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**DEVELOPMENT CO-OPERATION DIRECTORATE**

## **The funding models of bilateral Development Finance Institutions**

### **A comparative analysis of Proparco, FMO and British International Investments**

Development Finance Institutions (DFIs) are critical in supporting sustainable development. To date, there has been a limited level of analysis focused on their funding models.

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# Abstract

Development Finance Institutions (DFIs) are critical in supporting sustainable development. To date, there has been a limited level of analysis focused on their funding models.

Key messages from this paper:

- DFI funding models have material implications, whether they be linked to the instruments DFIs utilise to finance sustainable development, or to their ability to mobilise capital markets in support thereof.
- Issuing bonds, including Green, Social and Sustainability (GSS) bonds, allows DFIs to leverage balance sheets through the mobilisation of private capital, offering investors access to the unique expertise of DFIs through familiar instruments.
- There are advantages to diverging funding models, and risks associated with a uniform approach. Should they make use of the most appropriate funding model to take on specific and complementary segments of the demand for funding, individual DFIs would stand to add the benefits of specialisation to those of a complete product offering at the sector level.

# Foreword

This study investigates and compares the funding models of three of the 17 main bilateral development finance institutions (DFIs). Its objective is to encourage conversation around their respective merits and demerits, to help stakeholders make informed decisions regarding the DFI's balance sheet options and the use of debt capital markets-based leverage.

This paper has been prepared as an input to the discussion on Mobilisation in the OECD Development Assistance Committee Community of Practice on Private Finance for Sustainable Development (CoP-PF4SD).

This paper was written by Thomas Venon (Centre for Development Finance Studies), Wuraoala Okuwobi (Centre for Development Finance Studies), Dave Portmann (Centre for Development Finance Studies) and Paul Horrocks (OECD). It was informed by a series of interviews with relevant stakeholders, with specific thanks to Matt Robinson (BII), Paddy Carter (BII), Arthur Leijgraaff (FMO), Nic Wessemius (FMO), Jérémie Ceyrac (Proparco) and Frédérique Masi (Proparco), and benefitted from input, feedback, or reviews by Pilar Garrido (OECD) and Haje Schütte (OECD). The paper was reviewed by Santhosh Persaud (OECD) and Christian Novak (Professor of Practice, McGill University). The paper was revised and structured effectively by Rebecca Lowe (OECD). The paper's structure and content benefitted significantly from input and advice from Henri-Bernard Solignac-Lecomte (OECD).

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# Abbreviations and acronyms

ADB	Asian Development Bank
AFD	Agence Française de Développement
AfDB	African Development Bank
AIIB	Asian Infrastructure Investment Bank
ALM	Assets & Liabilities Management
AUD	Australian Dollars
BII	British International Investment
B/S	Balance sheet
CAF	Corporacion Andino de Fomento (Development Bank of Latin America)
CAGR	Compound annual growth rate
CDFS	Centre for Development Finance Studies
CET1	Common Equity Tier 1 capital
COE	Council of Europe Development Bank
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
DFI	Development Finance Institute
EBRD	European Bank for Reconstruction and Development
ECL	Expected credit loss
ESG	Environmental, social and governance
EUR	Euro
FCDO	Foreign, Commonwealth and Development Office

FMO	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.
GBP	Great British Pound
GSS	Green, social and sustainability
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IFRS9	International Financial Reporting Standard 9
JPY	Japanese Yen
LCY	Local currency
MASSIF	Micro and Small Enterprise Fund
MDB	Multilateral development bank
ODA	Official development assistance
ODI	Overseas Development Institute
PTI	Pre-tax income
RAROC	Risk-adjusted return on capital
SBF	Sustainability Bonds Framework
SDC	Sustainable Development Certificate
SDGs	Sustainable Development Goals
SEK	Swedish Krona
S&P	Standard and Poor
TCX	The Currency Exchange Fund
USD	US Dollars

# Executive summary

The purpose of this study is to contrast the funding models of three otherwise comparably sized development finance institutions (DFIs) to develop an understanding of the implications of their respective ability and incentives to deliver on their mission, optimise their balance sheets and mobilise private capital, and ultimately what it could mean for development. As the winds of reform tentatively blow over multilateral development banks (MDBs), and stakeholders interrogate capital adequacy frameworks and their implications for funding models and mobilisation, it is opportune to bring bilateral DFIs into the conversation. Whilst MDBs have adopted a relatively consistent funding model, national DFIs have, perhaps unsurprisingly, developed diverging approaches.

Based on an analysis of publicly available financial information, this study provides a comparative overview of the funding models of three of the largest European bilateral DFIs: France's Proparco, the Netherlands' Financierings-Maatschappij voor Ontwikkelingslanden (FMO) and the United Kingdom's British International Investment (BII). Whilst they are of comparable size, their funding models differ significantly.

BII is entirely equity funded and has in the United Kingdom Government's Foreign, Commonwealth and Development Office (FCDO) a single shareholder. This makes for the simplest of the analysed funding models and theoretically for the highest observed level of flexibility, whether it be in terms of risk or investment tenor. Being entirely equity funded does however limit the growth paths available to BII, and both its ability and incentives to mobilise private capital.

FMO is in contrast only 51% owned by the government of the Netherlands, and issues debt directly on capital markets. It does so on the back of a AAA credit rating reinforced by the explicit support built into its agreement with the government. This allows FMO to forge its own growth path and, combined with retained earnings, debt issuance will be a key driver of its ambitious 2030 strategy that should see its footprint exceed EUR 20 billion. As financial institutions go however, FMO is a modest-sized actor, and the lack of economies of scale, whether it be in its capital markets operations or its currency exposure management, is a limiting factor. The fact remains that FMO has demonstrated some leadership in the field of risk sharing and off-balance sheet fund management.

