British International Investment

# Driving mobilisation

## Discussion Paper

**Published:** August 2023

**Authors:**
Wasim Tahir, Director, Mobilisation Strategy and
Matt Robinson, Head of Group Strategy & Development,
British International Investment

## Introduction

Commercial banks aim to maximise the financial return on their shareholders' capital. This aim shapes their funding and business models in two important ways. First, they leverage their shareholder equity with debt, which allows them to increase the total value of assets they hold. Second, they systematically rotate their assets, by shifting more mature investments off their balance sheets and freeing-up risk capital for newer investments, thus earning distribution and origination fees more frequently.

Development finance institutions (DFIs) do less of both. This difference may seem to be explained by DFIs' defining goals. They are not profit-maximisers. Rather, they aim to promote economic development in the countries they cover.

Nevertheless, DFIs would do well to consider any lessons from commercial banks' business models. As with commercial banks, DFIs should aim to make the most of their financial and human resources. Their development goal should be observed in a higher risk appetite and effective investee support, not in the under-utilisation of equity and people. DFIs might better achieve their development goals by moving some way towards the commercial banking model: that is, by optimising balance sheet leverage and by shifting from a buy-and-hold investment model towards an originate-to-share model.

Both are ways of mobilising commercial capital. Leverage draws commercial capital into DFIs, increasing the quantum of investments that can be funded. Originate-to-share draws commercial capital into the investments that DFIs originate and allows their capital to be recycled more frequently.

This paper describes these two ways of mobilising commercial capital – the techniques involved, and the new capabilities and organisational structures that might be required.

## Contents

**Introduction** 2

1 **Leverage** 3

2 **Originate-to-share** 4

3 **Requirements of the transition** 7

This report is authored by our Director of Mobilisation Strategy, Wasim Tahir, and our Head of Group Strategy and Development, Matt Robinson. The report contains their personal views and do not necessarily represent the views of British International Investment.

For questions please contact:
Matt Robinson,
**mrobinson@bii.co.uk**
Wasim Tahir
**wtahir@bii.co.uk**

# 01

## Leverage

DFIs are not commercial banks and cannot therefore take deposits. Nevertheless, they can borrow if their shareholders allow. By doing so, they can increase the funds they have available to invest in developing economies.

We are not talking about DFIs gearing themselves up to the hilt. The (nominal or non-risk-weighted) leverage ratio of emerging market banks ranges from 10-15x. By contrast, FMO of the Netherlands, which is among the most leveraged of DFIs, has a leverage ratio of less than 5x. BII currently has no leverage at all, but if it tried to match its existing debt assets (held via its investment portfolio) with new debt liabilities (in the form of new borrowings), it would imply a leverage ratio of about 0.3x. Such a level of leverage may seem modest, but in absolute terms it would be equivalent to several billion dollars of additional funding.[1]

DFIs can also package their debt in ways that contribute to the development of impactful capital markets. By issuing "impact bonds" or "sustainable bonds", for example, they can offer investors something that ordinary government bonds do not. And by issuing high-rated bonds in the currencies of the countries where they invest, DFIs improve liquidity in those countries' debt markets. Thus, in the process of increasing their own funding, DFIs can help to reduce the illiquidity that deters commercial investors from incurring local currency exposures.

Leverage also means that additional equity capital has an outsized effect on the investible funds of DFIs. For example, with (nominal or non-risk weighted) leverage of 1:1 each dollar of additional equity allows $2 of investment. DFIs typically get additional equity capital from their shareholder governments, of course; often as part of the budget for official development assistance (ODA). But they can also get it from the private sector. For example, 45 per cent of the equity of FMO, the Netherlands DFI, comes from private investors.

