The Impact Investing Institute's response to the International Development Select Committee inquiry on Investment for Development: the UK's strategy towards development finance institutions

3 February 2023

1. ABOUT US

The Impact Investing Institute was launched in 2019 with a simple mission: to accelerate the growth and improve the effectiveness of the impact investing market in the UK and internationally. Our aim is for capital markets to be fairer and work better for people and the planet, in order to deliver sustainable and inclusive economic growth.

We are an independent, non-profit organisation, which brought together two influential initiatives: the Government's Taskforce for Growing a Culture of Social Impact Investing in the UK, and the UK National Advisory Board on Impact Investing. We are part of the GSG – the Global Steering Group on Impact Investing, which brings together leaders from finance, business, and philanthropy to contribute to solving some of the world's most pressing social and environmental challenges. Our Theory of Change describes how we plan to achieve change in the short-, medium- and long-term. We run a series of research, education, pilot and advocacy programmes designed to bring about the market conditions to enable impact investing to flourish.

With the backing of the UK's presidency of the G7 in 2021, we co-led the Impact Taskforce, to develop actionable pathways for mobilising greater amounts of capital to invest in solutions to help meet the long-term needs of people and the planet, including the achievement of the Sustainable Development Goals (SDGs). The Taskforce's report, 'Mobilising institutional capital towards the SDGs and a Just Transition', presents these pathways, based on engagement with 170 influential stakeholders representing over 110 organisations based in almost 40 countries. A focus area of this work was the mobilisation role that Development Finance Institutions (DFIs) and Multilateral Development Banks (MDBs) play, and British International Investment (BII) was a member of the Technical Working Group. **We were pleased to work with BII and are strongly supportive of the organisation, as it continues to contribute to sustainable development around the world.**

We are responding to this inquiry because **private capital plays a vital role in the UK's international development strategy**, including by deepening economic ties globally to deliver jobs and growth in both the UK and low-and-middle income countries, as well as supporting the global transition to net zero. BII is key to this success, and we have appreciated collaborating with them over the years on the particular role they can play in mobilising private capital to these ends. Below we highlight the potential for how their capital mobilisation role can be enhanced to support the delivery of the SDGs. We would also be delighted to provide oral evidence to the committee to answer any questions and discuss our recommendations in further detail.

We have provided a thematic response, reflecting on three of the inquiry's questions:

- *Q2: How does the BII's strategy align with the FCDO's development agenda?*
- *Q3: How does BII's strategic outlook compare with that of other comparable overseas institutions?*
- *Q7: What criteria does BII use to determine investment decisions and how are financial returns balanced with achieving impact?*

2. KEY CONTEXT: PRIVATE CAPITAL MOBILISATION

Traditionally, DFIs such as BII provide direct financing for projects that support economic, social and environmental development in emerging and frontier markets. In response to the need for greater speed and scale, they have increasingly also sought to mobilise private capital towards the achievement of such goals – i.e., attract additional capital to supplement investments made from their own balance sheets. Achieving the SDGs will cost multiple trillions of pounds per year, with delivering 'Net Zero' alone estimated to cost £1.3trn – £3.2trn per year. This far exceeds the current levels of deployment by DFI and MDBs', broader flows of overseas development assistance, foreign direct investment, the public sector, and philanthropists. At the same time, all evidence indicates that the planet will suffer irreversible loss if more isn't done to tackle the climate crisis in the next decade. There is, therefore, little time to act to provide the capital needed to support a global transition to Net Zero and the achievement of the SDGs, particularly in the Global South.

To meet these imperatives of speed and scale, one obvious solution lies in the **£125trn held globally in private pensions, insurance policies and endowments** within the global financial system. There is a further opportunity to do this now given the **high appetite of mainstream investors for environmental, social and government (ESG), sustainable and impact investments**, which has driven record capital deployments toward green and socially beneficial investments. Private finance, however, rarely flows to where need is greatest, particularly in the Global South. Investors usually cite a range of barriers or concerns to investing in emerging and frontier markets, including real and perceived macro risks, lack of investment size, lack of liquidity and available pipeline, lack of reliable information, higher costs and lower credit ratings.

