Centre for Policy Studies

Investing for Prosperity

How Britain can turbocharge its development finance ambitions

BY GARETH DAVIES MP

FOREWORD BY
THE RT HON ANDREW MITCHELL MP

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Foreword

In years to come, there is little doubt that British International Investment (BII), formerly CDC, will be seen as the UK's most visible and most effective commitment to international development.

One of the first acts of the Coalition government in 2010 was to pursue a root and branch reform of CDC, which as a 'fund of funds' (a one-club golfer on the golf course of international development), had rather lost its way.

We determined that it should be reformed from top to bottom and become a source of both Patient and Pioneer capital: Pioneer, because it would go where the private sector feared yet to tread; and Patient, because a financial return of less than the full commercial rate and of longer duration would be acceptable.

This matters because we understand that private sector investment creates jobs – whether in the rich or the poor world. Around the world, 90% of jobs are created by the private sector and not by governments. The private sector is the engine of development and not, as believed by too many on the left, the enemy of development. It is being economically active – having a job – that empowers and equips the poorest to lift themselves out of poverty.

And remarkably, it works!

BII is now widely seen as the best Development Finance Institution in the world. 100% owned by the British taxpayer, BII's investments have returned an average return of 6% each year since 2012.

BII now employs, directly or indirectly through its investments, almost 1 million workers, of whom nearly 30% are women. This is putting food on the plates of up to 1 million poor families.

Last year, tax of more than $4 billion was paid, which – at least in theory – boosted spending on public goods such as education and health in some of the poorest parts of the world.

In his excellent paper, Gareth Davies MP looks to the future – to how together with our allies, the UK can stand up for our values and contest the Chinese Belt and Road Initiative in vulnerable countries. As Gareth says, BII is providing what successful and determined countries want: an alternative to the 'thankless obligation' of aid. This is why BII will become even more critical as we move forward. It will be seen as the key British contributor to the eradication of the extremes of poverty which so disfigure our world, and which we, in our generation, have the power to defeat.

Rt Hon Andrew Mitchell
The Rt Hon Andrew Mitchell MP is Minister for Development

Introduction

There are many aspects of our Victorian heritage that are familiar. But one thing that few people know is that the wealth of 19th century Britain was founded not just on its own industry, or the colonies it controlled, but the fact that it was, by some considerable distance, the world's leading investor in the enterprise and infrastructure of other nations. Those investments not only created jobs and fostered growth in the places they were made, but in doing so provided substantial private and social returns for British citizens, from greater dividends to lower prices.[1]

The world is a very different place today. And the way that Britain engages with it has changed. We still trade with and invest in other nations. But we have also become a pioneer in development investment – deploying our capital and expertise to help create growth and opportunity in the places around the world that most urgently need it.

By investing in overseas development, the UK fulfils its **strategic responsibility** to enhance its security, by strengthening ties with our allies and mitigating the influence of our enemies.

By funding development through *investment* specifically, the UK exercises its **economic responsibility** to the British taxpayer, ensuring that our spending achieves optimal impact with minimal waste.

> **'Through its investment work, British International Investment has had a significant development impact – creating jobs, fostering economic growth, and improving livelihoods where it is needed most'**

In addition, investing in overseas development is a way for the UK to fulfil its moral responsibility, as one of the most developed and successful nations the world has ever known, to help our global neighbours overcome want and hardship.

Already, the UK has an excellent story to tell. Through British International Investment (BII) – the development finance institution formerly known as the Commonwealth Development Corporation (CDC), the UK has a tried and tested mechanism for deploying investment capital overseas. BII is already producing impressive results, and showcases the multiple policy goals which can be fulfilled by investing in international development.

Through its investment work, BII has had a significant development impact – creating jobs, fostering economic growth, and improving livelihoods where it is needed most. It has also been strategically significant – strengthening our ties with long-term partners such as India, and offering to others a welcome and reliable alternative to China's 'Belt

1 'Foreign investment, accumulation and Empire, 1860–1914', Michael Edelstein in *The Cambridge Economic History of Modern Britain*, pp. 190-226. Link

and Road' loans. Moreover, it has done all of this while consistently producing a return on investment for the British taxpayer.

This last point is worth emphasising. It reveals how an investment-led approach to our international development strategy can help quell the common criticisms about waste, accountability and impact that are so often directed at a grant-led approach to aid spending.

