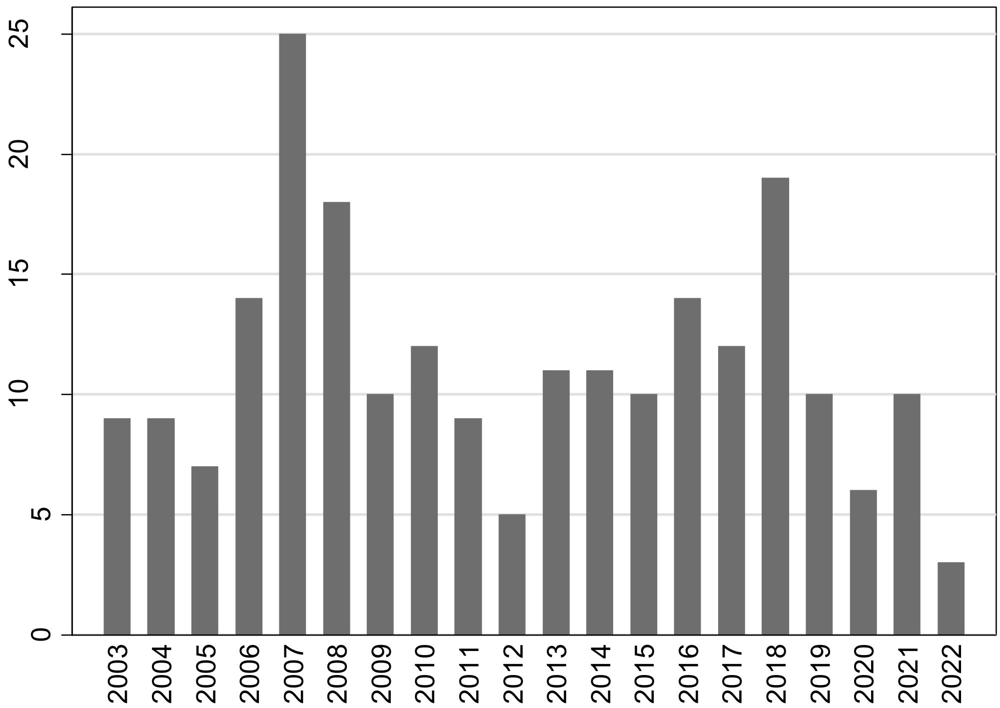


Figure A9: Regional breakdown of recent intermediated investments (2013-2022)

