IDC inquiry on investment for development

The UK’s strategy towards development finance institutions

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Introduction and context

Our previous submission[1] outlines the critical role of BII investment. Tackling poverty reduction requires a suite of interventions including social protection schemes, public investment which provides free education, free healthcare etc. but also private investment which improves productivity, creates jobs and fuels growth. By targeting the latter, BII investment is an important part of the government's toolkit to help tackle poverty, complementing traditional UK ODA spend which targets the former.

In considering the UK's international development strategy, it is important to consider the perspective of the citizens of the global south and what many of them identify as their priority issues. For example, in Afrobarometer surveys of African citizens, jobs and economic growth repeatedly feature as top priorities. Likewise, in World Bank country surveys, job creation is again identified as a key priority for the majority of countries.

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Further, we note that increasing emphasis on BII and private investment is in line with the shift that we observe 'domestically' in terms of how many governments in OECD countries are thinking about supporting their own growth and transformational change (e.g., green growth). OECD governments have recognised the important role of using public capital to support private investment, their growth and shape its nature (e.g., the Inflation Reduction Act in the United States). It is therefore appropriate that this thinking spills over into our thinking about ODA including how to support sustainable growth and development in the global south.

BII is therefore a critical tool of UK international development policy but we believe that there is: (1) room for BII to make better use of its capital; (2) for it to deliver higher development impact; and (3) a need for greater transparency and better articulation and communication of BII's value as a tool of UK international development policy.

This submission offers some additional reflections in three areas based on ODI's participation in the oral evidence session on the 7th March as follows:

1) BII funding
2) Development impact

[1] BII0086

2.1. Geographic allocation
2.2. Financial services investment
3) Gender

Relevant research and references have been hyperlinked in the submission.

1. BII Funding

Payment of a dividend may not result in an overall increase in aid and create pressure on BII to water down development impact

In a number of oral evidence sessions as part of the inquiry on BII (held on 24th January and 7th March), the question has been raised about whether BII should pay a dividend.

There are several issues that must be considered when contemplating this idea.

First, under OECD DAC ODA rules[2], the provisional reporting methods for private sector instruments (PSI) state that any dividend paid to the Government would be treated as negative Overseas Development assistance (ODA)[3]. But, given current pressures on the UK fiscal position, it may not be used by the government to increase the overall ODA budget in a given year.

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Given that ODA is meant to be a measure of donor effort in funding UK ODA, such a dividend goes against the fundamental principles of ODA.

Second, there is a risk of setting a precedent that part of the UK ODA budget is regularly funded by BII profits made from investing in the global south. This could create an expectation of a regular dividend which could create tensions with BII's development impact objectives. BII may, for example, be pressurised to focus on increasing returns and pursue easier/more profitable investment at the expense of development impact.

BII business model: new periodic funding has enabled BII to materially grow its portfolio. Reinvesting profits would allow this growth to accelerate as it would be partially 'self-financed' by BII.

2 The OECD Development Assistance Committee (DAC) is the global body which sets the international rules for what can be counted as aid and how it is measured.

3 The UK government has chosen to use the 'institutional' method under the OECD DAC PSI approach. Under this approach the UK government has counted capital contributions to BII as ODA at their face value in the year made. Any 'reflows including profits' (e.g., dividends) would count as negative ODA.

The scale of the Sustainable Development Goals (SDGs) and green transition challenge demands that DFI financing is stepped up. When considering whether BII should benefit from further capital injection it is important to not only consider development impact but also how to optimise UK government support in maximising BIIs ability to finance acceleration of investments.

BII invests the capital it receives from UK government, earns a profit/return which is then reinvested. In the absence of new capital, this model allows for a steady level of annual investment to be maintained and a certain level of risk to be taken in its investment portfolio. If the UK government wants BII to materially increase this level of 'steady state' investment it must provide BII with new capital or BII must leverage its balance sheet (e.g., issue bonds).

New capital injections have enabled a significant increase in BII's investment capacity. For example, annual investment levels increased from £297 million in 2014 to £2 billion in 2021; and the investment portfolio has grown from £2.9 billion in 2014 to £8.1 billion in 2021. BII is now one of the largest European DFIs, similar in capacity to FMO.

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Since BII was established, the UK government has paid in £4.6 billion in equity capital, this capital has been invested and has generated £3 billion in return, all of which has been retained and has been reinvested to support the growth and development of countries in the global south, allowing the portfolio to grow significantly.