Proparco's destinies, and along with them its funding model, are intrinsically linked to its parent Agence Française de Développement (AFD), which not only holds almost 80% of its equity, but provides it with 100% of its debt. This is done according to a matching loans system that insulates Proparco from a significant proportion of the risk derived from its lending operations. Whilst this allows Proparco to operate with superior efficiency, it does limit its ability to be flexible or reactive to market developments, and strategic decisions must be taken at the AFD group level. Its ability to provide equity capital is limited by its own, comparatively low equity capitalisation. Proparco does, however, benefit from AFD's large issuance programme and from mutualised services.

The synthesis of these three concurrently run analyses, as well as perspectives from the authors, highlights the power and the limitations of *leverage* in a development finance context. Whilst it is noted that a risk-weighted approach would yield a more nuanced picture, the cash amount of *development finance bang per buck of donor contributed equity* of the leveraged models are unsurprisingly a multiple of that delivered

by an equity-only scenario. The latter does in theory offer a higher risk tolerance, and it is incumbent on DFIs and their shareholders to ensure this is put to good use. The lure leverage can offer of a larger cash footprint would otherwise be cause for reflection. However, from a purely development perspective, equity may have the potential for greater impact. The report is therefore not suggesting that there exists a single optimal funding model, or that leverage should be universally or uniformly applied.

It is also clear that size does matter where debt issuance is concerned, and whilst it may not be possible to re-engineer existing setups, institutions considering entering debt capital markets should keep this in mind when structuring their funding operations.

The management of currency exposure is once again found to be a pain point for development finance. The low levels of local currency funding remain a thorny issue, and the continued predominance of US dollar lending by other hard currency based financial institutions may be worth interrogating.

This paper suggests that debt issuance on the part of DFIs should be recognised as an important instrument of private capital mobilisation, even if the level of risk thus shared is limited (as lenders enjoy seniority) and acknowledging that it does increase the level of donor effort linked to government held equity. The paper further suggests that the use of securitisation-based debt instruments capable of transferring specific pools of risk to capital markets should, where applicable, be explored.

In this respect, it is observed that leveraged balance sheets do in addition act as incentives for risk transfer-based mobilisation, be it through credit insurance markets or synthetic securitisation. It is, however, acknowledged that bilateral DFIs are subject to different incentives and are often less suitably equipped to take advantage of these instruments than their multilateral counterparts.

Whilst the developmental value of private equity investments is recognised, findings do suggest that their presence on the balance sheet of predominantly lending institutions should be interrogated, particularly in the context of exit-mobilisation dynamics and mobilisation initiatives.

Aside from the need for further work to analyse the regulatory frameworks within which bilateral DFIs operate there are a number of other challenges. Many of these are inherent to the growth and efficiency of debt issuance, risk transfer and private capital mobilisation DFIs face, which could be met with greater ease should they work in a co-ordinated and collaborative, if not integrated, fashion. Such approach should ensure that there is complementarity across the offering of individual DFIs, and that their funding models are calibrated accordingly.

# 1 Methodology

This study is based on the detailed review of publicly available financial documentation, augmented by interviews with relevant representatives, for each of the three DFIs selected.

This study is not intended to present a comprehensive accounting of development finance institution funding models. Rather, by thoroughly examining a limited sample of bilateral DFIs, it seeks to uncover and examine efficiencies, commonalities, differentiating features and opportunities relating to how these institutions fund their activities.

The exercise is designed as a precursor to future investigations sufficiently resourced to sample DFIs and MDBs more widely, and to dig deeper into their funding models. The methodology employed here was to (a) establish a sample and timeframe for assessment, (b) thoroughly examine publicly available information and (c) augment these desktop research findings with direct interactions with relevant representatives of the sample institutions. Each of these aspects is touched on in more detail below.

## Sample selection

It was decided at the outset that the most appropriate allocation of available resources would be to define a sample of bilateral DFIs relatively narrowly, thereby allowing for a thorough assessment of each.

Another consideration was the extent to which sample DFIs should have structural and operational similarities or differences. Similarities would allow more readily for the identification of trends, while differences would plausibly allow for the detection of a wider number of differentiated observations.

Ultimately, it was decided to focus on three European DFIs that were determined to provide sufficient scope for comparison but also enough differences to infer broader learnings. The institutions selected were British International Invest (BII), Financierings-Maatschappij voor Ontwikkelingslanden (FMO) and Proparco.

- BII is owned by FCDO and financed entirely by equity contributions from the UK government.
- FMO is majority owned by the Dutch government (FMO, 2023<sup>[1]</sup>) and among the sample is unique in that it is regulated as a bank.
- Proparco is a subsidiary of the AFD Group. The majority of its equity and all its debt are provided by AFD (AFD (Proparco), 2023<sup>[2]</sup>; AFD (Proparco), 2023<sup>[3]</sup>; AFD (Proparco), 2022<sup>[4]</sup>).

## Quantitative research and qualitative overlay

The research methodology was based upon an extensive review of key public documents for each DFI for the years 2010 to 2021.<sup>1</sup> These included annual reports and financial statements in the main. Where necessary, articles of association or terms of reference as well as regulatory filings were also reviewed to draw a fuller picture.