In response, DFIs are increasingly using their status, networks, and local market expertise to help mobilise more of the private capital that is needed. DFIs are usually government majority-owned and source their capital from national funds or benefit from government guarantees. They can therefore go to where the private sector currently cannot, **creating investable pipelines, investment track records and – ultimately – functioning markets, so that private capital can follow**. The potential is huge: even by using a single, familiar mobilisation instrument (debt funding), and using conservative estimates, BII, the US International Development Finance Corporation (DFC) and Norway's Norfund could have jointly mobilised an extra £10.6bn for investment in 2020 alone.

Despite this potential, **capital mobilisation should not be seen as a silver bullet or as a replacement of the traditional financing functions of DFIs. Expectations should be managed, and clear safeguards set to ensure value for the taxpayer**. Earlier claims that highly exponential amounts of private capital could be mobilised through the deployment of public monies (the so-called "billions to trillions" agenda) have proven somewhat optimistic. Similarly, expectations that DFIs should fulfil the three expectations of being (i) strong balance sheet investors, (ii) risk-tolerant investors in frontier and other markets and (iii) providers of de-risking mechanisms (for example blended finance approaches) to crowd in private investment have, at times, been contradictory and counterproductive.

A better understanding of mobilisation would frame it as a tool in the toolboxes of DFIs, such as BII, to enable them to achieve their aims of supporting sustainable economic and social development through investment, building on their unique characteristics within the global financial markets. Given the UK's position as a global financial centre, and particularly so for green and responsible finance, BII has a clear opportunity to leverage private capital at the scale and speed needed, in line with the UK's international development priorities.

We therefore recommend that the UK government supports BII to:

1. **Develop private capital mobilisation as a core objective and business activity,** with the aim for it to become of equal importance to balance sheet investment at the time of BII's next business strategy.

2. **Increase de-risking investment propositions in target emerging and frontier markets**, in particular through the increase in 'blended finance' solutions.

3. **Build a stronger investment offer in emerging and frontier markets**, in partnership with asset managers and other capital markets ecosystem players.

4. **Share relevant performance data** to reduce misperceptions and encourage greater capital flows to emerging markets.

These proposals are practical and grounded in best practice by BII's peers. We recognise that their implementation might have implications for the business model of BII, and have, where possible, provided further comment on how these might be addressed.

3. RECOMMENDATIONS

3.1 Develop private capital mobilisation as a core objective and business activity

We recommend that the Foreign, Commonwealth and Development Office (FCDO), as BII's shareholder, **develops private capital mobilisation as a core objective and business activity for the DFI**. In particular, we would support amending the performance expectations off BII to make capital mobilisation and balance sheet investment of equal importance, as well as adopting a target 'mobilisation ratio' – i.e., the amount of private finance mobilised by the amount of DFI investment (more information on p63-64 here). A number of DFIs have included mobilisation as part of their strategies, including DFC, Proparco and FMO, in some cases with explicit mobilisation targets. BII, in comparison, has highlighted the need for mobilisation of private capital in its 2022-2026 Technical Strategy (p35-37), while not committing itself to quantified targets. We are aware that BII is currently furthering its mobilisation approach and plans to report back on specific plans later this year. We would therefore suggest gradually increasing expectations of mobilisation, with the aim to make it a core objective for the next business strategy

This approach would also have implications for BII's business model, which should be supported by its shareholder. We therefore recommend that **BII is provided with additional financing and support to**: **further develop market infrastructure** in emerging and frontier markets and assist market actors to establish new investment vehicles; **expand project pipeline development** and the generation of primary investable opportunities in these markets; **expand the investment tools within these institutions**, especially those to address (real and perceived) risks; and **expand its ability to provide concessionary capital** for blended finance solutions alongside institutional investors.