Privately supplied equity capital could bring benefits besides the addition to funding. It could bring private sector expertise onto DFI boards and involve a greater degree of emerging market risk discovery. However, thought would be needed on whether the interests of governmental and private owners can be aligned. Governments invest in DFIs not for the purpose of earning a profit on taxpayers' funds but of promoting economic development in poor countries. So, they have lower target return on equity than a commercial investor. For example, BII seeks a rate of return consistent with preserving the UK government's equity capital over the long run.

Competing shareholder interests could cause tension over investment strategy and risk appetite. One structuring solution might be to give private owners preference shares that lack voting rights. Another might be to look for a more impact-orientated private shareholders who are prepared to share the government's target return on equity in return for pursuit of development goals.

1 For further exploration of the leverage question, please also see our colleague Paddy Carter's blog at https://www.bii.co.uk/en/news-insight/research/should-dfis-leverage-their-balance-sheets

# 02

## Originate-to-share

BII has been investing in emerging markets since 1948. Other DFIs have also been operating for decades. Over this period, DFIs have developed extensive networks across emerging markets, reaching into their financial and business sectors and working closely with their governments. And DFIs have developed deep expertise in the special challenges associated with investing in these economies. DFIs are thus well positioned to originate investment opportunities in many developing economies; sometimes more so than commercial players. This explains why DFIs are often lead investors, drawing commercial funds in behind their own investment activity.

As markets mature – hopefully in part due to DFI's contributions – they become better able to attract purely commercial investment. DFIs can then refocus their efforts on those markets that remain relatively unattractive to commercial investors. Or, to put it another way, DFI capital can move back down the "mobilisation escalator" (see Figure 1) to invest where capital and expertise can do the most good.

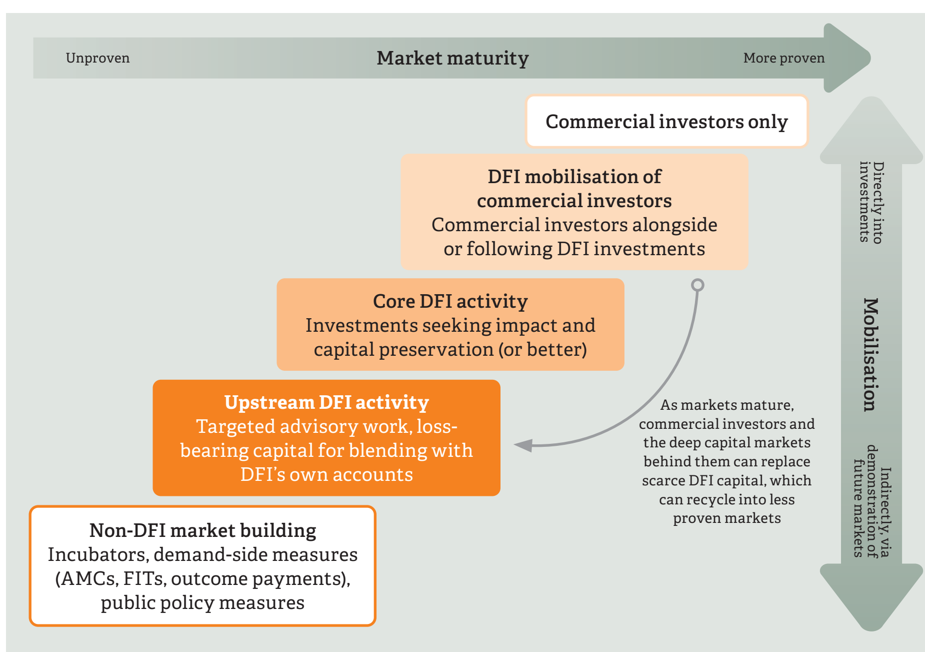


*Figure 1: The mobilisation escalator*

But the buy-and-hold model typical of DFIs can mean they fail to make the most of their advantages. Risk capital is tied up in an investment until its maturity (whatever that amounts to in each case) and origination capabilities are under-utilised for lack of capital to deploy. Adopting an originate-to-share model, whereby exposures are distributed to commercial investors more rapidly, would allow DFIs to recycle capital sooner and increase the deal flow through origination teams. It would speed up the mobilisation escalator.