Depending on the quality of reporting, it was possible to quantitatively piece together the funding models and how they strategically and operationally fit with deployment activities. This is in itself linked to the

status of an institution; FMO, for example, is a regulated bank and therefore provides more granular loan information.

The next step was to test tentative conclusions emanating from the desktop exercise relating to the respective and comparative efficacies of the different models. This was done through direct interactions with key representatives of each of the DFIs.

Notwithstanding the limited scope of the study, this final qualitative overlay both ensured robustness and added richness to the findings.

## 2 A tale of three cities

### Proparco

Proparco, France's development finance institution, is part of the wider AFD Group. It presents a compelling case study for the use of an indirect funding model, whereby much of the equity and all the debt is provided by a larger development agency, alongside mutualised services.

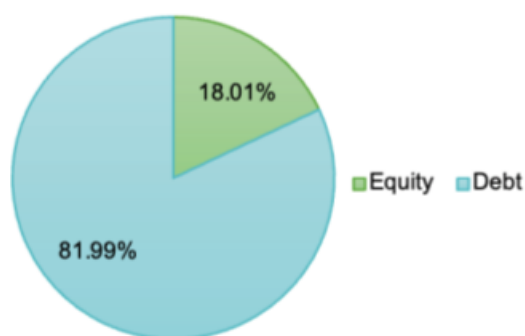
#### Overview

Proparco's balance sheet stood at EUR 7.2 billion at the end of 2021, making it the smallest of the three institutions studied for the purpose of this report.

#### *Liabilities*

The liabilities side of Proparco's balance sheet is a rough 80/20 split. This model has been remarkably stable over time.

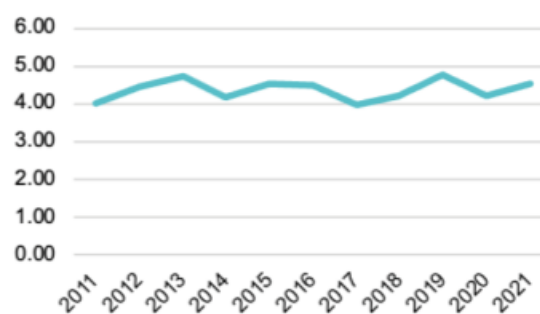
Figure 2.1. Proparco's Funding Mix



Note: As of 31/12/2021

Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

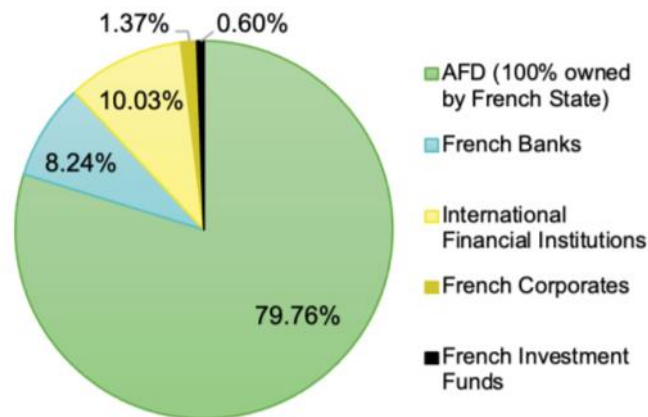
Figure 2.2. Ratio of Debt to Equity in Proparco's Funding



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

Proparco's equity, as detailed in Figure 2.3, is held by a diverse constituency of over 20 distinct shareholders, ranging from the Development Bank of Southern Africa to BNP Paribas and a couple of French *Investissement Solidaire*<sup>2</sup> mutual funds.

**Figure 2.3. Proparco's Shareholding Structure**



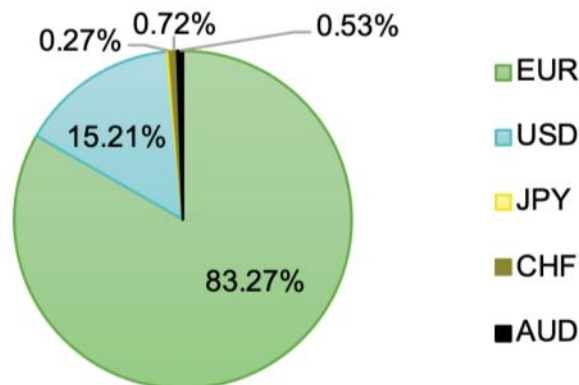
Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

The big picture is slightly more straightforward, as AFD held 79.76% of Proparco's shares in March 2022, a number that has been trending upwards as a result of several dilutive equity rounds it dominated.

AFD is the sole provider of Proparco's debt. It is important to note that AFD's debt/equity ratio was, according to the parent company's financial statements, 6.72 at the end of 2021, and that it derived 77% of its liabilities from capital markets debt. The analysis of the AFD/Proparco funding model should take this indirect approach to debt issuance into account.

It is therefore to AFD's funding that one must turn to observe issuance currency patterns.

**Figure 2.4. Currency Mix of AFD's Debt**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

The fact that AFD raises over 80% of its debt in Euros is important given that, as is the case with most DFIs, Proparco is predominantly a USD financier.

It is also worth noting that AFD is a long-term borrower, with its redemption schedule stretching beyond 2037 (AFD (Proparco), 2023<sup>[31]</sup>). Many infrastructure projects require sources of long-term funding and, if their funding models allow, DFIs can play a unique and crucial role in its provision.