We also recommend that **mobilisation ratios should be embedded into BII's annual reporting** to monitor progress.

3.2 Increase de-risking investment propositions in target emerging and frontier markets

Although the level of investment is increasing, private investors continue to face real and perceived barriers to investing in emerging and frontier markets – such as macro and market risk, lack of liquidity and low credit ratings. **By deploying risk-mitigating instruments as part of a 'blended finance' transaction, BII can play a key role in helping to de-risk transactions for other investors**. Blended capital can help to direct large-scale private sector capital into opportunities in emerging and frontier markets that would otherwise not be investable.

There is a range of tried-and-tested tools that could be implemented at scale by BII, including: **subordinated capital** to absorb institutional investors' losses first; **guarantees** provided on loans of other debt structures; **insurance** to cover specific risks (e.g., political, credit and non-payment); **syndication** of loans to third-party investors to allow investors to benefit from their sourcing capabilities, market network and preferred creditor status; and **securitisation** of parts of its loan portfolio to sell loan cashflows as securities to investors, freeing up additional balance sheet funding for reinvestment. Despite having the greatest potential for larger-scale mobilisation, few DFIs currently focus on mobilisation at the institutional level, such as securitisation, insurance or debt issuance.

We suggest that the Foreign, Commonwealth and Development Office (FCDO) supports BII in its deployment of these instruments by including the activity in its mandate and setting appropriate expectations and incentives. We understand that concessional and risk-tolerant capital is scarce, so its use needs to be disciplined. It should be used where it is needed to mobilise investors and where mobilisation multiples can benefit as many transactions as possible. Scrutiny is needed to see how its use might be reduced over time as data and track records are generated.

3.3 Building a stronger investment offer in emerging and frontier markets

Indirect investment vehicles, such as pooled investment funds, offer the most practical and familiar means to mobilise capital among private investors at scale. By aggregating assets, pooled vehicles diversify risk and enable inclusion of smaller, more dispersed investments – which is especially important for emerging and frontier markets. Given its ties with the City of London and global investors, **BII is uniquely placed to partner with asset managers and other capital markets ecosystem players to develop investable proposals for large scale institutional investors**.

BII has recently established Catalyst Strategies to explore a broad range of investments addressing persistent market failures or building on emerging trends, and **we recommend that such an approach is expanded upon**. We recommend, in particular, that BII increases its catalytical partnerships by further exploring models such as: **co-creation**, where traditional investors and impact-focused investors (in this case, BII) jointly design and sponsor an investment structure with a specific impact objective (e.g., an SDG); **co-management**, where different managers with complementary skills (e.g., a mainstream manager and a DFI) provide a combined offering to institutional investors, allowing a fund to scale rapidly; and **capacity-building support**, provided by major impact investors to local, emerging and first-time fund managers, incrementally increasing allocations to such managers and showcasing them to other investors.

3.4 Sharing relevant performance data

We welcome BII's commitment to "look to enable open-source investment data to reduce misperceptions of risk in our markets" in its 2022-2026 Technical Strategy (p36), and recommend that **BII is encouraged to share all relevant performance data where possible, bearing in mind commercial sensitivities**. We are pleased that BII has further expanded its collaboration with initiatives such as the Global Emerging Markets Risk Database Consortium (GEMs) and has partnered with various institutions, including the Impact Investing Institute, to increase transparency around its activities.

Nevertheless, we invite BII to further share its relevant emerging markets data, including on performance. Sharing data with investors, asset managers and rating agencies could significantly increase the flow of capital to emerging markets. Greater flow of data could also reduce the risk premium demanded on emerging market securities, potentially provide billions in savings to entities seeking to raise capital in these markets. BII's long-term data and track record in emerging markets can assist institutional investors in their own risk assessments. It can also help to challenge the perception of an inverse relationship between social or environmental impact and financial return, with the appropriate contextualisation of the contexts in which it operates.