An investment-led approach limits waste because, instead of simply giving money away, it transforms every pound invested into an asset owned; it hardwires in accountability, as success is ultimately measured not by input but by outcome; and it guarantees impact by creating jobs, which is proven to be the surest and most sustainable route out of poverty.

The many benefits of investment as an instrument, development finance institutions as a concept, and BII as an organisation are outlined in greater detail below. But the real purpose of this paper is not to recite existing successes, but to consider how these advantages can be maximised – and more specifically, how BII can be scaled up.

This line of inquiry is particularly needed because, by its own admission, the tendency of BII towards ever higher-impact, higher-risk and lower-return investments is placing a ceiling on its scale. It is therefore vital to find ways to enable BII to continue to grow and increase its impact in absolute terms.

To that end, this paper offers three key recommendations:

Key recommendations

Unlock new sources of capital	BII should enable institutional investors and others to contribute towards its funds, capitalising on the recent rise to prominence of ESG investing.
Harness new financial instruments	'Unfunded risk', where insurance companies shoulder liability in order to reduce the cost and boost the volume of investment, has recently been deployed by the International Finance Corporation, the sister organisation to the World Bank. BII could do the same.
Expand the investable universe	BII should invest in high-return projects among our strategic allies around the world, using the returns to grow its high-impact investments in absolute terms.

This paper sets out both the 'why' and the 'how' of bolstering the UK's development finance work. In this, it builds on the excellent Development Strategy issued by the Foreign and Commonwealth Office in May 2022, which signalled the priority of investment-driven solutions to international development.

If we can get this right, the prize is great. We can shift both the perception and the reality of international development away from thankless obligation, and towards incredible opportunity for us here at home just as much as for those in developing countries.

Why we should scale UK Development Finance

The effectiveness of Development Finance Institutions

Development finance institutions (DFIs) are typically government-backed organisations, whose speciality and focus is investing in private sector projects in low- and middle-income countries. The goal is to promote job creation and sustainable economic growth.

Access to finance is a cornerstone of growth, in the developing world as in the developed. The difference is that finance is in much shorter supply in under-developed countries, primarily because the risks of investing are deemed too high by most commercial investors. Across the world, domestic credit worth an average of 129% of GDP is loaned to the private sector, but in Africa the figure is 46% and in South Asia it is 48%.[2]

To put in absolute terms, the UN agency UNCTAD estimates that there is a $4.3 trillion funding gap in sectors relevant to its Sustainable Development Goals, up from $2.5 trillion in the mid-2010s.[3] The causes of this trillion-dollar financing gap are legion: weak macroeconomic fundamentals, political instability, poor regulatory environments, lack of infrastructure, scarcity of skills, paucity of viable business models, lack of exit options, absence of track record, incompleteness of information, etc.

> **‘Across the world, domestic credit worth an average of 129% of GDP is loaned to the private sector, but in Africa the figure is 46% and in South Asia it is 48%’**

This is a tragedy – because successful investment holds great catalytic and transformative potential. The exemplary case study is the pioneering Desh Garments firm in Bangladesh, which received knowledge seeding from Korea’s Daewoo. It became the largest factory in Bangladesh before revolutionising the entire sector through imitation. Whereas there were only 300 factories in the country in 1980, today there are over 4,500.[4]

The spillover effects of a single successful industry are significant: in terms of job creation, disposable income, supply chain formation, tax revenue, infrastructure improvement, knowledge production, and subsequent investment. All of which reduces risk for future investors. However, by doing so it shows that there is a risk premium, and thus a further disincentive for pioneering investments.[5]

2 GOV.UK, ‘Capital increase to CDC, the UK’s development finance institution’ (2017), p. 12. Link

3 UNCTAD, ‘World Investment Report 2022’, p. v. Link; GOV.UK, ‘Capital increase to CDC, the UK’s development finance institution’ (2017), p. 9. Link

4 IGC, ‘Strengthening development finance in fragile contexts’ (2021), pp. 16-17. Link

5 Ibid, pp. 9-12

The need for DFIs, and their potential to provide 'additionality', is therefore transparent. It is they, as investors with a development mandate first and foremost, and with the credibility (both institutional and fiscal) that comes with central government backing, who can shoulder the burden of risk, pay the pioneering premium, and kickstart economic growth.