**Figure 2.5. AFD’s Debt Redemption Schedule (€ million)**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

**Figure 2.6. AFD and Proparco’s Credit Rating**

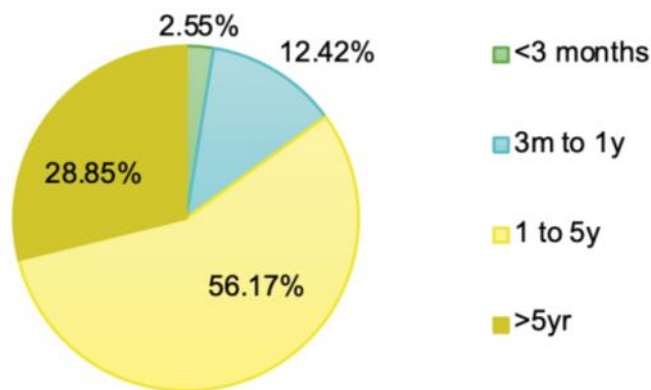


Source: Created by CDFS.

AFD’s AA credit rating is strongly linked to France’s sovereign AA rating (Fitch Ratings, 2022<sup>[6]</sup>) and owes as much to the perception of the strength of support from the latter for the former on the part of credit rating agencies as it does to the specific strength of its balance sheet. Proparco’s own AA rating is equally resulting from AFD’s ownership, control, and support.

The residual duration of the loans Proparco receives from AFD, when juxtaposed to the residual duration of the loans it extends to its clients, serves both to illustrate the specific nature of Proparco’s debt funding model, whereby loans made are backed by a matching loan from AFD, and to make the link to the assets side of its balance sheet.

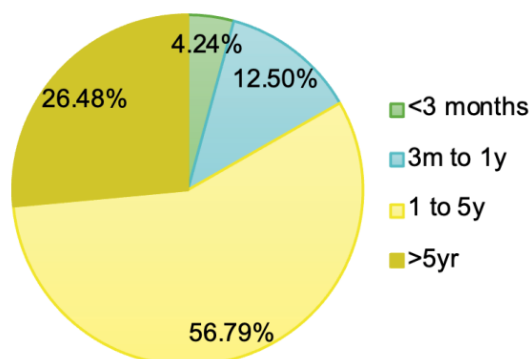
**Figure 2.7. Residual Durations of AFD’s Loans to Proparco**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

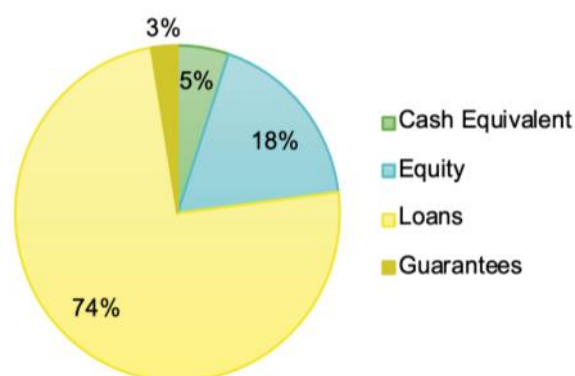
## Assets

**Figure 2.8. Residual Durations of Proparco's Loans to Clients**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

**Figure 2.9. Proparco's Asset Allocation**

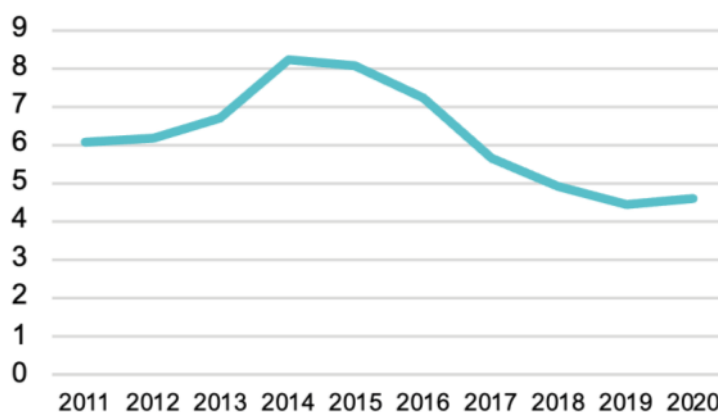


Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

A similar symmetry can be observed when comparing Proparco's product mix to its funding mix. As will be discussed later, this stems from a model whereby equity assets and debt assets are respectively funded by their corresponding component of Proparco's liabilities.

There has, however, been an increase in the relative allocation over time, with equity gradually gaining in importance.

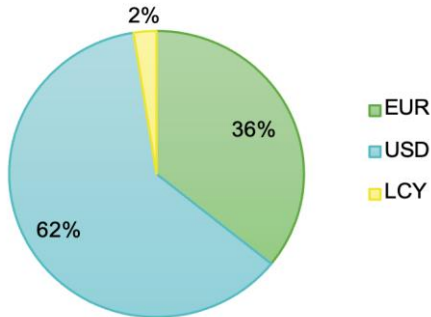
**Figure 2.10. Debt to Equity Ratio of Proparco's Assets**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

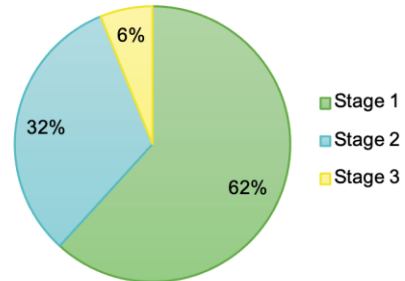
As hinted above, Proparco has in 2021 and 2022 mostly been lending in USD, although the EUR component was considerably higher than either FMO's or BII's. Figure 2.11 shows that local currency lending was observably anecdotal.