The "share" in "originate-to-share" can be achieved in several ways, all familiar from investment banking, though less tried-and-tested in the case of most bilateral DFIs. The least demanding on the current capabilities of DFIs involve sharing exposure to single investments.

**Single exposures**

A relatively simple way for a DFI to release its capital from an investment is to sell some of it. For example, DFI loans can be sold in the secondary market, particularly when the underlying project or business has passed its early stages and presents a clearer credit risk (such as once an infrastructure construction phase is passed and the project begins operations). Equity investments can also be sold, as long as the necessary rights to exit have been negotiated as part of the original investment. Regular 'fit-to-sell' analyses across DFI investment portfolios can help ensure investments are not held longer than necessary to fulfil their intended development impact.

The goal of freeing up DFI capital is also effectively achieved if commercial capital is drawn in from the start. For example, DFIs can play the role of lead arranger in a loan syndication. The DFI negotiates the pricing and other terms of the loan but contributes only a fraction of the funding, with the bulk of it provided by other lenders who rely on the expertise of the DFI. The same in theory also be attempted with equity investments (although in practise, this is far rarer). A DFI originates the investment, arranges the terms of equity, retains day-to-day management of the investment and associated rights, but takes only a portion of the economic interest, with the rest shared with commercial investors following the lead of the DFI.

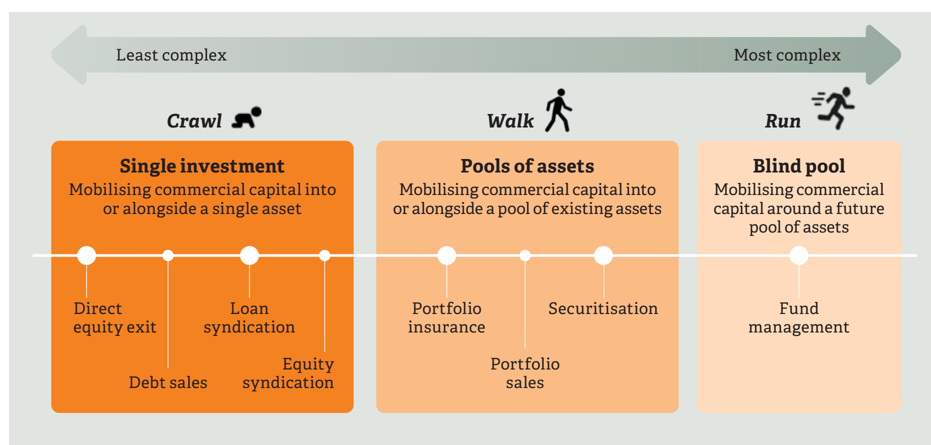


*Figure 2: Originate-to-share: simple to sophisticated*

## Pools of assets

At any point in time, a DFI will have a portfolio of emerging market assets. Besides offloading individual exposures, it can take measures that release capital tied up by pools of assets. One is insurance. A policy that covers a DFI's credit losses from a pool of assets transfers the risk to the balance sheet of the insurer. It thereby frees up a DFI that was constrained against particular risk limits to make more investment. The capital of the insurer has effectively been mobilised into the DFI's investments.

Securitisation is another familiar technique that could remove pools of assets from a DFI balance sheet. The DFI issues securities whose value varies with the returns on a specified pool of assets held by the DFI. Risk is transferred to investors in the securities, who suffer any losses on the underlying pool of assets. The DFI's risk capital is thereby liberated to support new investments.