To further underline the point, consider the following statistics: a 1% increase in DFI investment in a given country translates to a 3.4% increase in labour productivity;[6] a 1% increase in the rate of capital accumulation translates to a 2% increase in the rate of poverty reduction;[7] and a doubling in the rate of investment translates to a 2% increase in the rate of GDP growth.[8] In fact, capital accumulation is a better predictor for poverty reduction than income distribution, commodity prices, quality of local institutions, or aid levels.[9]

The geopolitical and environmental importance of DFIs

Development finance has also increasingly intersected with the field of geopolitics – which speaks to the point above about their strategic role. This has been partly prompted by the expansion of China's 'Belt and Road' initiative, which has funded infrastructure projects across the developing world, hoping to bring more countries within Beijing's orbit.

As global order fragments into a more multipolar world, there has been a corresponding turn towards bilateral development finance to strengthen ties between countries. The UK's Integrated Review of Security, Defence, Development and Foreign Policy (2021) therefore included a commitment to a new Development Strategy which would 'ensure close alignment of UK aid from 2022 onwards with the objectives in this Strategic Framework'.[10]

> **'It is no wonder that DFIs are in the ascendant, and have become prominent among developed countries around the world – growing at an average annual rate of around 10%, with annual commitments growing globally from $10 billion to $70 billion between 2002-2014 alone'**

Not only that, but DFIs are also increasingly focused on the imperative of climate action, which of course brings its own further financing needs. Governments are recognising that DFIs can help mobilise more private capital to invest in renewable infrastructure to help in the energy transition. Indeed, the role of private finance for a green transition has been emphasised both in the UK Government's 'Net Zero Strategy'[11] and across the world, with the delivery of $100 billion in climate finance per annum at the heart of the COP26 and COP27 agenda.[12]

By investing in development – improving economic growth, employment, and productivity – DFIs are helping countries become more prosperous, more friendly and greener. It is therefore no wonder that DFIs are in the ascendant, and have become prominent among developed countries around the world – growing at an average

6 ODI, 'Impact of development finance institutions on sustainable development' (2019), p. 58. Link

7 BII, 'Investment and poverty reduction' (2021), p. 2. Link

8 GOV.UK, 'Capital increase to CDC, the UK's development finance institution' (2017), p. 9. Link

9 BII, 'Investment and poverty reduction' (2021), p. 4. Link

10 GOV.UK, 'Global Britain in a competitive age: The Integrated Review of Security, Defence, Development and Foreign Policy' (2021), p. 46. Link

11 GOV.UK, 'Net Zero Strategy: Build Back Greener' (2021), p. 10. Link

12 House of Commons Library, 'COP26: Delivering on $100 billion climate finance' (2021). Link

annual rate of around 10%,[13] with annual commitments growing globally from $10 to $70 billion between 2002-2014 alone.[14]

Clearly, DFIs are institutions that should command our attention and excite our ambition. Their mission is both noble and strategically significant: they fill a real financing gap and alleviate hardship, while also strengthening commercial and diplomatic relationships. And with the right focus, we can optimise and grow their impact still further.

The performance of British International Investment

The UK's own development finance institution, British International Investment (BII), has experienced an ascendancy of its own in the last decade.

Having received no capital injections from central government between 1995 and 2015, the last seven years have seen BII receive over £3 billion, as well as more than doubling the value of its assets.[15]

Just over 10 years ago – before its 2012 restructuring, driven by Andrew Mitchell during David Cameron's premiership – BII operated as a 'fund of funds'. Under the new system, the organisation expanded into direct equity and debt, and now 'may use any instrument which enables it to achieve the objectives set out in [its] Investment Policy'.[16] And whereas BII previously generated most of its returns from legacy holdings, the majority of its returns now come from newer investments.[17]

'Before Andrew Mitchell's reforms, BII had 80 members of staff and invested roughly £300 million a year. Today, it has more than 500 staff and invests roughly £1.5 billion on average. It now boasts £7.7 billion in total net assets'

This is, in other words, a great British success story – and one which the Conservative Party can be extremely proud of. Before the Mitchell reforms, BII had 80 members of staff and invested roughly £300 million a year. Today, it has more than 500 staff and invests roughly £1.5 billion on average. It now boasts £7.7 billion in total net assets.