**Figure 2.11. Currency Mix of Proparco's Lending**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)[5]).

**Figure 2.12. Breakdown of AFD's Non-Sovereign Loans by Stages**



Note: Information on the IFRS9 Stages can be found here (Bank for International Settlements, 2017[7]).

Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)[5]).

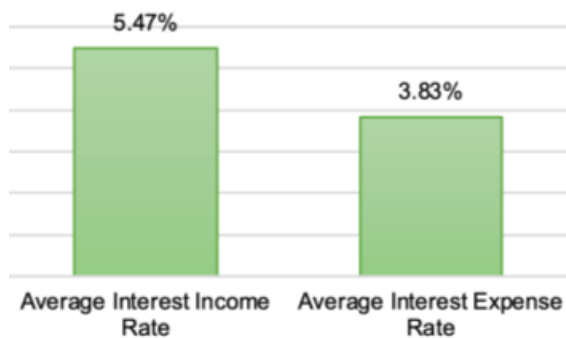
This report was purposefully built using publicly available information, and Proparco does not provide a breakdown of its loan book using the IFRS9 three-stage approach to the measurement of expected credit loss. Still, AFD does publish data pertaining to its non-sovereign loan book as a useful proxy, as summarised in Figure 2.12.

Proparco does not publish the tenor for all its loans but evidence, where it can be found, suggests that it extends loans for at least up to 16 years<sup>3</sup>.

Given Proparco's reliance on loans from AFD for the funding of its own lending operations, it is useful to note that when comparing the interest rates charged to clients and the interest rates charged by AFD, a relatively slim margin for Proparco's lending activities is suggested.

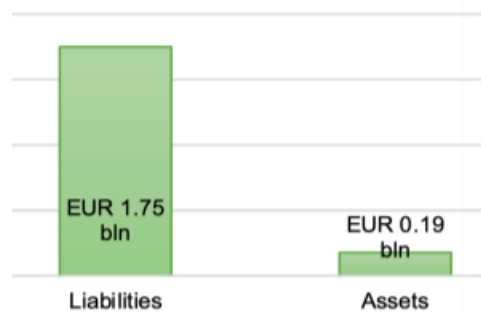
This is an admittedly crude measure, but it does demonstrate consistency with a comparatively straightforward business model that does not require significant fundraising and treasury resources. It may be useful to further discuss whether this margin reflects an appropriate approach to risk-pricing.

**Figure 2.13. Comparison between Proparco's Interest Income and Interest Expense Rate**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)[5]).

**Figure 2.14. Comparison between Proparco's off-balance Sheet Guarantees Received and Extended**



Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)[5]).

Proparco does report off-balance sheet guarantees, clearly showing that it receives protection far in excess of the amounts it provides to its clients. The difference serves to de-risk Proparco's loan book. At the end of 2021, 96% of these emanated from the AFD itself.

### **Funding Model**

*There is a beautiful simplicity to Proparco's funding model.*

On the equity front and as described above, AFD is the dominant shareholder. Equity injections are by and large negotiated with AFD, and it has contributed the lion's share of recent capital increases, thereby progressively diluting the holdings of external shareholders.

Simpler still is the debt component of Proparco's liabilities. 100% of its debt funding is provided by AFD. This must be understood in the context of the mutualisation of services across the AFD Group. Proparco is deeply integrated into its owner.

At the risk of over-simplifying, a loan that Proparco extends is essentially mirrored by a loan from AFD, with matching characteristics. These include, crucially, the currency in which both loans are denominated, as well as their respective tenor.

This means that Proparco's economic model is 'immunised' against market risk. It also dispenses Proparco from the need to run an Asset & Liabilities Management (ALM) programme. AFD is equally in charge of debt issuance for the group. Proparco does not tap debt capital markets directly as AFD takes care of debt capital issuance.

The pricing of the loans from AFD to Proparco is meant to reflect the costs incurred by AFD:

$$\text{Pricing} = \text{cost of AFD's debt} + \text{premium for mutualised services} + \text{hedging costs}$$

It is important to note that there is no risk premium corresponding to the specific borrower. This should in theory be incorporated into Proparco's pricing, but there is little evidence of such an approach. A small component of the currency risk derived from Proparco's loan book is backed by its own balance sheet, typically in cases where atypical risk is taken on. This, for example, applies to operations denominated in CFA Francs. Both AFD and Proparco report in Euros and all loans must therefore be hedged back to that currency.

As detailed above, Proparco does benefit from external guarantees. The vast majority of these are once again provided by AFD, but it is worth noting that Proparco receives a guarantee from the European Commission's EFSD programme. This, for example, supported Proparco as it extended loans and credit lines to banks and non-bank financial institutions in Madagascar<sup>4</sup>, Burkina Faso<sup>5</sup> and Georgia<sup>6</sup>.

AFD's guarantees fall into two categories. In most instances, these are used to guarantee a significant part of the loan book and to allow Proparco to transcend internal limits by making AFD a silent sub-participant in some operations. In other cases, Proparco essentially acts as the originator, and the risk is passed on to AFD through its provision of a matching guarantee to Proparco.

Whilst this funding model does obviously result in an easily observable symmetry between both sides of the balance sheet where debt is concerned, the same is true when the observer turns to equity matters. Simply put, Proparco's equity investment programme is fully funded by its own equity. This in turn means that its growth has thus far been made possible, and will in the future, ceteris paribus, be subjected to equity injections which, as described above, are largely AFD's prerogative. This may, as will be discussed, have implications for mobilisation and capital recycling dynamics.