In theory, the process can be repeated indefinitely, significantly loosening the capital constraint on a DFI's ability to originate investments in developing economies. The major constraint is investor appetite for the securities. DFI asset have some positive attributes in this regard. Their distinctive assets can be bundled around features that could make their securities marketable to ESG investors, especially to funds whose business models or mandates mean they cannot take on relatively small individual exposures. Securitisation thus could be a way of extracting more value from the expertise that DFIs have developed in the appraisal of projects and enterprises for their environmental and social implications.

**Investment management**
In the above examples, DFIs transfer the risk of well-defined pools of assets. However, DFIs could also attract commercial capital into a "blind pool" of assets, unknown in advance. A DFI would propose and agree an investment strategy with co-investors, and then originate and manage investments against that strategy. Investment decision making could either be joint and asset-by-asset, or fully delegated to the DFI. Variants of this model have been successfully developed by some of the Scandinavian DFIs.

These three ways of "sharing" assets – on a single asset basis, across a known pool of assets and/or managing a blind pool – all entail an expansion of the secondary market for development finance. This will be made easier if transaction costs can be reduced by way of standardisation. Commercial investors will be more likely to participate if they can become familiar with common approaches to assessing and scoring the credit quality and ESG risk. The Equator Principles, based on IFC's ESG performance standards, are a step in this direction. Standardised legal documentation will also encourage participation. Again, IFC is leading the way by creating Master Cooperation Agreements with other financial institutions, including fellow DFI and MDBs. As the secondary market grows, we would expect independent firms to begin offering information and legal services that increase transparency and certainty and, thereby, reduce transaction costs.

# 03

## Requirements of the transition

Transitioning from a buy-to-hold model to an originate to share model, possibly with added leverage, requires significant transformation. It would require DFIs to acquire or develop new skills, as would the less demanding ways of transferring exposures to commercial investors. Specifically, adopting an originate-to-share model will require DFIs to beef up their risk management capabilities. The model exposes DFIs to market, counterparty, operational and reputational risks to a much greater extent than the buy-and-hold model. It also demands portfolio management and financial engineering skills that are not currently in abundance, and it needs people who can effectively market new offerings to commercial investors.

Obtaining these skills will require training, recruitment and organisational reorganisation. The right people need to be in the right places, reporting to managers who understand and support their activities. They will either need incentives akin to those of their counterparts in commercial enterprises (where they could otherwise work) and/or a deeper cadre of investors and distributors who value the developmental goals they are enabling will need to emerge.

These are the internal changes. The transformation will also require DFIs to engage with external stakeholders. The new activities will require compliance with domestic and international regulations covering capital markets (especially securities issuance), investment management, and risk-sharing. Ensuring compliance, and the investor confidence that comes with it, are likely to require additions to the in-house legal, compliance and operational staff.

Perhaps more importantly, they will need to secure the backing of their governmental owners. Governments provide DFIs with capital, initially sourced from taxpayers, for the sake of promoting economic growth in poor countries. DFIs seeking to make the transformation set out above must show their governments that it advances this cause, with manageable downsides.

For there will be downsides. Shareholder governments will have to accept some dilution of control. Most obviously this would come with new private shareholders and, to a lesser extent, introducing DFI creditors. But it also is implied by some of the originate-to-share activities, to the extent they introduce client and regulatory responsibilities.

There may also be a temporary hit to DFI performance. The transformation will be disruptive. It will require staffing and cultural changes that will inevitably cause complaint. And much of the cost will be incurred before the increased investment and mobilisation of commercial capital are achieved. In the quasi-governmental environment of DFIs, it could be all too easy to decide that it isn't worth the trouble, particularly if there is not sufficient ambition about the scale of future mobilisation.

That could be a mistake. The combination of leveraging DFI's government-supplied equity capital and rapidly recycling it could significantly increase the investment that DFIs can initiate. For anyone committed to the purpose of DFIs, the transformation is well worth considering.

## For further information:


- **British International Investment**

  Matt Robinson
  mrobinson@bii.co.uk
  Wasim Tahir
  wtahir@bii.co.uk
  bii.co.uk/insight