This investment also then mobilises additional private investment in the global south. For example, during the last strategy period 2017 to 2021 BII's investment mobilised £4.7 billion in private finance. There is a powerful financial multiplier effect at work (although ODI's recent research suggests that this multiplier effect could be larger).

Should BII receive new capital? We believe there is room to make better use of BII's capital, which should be explored in the first instance.

As noted in ODI's first submission[4] to this inquiry, fiscal pressures and ballooning SDG and green financing gaps mean there is an urgent need to explore whether there may be other ways to fund the much needed increase in BII's investment capacity.

As noted in our first submission and as raised by ODI in the oral evidence session on the 7th March, we believe that the UK

[4] Reference BII0086.

government and BII should explore the risks and opportunities of allowing BII to issue its own bonds in the capital markets. Our first submission discusses a number of potential benefits of funding BII in this way.

One question that was raised during the oral evidence session on 7th March was whether BII could borrow as cheaply as the UK government. This would need to be tested in the market but in theory we think that it could as it is very unlikely that BII would be rated on a stand-alone basis by the credit rating agencies. In all likelihood its rating would most likely be driven by a guarantee by the UK government (whether explicit or implicit[5]).

2. Development impact of BII portfolio

There is room to increase the development impact of BII's investments.

2.1 Geographical allocation

BII argues that its high deployment of equity capital (e.g., 68% in total of which 35% is direct and 33% is intermediated) and its focus on South Asia and Africa means its takes more risk than its peers but also delivers more development impact as a result. On paper this looks to be true, however, ODI's recent study questions whether the level of risk in BII's portfolio and, hence, development impact, is as high as it could be.

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An important aspect of this is that BII's portfolio has significant country concentration in the more developed economies in the global south (more formally defined as middle-income countries). India, a middle-income country which has experienced strong economic growth over the last decade and is increasingly taking a role on the global and political stage and who the UK sees as an equal partner (see ICAI India Country Review, 2023 for detailed discussions), alone accounts for 28% of BII's portfolio. Five more developed economies in these target regions account for a further 22% of BIIs total portfolio. This includes Nigeria, African's largest and most populated economy with significant oil and gas reserves, as well as Kenya, Egypt and Morocco.

While all of these countries do have significant pockets of poverty - often concentrated in marginalised areas, ethnic groups or by gender groups - they also have all achieved significant economic growth in recent years, raising the issue of whether they are worthy recipients of the majority of BII's investments. This is especially on a comparative basis because in many low-income countries, private sector investment is scarce and its absence is a significant constraint on economic growth. That means that BIIs relative impact in low-

5 An "almost certain" likelihood of extraordinary support from the UK government

income countries would potentially be higher than in middle-income countries.

Other publicly funded DFIs, such as Norfund ,have more challenging geographical investment targets. For example, 100 percent of Norfund's investment must be in low-income and lower-middle income countries, at least 33 percent must be invested in Least Developed Countrie; and at least 50 percent must be invested in Sub-Saharan Africa.

2.2 Financial services investments

Financial services compose 34 percent of BII's 2021 portfolio and 26 percent of its 2021 investment commitments. The sector is its' largest sector by portfolio and the second largest (after infrastructure) for 2021 commitments. As such the impact of these financial service investments are crucial to BII's overall impact and returns.

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In itself, this level of allocation is not necessarily an issue as there are significant benefits to investing through intermediaries (see previous submission[6]). However, there are important criticisms of BII's approach in the sector as follows:

BIIs largest investments are concentrated in large banking groups where financial additionality is not apparent and where beneficiaries are vaguely identified.

BIIs investments in large banking groups totals £457.5 million of the 2021 direct investment portfolio and compose over 30 percent of their 2021 direct investment commitments (these being identified as ABSA Bank (£123.0 million investment), Citibank SCF (£75.2 million investment), Equity Bank (£37.6 million investment), First Bank of Nigeria (£73.9 million investment) and Ecobank (£36.3 million investment).

These are large and broad-based financial services groups with pan-border business, broadly-based customers and a wide range of products and services. Most are also listed companies with access to capital markets. As such the case for financial additionality needs to be carefully-defined.

BII approach this by making these investments for specific purposes – mostly commonly trade finance, MSME finance and or climate

[6] Reference BII0086

finance. BII also commonly use risk-sharing approaches and coinvest with other DFIs.