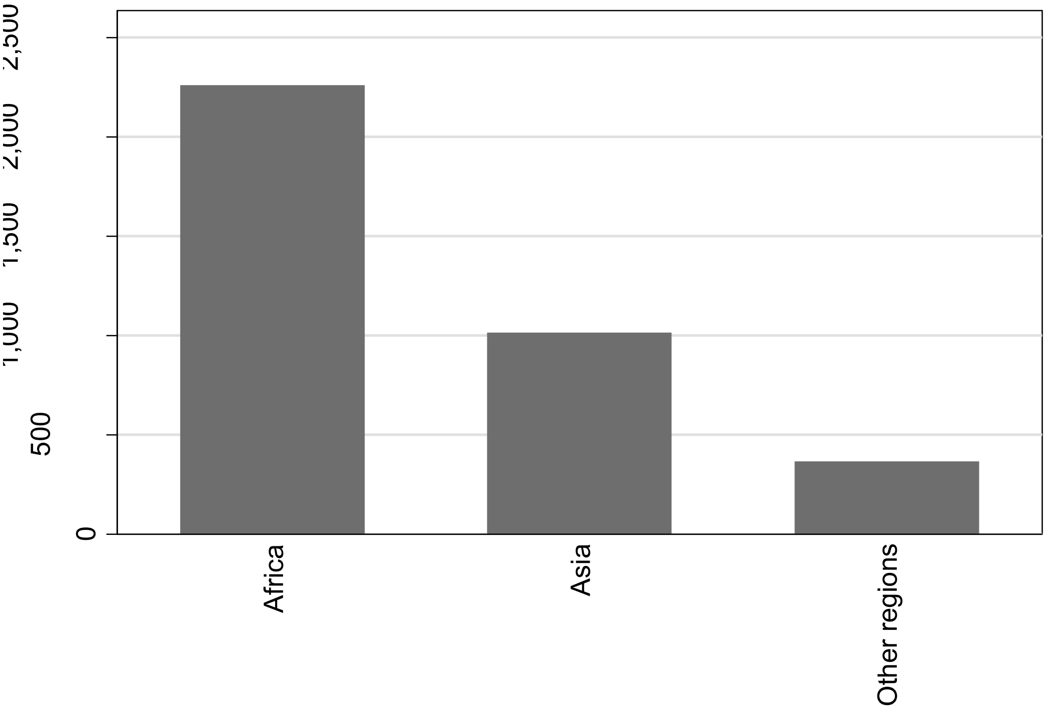


Figure A10: Number of recent intermediated investments (2013-2022)