Beyond those headline figures, BII has also ticked all the boxes for a DFI in terms of achieving a meaningful impact, advancing Britain's strategic goals, and delivering a return on investment for taxpayers.

When it comes to impact, it was estimated in 2017 that providing BII with £3.1 billion in capital funding would enable it to support 2.4 million additional jobs and deliver £5.8 billion of socioeconomic benefits over the next 25 years. That is an overall benefit/cost ratio of 2.21, even before indirect benefits are considered.[18]

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13 EDFI, 'About DFIs: Development Finance' (accessed 2022). Link

14 Centre for Global Development, 'Comparing Five Bilateral Development Finance Institutions and the IFC' (2018), p. 1. Link

15 CDC, 'Growing in ambition and impact: CDC Group plc Annual Review 2015' (2015), p. 11, Link. CAFOD 'CDC's energy investments: building just, green development?' (2020), p. 6. Link, FCDO, 'Annual Report & Accounts: 2020-21' (2021), p. 210. Link

16 BII, 'Investment Policy for the period from 1 January 2022 to 31 December 2026' (2022), p. 6. Link

17 BII, 'Rising to the challenge: Annual Accounts 2020 CDC Group plc' (2020), p. 10. Link

18 GOV.UK, 'Capital increase to CDC, the UK's development finance institution' (2017), p. 53. Link

If anything, however, those estimates were too pessimistic. In the last five years alone, BII has in fact invested £7 billion, mobilised a further £2.5 billion, supported nearly 1 million jobs, and generated £10 billion in local tax revenue.[19]

Strategically, BII has recently expanded its geographic remit to include the Caribbean and Indo-Pacific,[20] while the recent rebranding to 'British International Investment' (from Commonwealth Development Corporation) emphasises its status as a British bilateral entity.

BII is also part of the UK's Net Zero effort, with a new five-year strategy that includes a commitment 'to address the climate emergency by helping to transform economies to reduce greenhouse-gas emissions, protect the environment, increase climate resilience, and contribute to a greener, cleaner planet'.[21] Last year it committed £479 million in climate finance, up from £80 million in 2020.[22]

> **'In the last five years alone, BII has invested £7 billion, mobilised a further £2.5 billion, supported nearly 1 million jobs, and generated £10 billion in local tax revenue'**

The Government's Development Strategy, released in May 2022 by the Foreign, Commonwealth and Development Office (FCDO), highlighted BII as a key vehicle for delivering investment and reaching the target of ensuring that £8 billion of UK-backed development financing is available each year by 2025. Additional priorities were to advance gender equality and to tackle climate change. The Strategy also signalled a change in approach, with a shift towards doing more through bilateral programmes: the aim is that three quarters of FCDO funding will be spent bilaterally by 2025.[23]

Thus, as a bilateral investment institution, BII is not just an element of the UK Government's new strategy, but its embodiment. In fact, it may be considered a geopolitical pillar for the UK going forward.

How BII achieves impact while making returns for taxpayer

In short, BII delivers on Britain's strategic objectives in development and diplomacy. And it also delivers on the last remaining box to be ticked: fulfilling the economic responsibility which the government has to taxpayers.

Since the turn of the millennium, even as BII has evolved to take on additional responsibilities, it has consistently surpassed expectations. A Harvard Business School Report found that it had 'exceeded its internal and external investing benchmarks and successfully advanced its developmental goals'.[24] A National Audit Office study in 2016 found that it had exceeded its target for return on investment every year since 2012 while delivering strong development results.[25] Across 2012-21, BII's average portfolio return in pound sterling was 6.6%, well above its 3.5% target.[26]

19 BII, 'Foundations for the future: Annual Review 2021' (2022), p. 3. Link
20 BII, 'Productive, Sustainable and Inclusive Investment 2022 – 26 Strategy Summary' (2020), p. 3. Link
21 BII, 'Productive, Sustainable and Inclusive Investment 2022 – 26 Strategy Summary' (2020), p. 3. Link
22 BII, 'Foundations for the future: Annual Review 2021' (2022), p. 23. Link
23 FCDO, 'The UK Government's Strategy for International Development May 2022' (2022). Link
24 Harvard Business School, 'The Impact of Funds: An Evaluation of CDC 2004-12' (2015). Link
25 NAO, 'Department for International Development: investing through CDC' (2016), p. 7. Link
26 BII, 'Foundations for the future: Annual Review 2021' (2022), p. 9. The average return in US dollars was roughly 5%, despite sterling depreciation. Link