## Advantages & Disadvantages

### Advantages

There are two obvious, interlinked, advantages to the ‘indirect’ funding model employed by Proparco and its effective owner AFD.

The first is the ‘immunisation’ of Proparco’s balance sheet from much of the risk of its lending operations through the matching loans system. This essentially leaves Proparco with idiosyncratic risk and the risks of its equity programme. The use of AFD guarantees to smooth out internal headroom limits acts to reinforce this simplifying effect. In terms of operations, this makes ALM and large components of risk management redundant, allowing Proparco to focus its resources on origination. It should of course be clear that what Proparco is spared, AFD is left to manage. It does however stand to reason that there are significant economies of scale at the parent level.

Whilst this would in theory also serve to reassure credit rating agencies, the reality is that Proparco’s AA credit rating, which it largely maintains for the purpose of issuing guarantees and for some atypical operations, is directly linked to AFD’s. As Proparco does indeed state on its website, its ‘ratings are aligned with those of its parent company Agence Française de Développement (AFD), itself mirroring France’s ones’ (AFD (Proparco), 2018<sup>[8]</sup>).

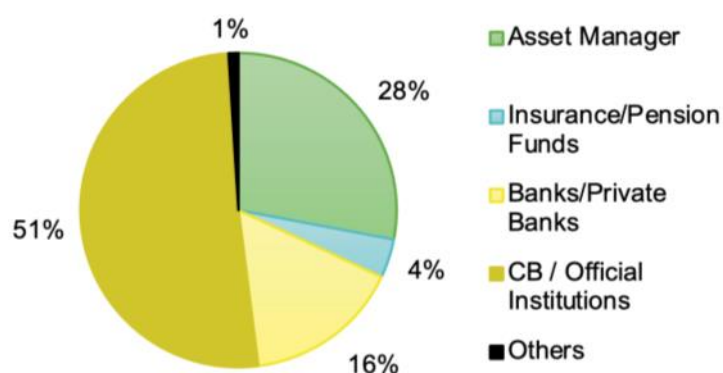
There are, however, real advantages from a regulatory standpoint. This aspect of the equation is not within the scope of this initial work, but it is extremely relevant to Proparco’s ability to deliver on its mission, as it plays a key role in determining the quantum and the nature of the risk it can take on.

In fact, and whilst Proparco will be constrained under its supervisory framework, both in terms of cash holdings and leverage, the comfort derived from its funding model should mean that Proparco is able to operate with lower buffers, delivering a more efficient use of its resources than is for example the case with standalone entities such as FMO.

A second key advantage is linked to the fact that AFD, as a much larger institution with a debt issuance programme trending towards EUR 10 billion a year, is a major and sophisticated issuer. To put things in perspective, AFD is currently issuing debt in amounts comparable to the IFC, and in excess of that raised by the AfDB or the EBRD in 2022.

Crucially, by ‘raising the issue size of its bonds to EUR 2 billion’ (AFD (Proparco), 2023<sup>[9]</sup>), AFD taps the liquid end of capital markets most institutional investors are active in. Its public issues are taken up by a universe of investors diversified across geographies and investor types.

**Figure 2.15. AFD Debt by Investor Type**



Note: As of 2022

Source: Based on calculations made using data published on the Proparco website (AFD (Proparco)<sup>[5]</sup>).

This indirectly means that Proparco can, through AFD, rely on a resilient, continuous, and cost-effective access to debt capital markets.

### *Disadvantages*

With limited responsibility comes limited power, or rather flexibility. A significant limitation inherent to Proparco's funding model is the extent to which its activities are dependent on AFD's own funding model and decisions. In the name of operational efficiency, given that any loan will need to be backed by a matching loan from AFD, relatively fixed guidelines must be in place, potentially constraining Proparco's ability to be creative and reactive in the face of atypical or changing market demand patterns. Any change in policy needs to take place at the group level and thus likely subjected to the institutional rigours this usually entails.

This is particularly evident in the case of Proparco's private equity investment programme, the growth of which is linked to equity injections by AFD. Although AFD has clearly been supportive, such transactions are not traditionally quick affairs, and this must act as a significant hurdle to Proparco's ability to reactively grow the size of its portfolio.

### **Reflections**

Proparco's funding model creates stumbling blocks and incentives alike where risk transfer and capital markets mobilisation are concerned.

Well-oiled, satisfyingly symmetric models do not easily lend themselves to change. Should Proparco for example decide to transfer some of the risk of its loan book to capital markets through securitisation or credit insurance, even notwithstanding the problematic regulatory capital charge associated with the former, this would upset the balance with the corresponding loans from AFD. Theoretically, this could be done in lieu of the AFD guarantees used to address internal limits tension, or designed to focus on the small volume of operations Proparco does off its own bat, but given the need to put together diversified, coherent pools, this too could prove challenging.

No such fragile equilibrium exists on the equity front. The ability to free up capital through the transfer of stakes to external parties would allow Proparco's equity programme to grow its footprint beyond the boundaries of its funding model. Beyond this observation, Proparco is a good illustration of the need for DFIs to interrogate whether the punitive approach of regulatory frameworks (Bank for International Settlements, 2013<sup>[10]</sup>) to private equity holdings should, given their high development impact, mean that off-balance sheet structures be actively considered.