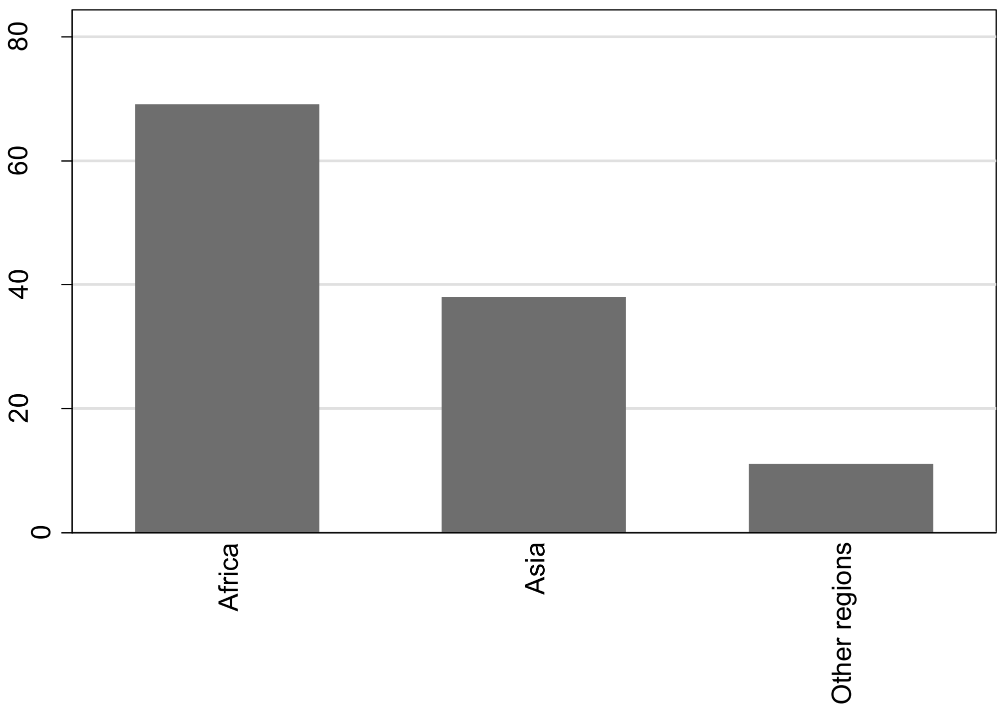
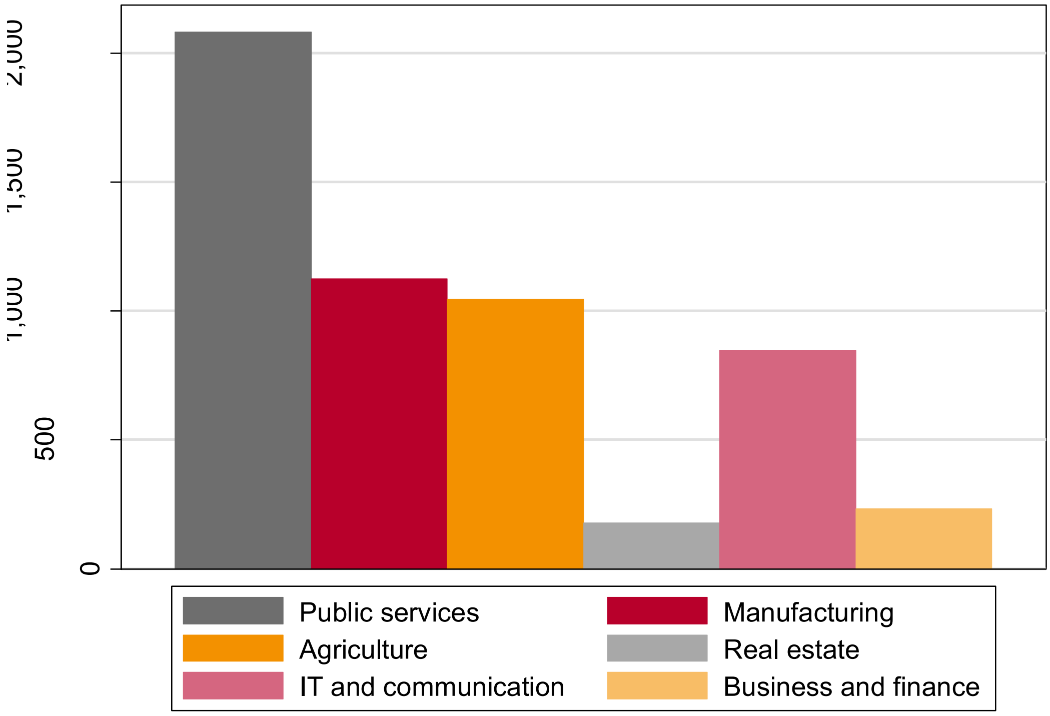
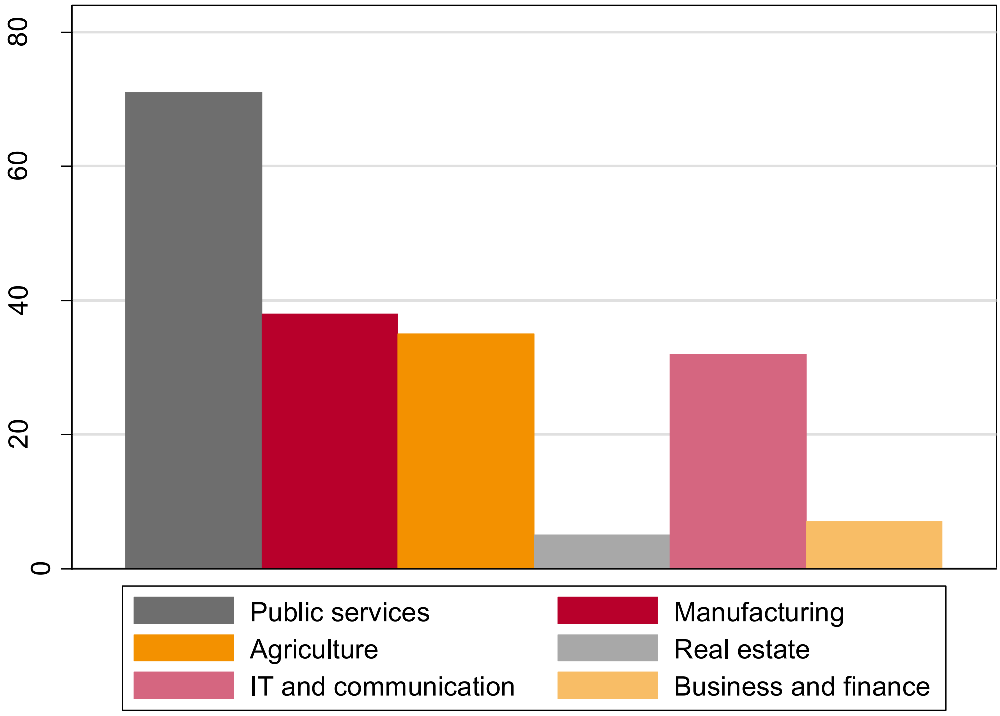


Figure A11: Sectoral breakdown of recent intermediated investments (2013-2022)



Note: The graph may potentially double count projects because one project may serve multiple sectors.

Figure A12: Number of recent intermediated investments across sectors (2013-2022)



Note: The data do not include infrastructure and climate change although they are reported in the aggregate on the BII website.