However, financial additionality is not always apparent. For example, BIIs trade finance and supply-chain finance is to banks with established trade finance businesses (Citibank, ASBA and EcoBank) and there is limited evidence that pro-poor and incremental expansion (as opposed to risk reduction) has been catalysed by BII. BII have provided finance for climate projects for Equity Bank but this sector is already well-provided for by private investors in East Africa including Equity Bank themselves who has an established financing business in solar and other small-scale green projects meaning, again, that the financial additionality is not apparent.

Finally, as highlighted in the recent ICAI India Country Portfolio review, there have also been instances where funds have not been appropriately ring-fenced for the stated purposes but were used for general funding of banking groups and were not exited promptly after the initial case for financial additionality was rendered void by growth and public listing of investee companies.

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Further, beneficiaries can be poorly identified. For example, BII use assumptions (such that that beneficiaries are 'mass market' for Ecobank and ABSA Bank) or use proxies that do not differentiate between large- and small- firms (such as the total scale of facilities for Citibank SCF) despite small-firm finance being the stated investment case. Such vague approaches create concerns that the impact channels have not be sufficiently well-identified in BIIs theories of change.

BII continue to invest in microfinance despite substantial evidence that it delivers only small long-run impact for wages and consumption, has failed to deliver transformation impact on economic growth and only delivers short-term poverty alleviation under limited circumstances.

There is now a substantive body of evidence[7] that microfinance does not deliver its once-promised positive impacts for poverty alleviation and welfare impacts in low-income households.

Instead, at a broader macroeconomic level, while microfinance can have positive impacts on wages and consumption, the impacts are

[7] See for example: (1) Jing Cai, Muhammad Meki, Simon Quinn, Erica Field, Cynthia Kinnan, Jonathan Morduch, Jonathan de Quidt, and Farah Said, "Microfinance", VoxDevLit, 3(2), March, 2023; (2) The literature review in the ICAI UK aid to India report published in March 2023.

'small' over the long-term and it has no impact on economic transformation.

There are some exceptions such in the context of absent social protection (most common in some in low-income countries) or in grossly underfinanced sectors with strong links to poverty such as smallholder farming.

However, BIIs investments are not limited to such niche areas. For example, the large allocation to the microfinance sector in India given the well-developed financial services and microfinance sectors in India and its reasonably good public social protection programs.

This gives rise to the concern that BII is attracted to the microfinance sector because of its high returns, including from high interest rates charged to the poorest households, rather than development impacts.

A more focused approach on whether the end use of funds is reaching targeted sectors of importance to inclusive growth would be more effective. For example, this might include finance that is limited to the agricultural sector or MSMEs and a limited number of low-income countries – and then only in the circumstances of clear financial additionality.

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In addition, the impact of investment in financial services needs to be reassessed on a relative basis versus other sectors where development impact may be higher.

3. Gender

Gender lens investing (GLI) has grown rapidly in recent years and there is increasing interest amongst DFIs including BII to better understand and intentionally target their investment towards supporting women's economic empowerment and gender equality, as exemplified by the 2X Challenge.

BII has been an important champion amongst DFIs to advance this agenda. It was a cofounder of the 2X Challenge, a movement that has quickly gained and continues to gain momentum. BII has also led the launch of the 2X Collaborative, a new global industry body to promote (GLI). In 2021 28 per cent of BII's 2021 investments qualified as supporting women's economic empowerment and gender quality using 2X Challenge criteria[8]. Under its new strategy, BII has

[8] The 2X Challenge Working Group has developed five '2X criteria', which define what it means to invest in gender equality and women's empowerment. DFI investments qualify as 2X-aligned

set a target that 25 per cent of all its new investments must advance this agenda using 2X Challenge criteria.

However, little is publicly known about the actual impact of BII's investment in support of this agenda. BII in its annual review only reports one gender metric for its portfolio. In 2021 woman accounted for 28% of the direct jobs that were supported by BII's portfolio. However, BII will have assessed its investment according to the 2X challenge metrics so this data is available.

BII should publish the 2X Challenge assessment of its portfolio according to the five 2X Challenge criteria. It should be noted, however, that these 2X challenge criteria/metrics are 'static' metrics which are used to categorise and label investment. It will be important for BII to set goals and develop reporting that captures the marginal change effected by 2X Challenge-aligned investments to better capture progress along the five 2X Challenge criteria. For example, Swedfund has set itself the goal that at least 60 percent of Swedfund's investments should meet the 2X Challenge criteria within three years of the date of investment. **BII could also consider more ambitious targets to advance this agenda.**

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if they meet at least one of the five metrics in areas that cover entrepreneurship, leadership, employment, consumption and intermediated investment.