## **Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO)**

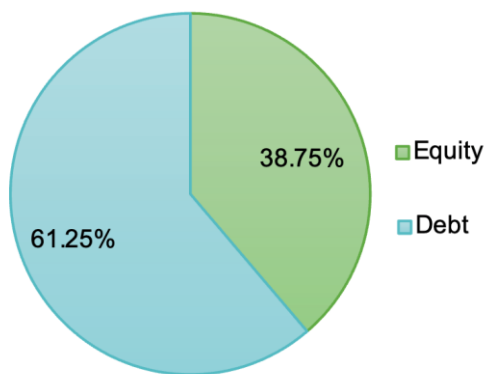
The Netherlands' DFI is regulated as a bank, and its financial statements offer a reassuring familiarity to financial markets practitioners. The explicit support of the Dutch government and the specificities of FMO's fund management model and approach to local currency funding do however provide some important learnings.

**Overview**

*Liabilities*

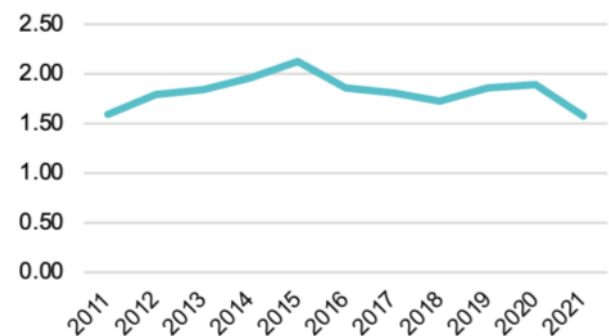
FMO’s balance sheet, with a debt/equity split of 61/39 is displaying a considerably lower level of leverage than Proparco’s 80/20. It is in addition important to note that FMO holds a surprisingly high 16% in cash and equivalents according to its consolidated financial statements dated 31/12/2021. Here again the relative equity and debt components of FMO’s liabilities have remained relatively stable over time.

**Figure 2.16. FMO’s Funding Sources**



Source: Based on calculations made using data published on the FMO website (FMO, n.d.[11]).

**Figure 2.17. Debt to Equity Ratio in FMO’s Funding (Liabilities)**

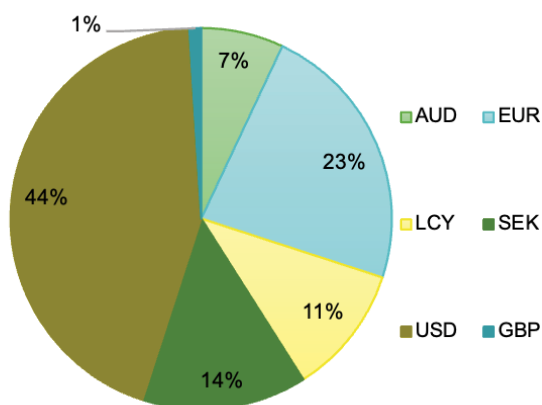


Source: Based on calculations made using data published on the FMO website (FMO, n.d.[11]).

Its debt funding presents an equally monolithic picture. Though, in stark contrast, FMO sources 100% of its debt funding from capital markets, through a mix of public market issues and private placements, in a diversified basket of developed and developing economies currencies, as illustrated in Figure 2.18.

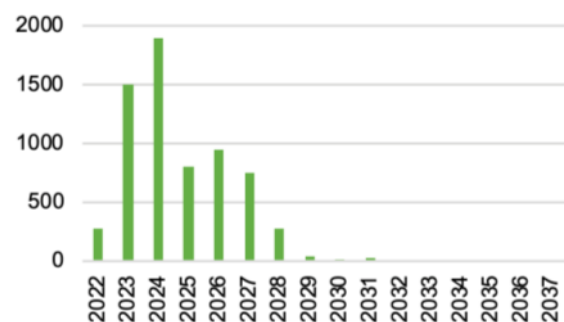
The fact that FMO sources as much as 11% of its debt funding in local currencies is a notable observation, and one that has interesting implications for its development strategy. These are described in detail later in the report.

**Figure 2.18. Currency Mix of FMO’s Debt**



Source: Based on calculations made using data published on the FMO website (FMO, n.d.[11]).

**Figure 2.19. FMO’s Debt Redemption Schedule (€ million)**



Source: Based on calculations made using data published on the FMO website (FMO, n.d.[11]).

FMO's redemption schedule is concentrated within a 5-year horizon, a marked difference to AFD's much longer-dated maturity picture. It should be noted that the duration of FMO assets is 3 to 4 years.

FMO benefits from a AAA credit rating, in line with the sovereign rating of the Netherlands.

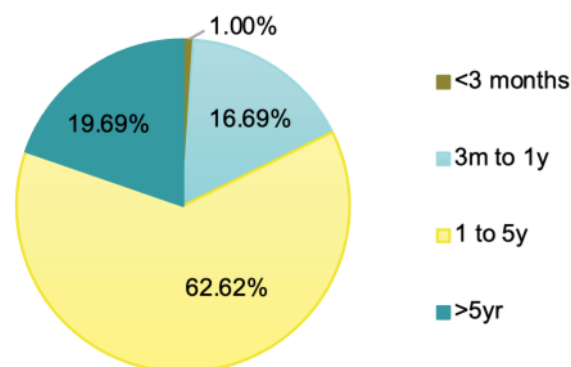
There is broad alignment between the respective residual duration distribution of FMO's debt and its loan book.

Figure 2.20. FMO's Credit Rating



Source: Created by CDFS.