This performance is all the more impressive if you consider that BII has historically devoted a greater proportion of its investment to fragile states (41% of its commitments between 2012 and 2017, compared to a total portfolio exposure of 22% for the International Finance Corporation, the World Bank's sister DFI) and has done so primarily through equity (70% of its commitments in 2018, compared to the IFC's 24%) which carries a higher level of risk than debt.[27]

These results compare especially favourably to the UK's multilateral aid spending via organisations like the IFC and the World Bank. With little say over how our contributions are spent, the Government admits it is 'not possible to directly track the recipient (sector or country) of UK core multilateral funding', let alone outcomes.[28] More to the point, the OECD has observed a declining overlap between multilateral outflows and direct bilateral aid 'across all portfolio dimensions', meaning that multilateral contributions are failing to reinforce bilateral aid spend in line with strategic priorities.[29]

'Across 2012-21, BII's average portfolio return in pound sterling was 6.6%, well above its 3.5% target'

Of course, multilateral aid does have comparative advantage when it comes to neutrality, total capacity and reach. And clearly it has a role to play in specific circumstances, for instance as the best vehicle for humanitarian crisis response. However, if we want to get bang for the taxpayer's buck, then bilateral investment through BII should be the standard vehicle for UK aid spending, on account of its transparency, accountability and strategic efficiency.

Indeed, in stark contrast to the lack of clarity and control around multilateral aid spending, BII's annual report provides a detailed breakdown of its impact across its development goals: 54% of the firms supported were SMEs, 28% of the workforce were women, 55 TWh of energy was generated (37% of which was from renewable sources), 86,410 jobs were created in healthcare, 1.8 million learners were supported by education providers, and $82 was mobilised from the private sector for every $100 committed.[30]

No wonder, given this weight of evidence, that the Government has confidence in BII to make good on taxpayers' trust. In 2021, it agreed to the organisation's new five-year strategy, which sets out an intention to invest £1.5 billion to £2 billion each year, expands its climate remit via a commitment to devoting 30% of new investments to climate finance, and – as already mentioned – expands its geographic remit to new include the Caribbean and Indo-Pacific regions.[31] The question addressed in the next section is whether there is still more we can or should do to amplify BII's reach and impact.

27 GOV.UK, 'Capital increase to CDC, the UK's development finance institution' (2017), p. 54. Link, Centre for Global Development, 'Comparing Five Bilateral Development Finance Institutions and the IFC' (2018), p. 6. Link

28 FCDO, 'Statistics on International Development: final UK aid spend 2020' (2022). Link

29 OECD, 'Comparing multilateral and bilateral aid: A portfolio similarity analysis' (2022), p. 11. Link

30 BII, 'Foundations for the future: Annual Review 2021' (2022), pp. 35-38. Link

31 BII, 'Enlarged remit announced for the UK's development finance institution to deliver jobs and clean growth' (2021). Link

How we can turbocharge the impact of our overseas investment

The ceiling on BII's scale

BII's record of delivering development impact is beyond doubt. And the next few years hold much promise. But there is a question mark over how BII will continue to grow and scale its impact further into the future. This conundrum is brought into sharp focus by the business case for the organisation's capital increase in 2017.[32]

The 2017 business case makes clear that, as you would expect given the trillion-dollar finance gap previously mentioned, demand is not a limiting factor: 'Market demand exceeds what CDC [now BII] could deliver with a commitment pace of $1.6 billion and the need for capital taking higher risk to address economic development challenges is great.'

On the other hand, when it comes to the supply of capital, the business case outlines a clear trade-off between level of impact and return on investment. This is because the investment propositions which promise the greatest impact also present the greatest risk: they tend to be bolder projects in poorer countries, with weaker legal and financial institutions.

> **'Market demand exceeds what CDC [now BII] could deliver with a commitment pace of $1.6 billion and the need for capital taking higher risk to address economic development challenges is great'**

The impact of shifting to higher-risk projects, in the least developed countries, is that 'average portfolio returns are projected to fall over the coming 5 year period, as CDC... continues the shift introduced in 2012 towards an exclusive focus on more risky markets in Africa and South Asia'.

The impact of that shift is further shown by the business case's consideration of a scaled-up higher risk investment strategy, in which $300 million is allocated annually to fill a financing gap in areas not risky enough for grant funding but too risky for normal DFI investment. The trade-off is again transparent here: the business case proposes a corresponding decrease in the commercial return required on BII's investments to a minimum of 3.5%, and provides a looser obligation to remain profitable at an institutional level on a 10-year rolling average. Return expectations have since been lowered even further, with BII's 2022 investment policy requiring a 'weighted cumulative investment return of at least 2%'.[33]

32 GOV.UK, 'Capital increase to CDC, the UK's development finance institution' (2017). Link

33 BII, 'Investment Policy for the period from 1 January 2022 to 31 December 2026' (2022), p. 9. Link

The logical end-point of this trajectory is for BII to recycle a fixed amount of capital, relying on external capital injections to scale-up. Indeed, this point has arguably now been reached. BII's 2022 strategy summary explains that 'any financial return from our investments is recycled into new investments for future impact' and that 'in steady state, this is a model that can continue indefinitely without the need for any new capital'. But it also concedes that 'during periods when we aspire to step up activity, as we will be doing in 2022-26, we will require some new core capital' – because it will not be generating enough from these higher-risk projects.[34]

Raising the roof of BII's impact

Given the scale of the global need for development finance, and the scale of the UK's ambition for BII, we need it to be firing on all cylinders. Yet there is a real risk that the momentum of the last decade might stall in the next. As BII invests more in higher-impact, higher-risk but lower-reward propositions, its expected return on investment is correspondingly reduced. It will still be doing good and worthy work. But it will be generating less additional capital to expand its operations and meet the huge global need for development finance.

> **'It is estimated that only 30% of impact investment assets are focused on emerging markets, due to the perceived risks and the need for considerable groundwork to make projects 'bankable'. Tellingly, 'no funds reported exposure to infrastructure investments in Africa' in 2019'**

As we have seen, on its current model, without capital injections from the central government, BII can only operate in a 'steady state': merely recycling a fixed amount of capital, rather than growing organically. Such is the vulnerability inherent in BII's existing structure.

We should urgently seek to prevent a situation arising where BII's scale is determined by any consideration other than the needs it can meet and the opportunities it can seize.

Accordingly, the key question we should seek to answer is how to lift this ceiling on BII's scale.

On that front, this paper has three key recommendations that would enable BII to scale to meet more of the huge and ongoing demand for development.

First, that alternative sources of investment into BII should be sought. Second, that new financial instruments should be harnessed by BII. Third, that the investable universe of BII should be expanded further.

1) Unlocking investment into BII

According to BII's most recent Annual Statement, any new equity is exclusively derived from the issuance of 'ordinary shares' purchased by the Government.[35] So, to repeat the central point of the previous section, BII has no capital to invest except that which the Government gives it, or the (diminishing) returns it makes on its prior investments.

34 BII, 'Productive, Sustainable and Inclusive Investment 2022 – 26 Strategy Summary' (2020), p. 17. Link
35 BII, 'Foundations for the Future: Annual Accounts 2021' (2022), p. 98. Link

Interestingly, the UK Government's Development Strategy and BII's 2022 Investment Policy both signal, in the words of the latter, an intent to 'consider the mobilisation of additional funding… in particular seeking co-investment from aligned global partners such as sovereign wealth funds and UK investors'.[36]

This is welcome, particularly in view of the £6.1 trillion wealth of UK pension funds, and the increasing emphasis placed by said funds on ESG investing (i.e. investment that aligns with Environmental, Social and Governance goods).[37] Indeed, it could even be said that there is an over-supply of impact investment available from such funds: the IFC estimates that only a quarter of assets with an intent for impact are matched with processes to manage and measure that impact[38] – processes which are clearly well established at BII.

'There are several possible vehicles for private institutional investors to buy in to BII so that its returns not only accrue to British taxpayers, but also British pensioners and savers'

Furthermore, it is estimated that only 30% of impact investment assets are focused on emerging markets, due to the perceived risks and the need for considerable groundwork to make projects 'bankable'. Tellingly, 'no funds reported exposure to infrastructure investments in Africa' in 2019.[39] Given that risk absorption and groundwork are key to the *raison d'etre and modus operandi* of BII, it seems that there is a clear role for it to play, at least in principle, as a conduit for the release of funds' blocked-up impact investments.

In practice, there are several possible vehicles for private institutional investors to buy in to BII so that its returns not only accrue to British taxpayers, but also British pensioners and savers. They include:

- **Fund management** – this is exemplified by FMO (the Dutch equivalent of BII), which has set up an investment management company to 'offer institutional investors access to its expertise in responsible emerging markets investing'. Of the €2.8 billion of private investment directly mobilised by FMO as a whole in 2021, €1.6 billion was mobilised through its FMO Investment Management (FMO IM) subsidiary.[40]

  It should be noted that funds configured to attract commercial investors often do not have the same shape as a DFI's overall portfolio. For example, FMO IM raised almost $400 million from investors for its 'Emerging Markets Loans Fund I' on the basis that it offered the following:

  a) a better return through a relatively high illiquidity premium

  b) protection against rate sensitivity via variable interest rates

  c) the advantages of broad portfolio diversification

  d) full integration of ESG in all parts of the process[41]

36 FCDO, 'The UK Government's Strategy for International Development May 2022' (2022), p. 8. Link, St BII, 'Investment Policy for the period from 1 January 2022 to 31 December 2026' (2022), p. 6. Link

37 SMF, 'The case for extending automatic pension enrolment to young workers' (2022), p. 7. Link

38 IFC, 'Mobilization of private finance' (2021), p. 29. Link

39 Ibid, p. 26

40 FMO, Annual Report 2021 (2021), p. 60. Link

41 FMO, 'NN FMO Emerging Markets Loans Fund' (accessed 2022). Link

- **Bond issuance** – in 2020, FMO issued €500 million in bonds which attracted €1 billion in demand within 50 minutes. Net proceeds were allocated either to 'eligible' green projects or social projects – that is, projects with a focus on climate or inclusivity, or based in Least Developed Countries (LDCs).[42] Bonds constituted 31% of FMO's funding portfolio in 2021.[43] Investor appetite for similar 'sustainability bonds' in the UK has already been demonstrated with £16 billion raised across two Treasury green bond issuances in the last year, with the tranches 10 and 12 times over-subscribed respectively.[44] BII bonds could either be issued with a government guarantee to ensure attractive rates, as in FMO's case,[45] or even possibly on BII's own terms as standalone ratings.

- **Create a British Development Bank** – I have written elsewhere about how a British Development Bank (BDB), bringing together the UK's SME, infrastructure and overseas development finance organisations, would command investor confidence and could issue bonds to fund new operations. A reasonable expectation is that a BDB would have a mobilisation rate of four, in other words that every £4 billion invested could generate £16 billion in total finance. Before reinvestment, £16 billion implies a long-run 0.2% increase in national GDP and £4bn in output. In addition to the capacity to self-finance, other potential benefits of a BDB include removing impact investments from the Government's balance sheet, and economies of scope and scale.[46] Conglomeration could see BII benefit not only from those economies, but also from the cross-pollination of experience and expertise, and from the broader strategic focus that comes with a joined-up operation.

> **'It is worth considering whether BII's investable universe should be expanded to include more high-return positions – the proceeds of which could fund additional high-risk, high-impact investments'**

2) Harnessing new investment instruments

BII is permitted to 'use any instrument which enables it to achieve the objectives set out in [its] Investment Policy'. This includes, but is not limited to, equity, debt, guarantees, grants, project preparation companies, funds, facilities and technical assistance.[47] However, in practice, BII only utilises a limited range of instruments heavily, and most of those listed above remain unused altogether.

As the UK Government seeks to free up insurance industry investment in the domestic economy via reform of Solvency II, there may also be an analogue in the world of international development finance: unfunded risk.

In effect, unfunded risk allows investment from commercial insurance to be channelled indirectly by DFIs. It involves the DFI making a loan from its own account but then transferring a portion of the risk capital to the insurer through its guarantee on that finance. This ultimately allows the DFI's finite risk capital to go further.

42 FMO, 'FMO successfully issues EUR 500 million 7-Year Sustainability Bond' (2020). Link

43 FMO, Annual Report 2021 (2021), p. 69. Link

44 GOV.UK, 'UK's first Green Gilt raises £10 billion for green projects' (2021). Link. GOV.UK, 'Second UK Green Gilt raises further £6 billion for green projects' (2021). Link

45 FMO, 'Investor Relations' (accessed 2022). Link

46 Onward, 'The case for a British Development Bank' (2020). Link

47 BII, 'Investment Policy for the period from 1 January 2022 to 31 December 2026' (2022), p. 6. Link

An added benefit is that, since this enables larger loans to be made, borrowers may be able to meet their entire financing need more efficiently – saving time and reducing costs. Moreover, insurers have shown considerable appetite for emerging-market financial risks, which are often uncorrelated with those they more typically might cover.

In 2019, unfunded risk made up 10% of the IFC's risk transfers, having risen from a negligible amount in 2016. In 2017, the IFC leveraged $1 billion of risk appetite from two insurers to lend $2.4 billion to 30 banks across 17 countries. This presaged the 2020 'Managed Co-Lending Portfolio Program', which allowed the IFC to support $5 billion of lending to both bank and non-bank financial institutions, with $2 billion in risk appetite provided by six insurers.[48]

Demonstrably, there is untapped potential here for BII to enable its loans to go further, both by reducing the cost of borrowing for those in receipt, and by reducing the cost of lending for itself.

3) Expanding BII's investable universe

Finally, it is worth considering whether BII's investable universe should be expanded to include more high-return positions – the proceeds of which could fund additional high-risk, high-impact investments.

> **'BII has already taken a step in the right direction with its geographic expansion to the Indo-Pacific. More expansion along these lines should be sought'**

To be clear, this is not advocating a redistribution of BII's portfolio away from areas of pressing need. Rather, it would be a way for BII's investment in those areas to increase in absolute terms. It would be hugely self-indulgent to congratulate ourselves for devoting a higher proportion of our investment to fragile states, when we could be investing a larger absolute amount in those countries, facilitated by returns elsewhere. For the businesses and entrepreneurs in the developing world who are trapped in that trillion-dollar financing gap, their concern is not for the precise balance of BII's portfolio, but whether they can get the investment they need or not.

BII has already taken a step in the right direction with its geographic expansion to the Indo-Pacific, which its five-year strategy acknowledges encompasses the 'the larger economies of the Philippines, Indonesia and the Mekong region'.[49]

More expansion along these lines – in larger economies, with larger returns on offer – should be sought, especially when those investments are in countries that are our strategic allies and in geopolitically significant locations. The US's OPIC (now DFC) committed $300 million to Israel between 2012-18,[50] and our Israeli allies could be a great place to start.

48 IFC, 'Mobilization of private finance' (2021), p. 14, 34. Link

49 BII, 'Productive, Sustainable and Inclusive Investment 2022-26 Strategy Summary' (2022), p. 3 Link

50 Centre for Global Development, 'Comparing Five Bilateral Development Finance Institutions and the IFC' (2018), p. 15. Link

Conclusion

Development finance institutions in general and British International Investment in particular have seen remarkable success in recent years both in delivering development impact and achieving financial returns. It is no wonder that these institutions have gone from strength to strength.

What is more surprising, however, is how little we talk about this phenomenon, and how rarely we consider the advancement of international development in terms of investment.

My hope is that this paper has gone some way towards rectifying this, so that the policy conversation can focus more on shared opportunities – and Britain's role as a world-leading investor in international development – rather than begrudging handouts.

> **‘Given the strategic, economic, and moral responsibilities which BII fulfils for us all, our responsibility is to fulfil BII's incredible potential’**

I also hope this paper has alerted readers to the risk that this progress could stall, as return on investment takes a back seat and impact in the abstract drives the agenda. When the rubber hits the road, this only leads to a dead end.

Given the strategic, economic, and moral responsibilities which BII fulfils for us all – advancing development and enhancing diplomacy, while delivering excellent value for the taxpayer – our responsibility is to fulfil BII's incredible potential. We can do this by unblocking private investment into BII, harnessing new investment instruments, and expanding BII's investable universe.

If we can get this right, the prize is great: Britain can reclaim its historic status as one of the world's leading international investors, and realise all the global good that comes with it.

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