Figure 2.21. Residual Duration of FMO's Debt

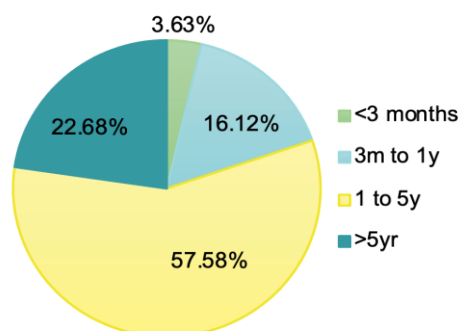


Source: Based on calculations made using data published on the FMO website (FMO, n.d.[11]).

### Assets

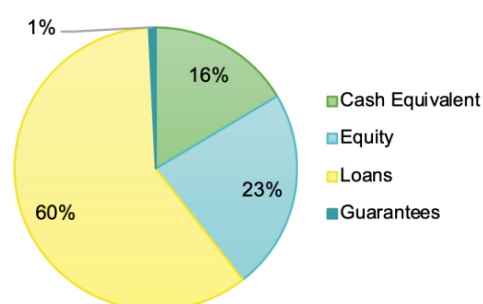
Whilst FMO's loan book does, as a percentage of its portfolio, approximately mirror the debt component of its liabilities, it is once again noticeable that FMO does hold a considerably higher level of cash and cash equivalents than either BII or Proparco. As will be discussed later, this is in part informed by the fact that FMO is a regulated bank.

Figure 2.22. Residual Duration of FMO's Loan Book



Source: Based on calculations made using data published on the FMO website (FMO, n.d.[11]).

Figure 2.23. FMO's Asset Allocation to Different Products



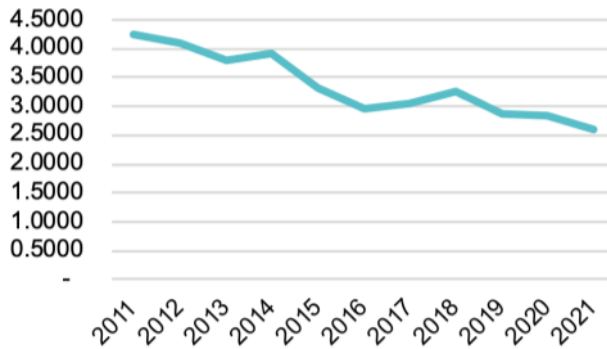
Note: Cash equivalent = cash at banks + short term deposits, as per FMO financial statements.

Source: Based on calculations made using data published on the FMO website (FMO, n.d.[11]).

The relative allocation to equity investments has however steadily increased over the years, broadly in line with Proparco.

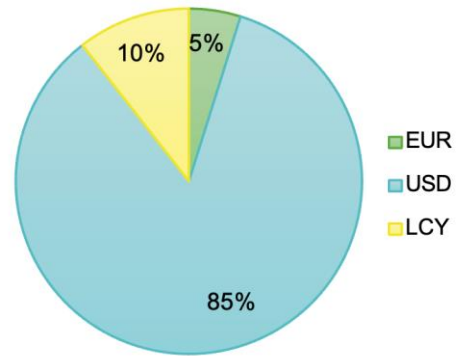
FMO is, even more than Proparco, predominantly a USD lender, with EUR lending only making up 5% of the aggregate consideration of loans extended in 2021 and 2022.

**Figure 2.24. Debt to Equity Ratio in FMO's Assets**



Source: Based on calculations made using data published on the FMO website (FMO, n.d.<sub>[11]</sub>).

**Figure 2.25. Currency Mix of Loans Extended by FMO**

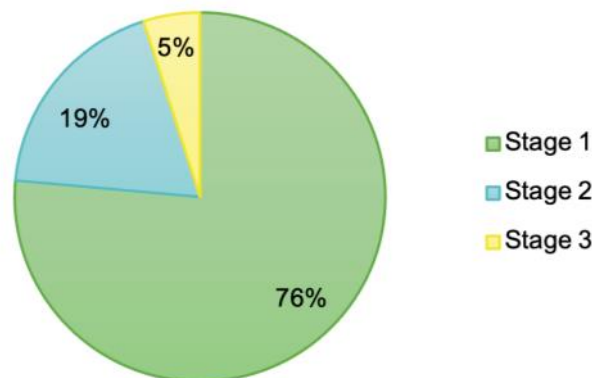


Source: Based on calculations made using data published on the FMO website (FMO, n.d.<sub>[11]</sub>).

FMO does not publish more information on the tenor of its loans than Proparco, but the available data suggests at least a range from 1 to 20 years.

Helpfully however, FMO's bank status does mean it reports with the highest level of granularity of the three DFIs studied. The IFRS9 stage breakdown it publishes in its financial statements suggests that close to 80% of the consideration of its loan book is in Stage 1 (Bank for International Settlements, 2017<sub>[7]</sub>).

**Figure 2.26. Breakdown of FMO's Loans by Stages**



Source: Based on calculations made using data published on the FMO website (FMO, n.d.<sub>[11]</sub>).

**Funding model**

Now is an interesting time to look into FMO's funding model. The Dutch DFI's Strategy 2030 calls for an ambitious growth path delivering 'up to EUR 22 billion portfolio by 2030' (FMO, 2022<sub>[12]</sub>), suggesting a 7%

compound annual growth rate (CAGR). To fund this growth, FMO primarily relies on equity growth through retained earnings and an accompanying scaling up of its debt funding programme.

In contrast to Proparco's setup, the Dutch government directly holds 51% of the bank's equity capital, but here too the country's largest banks have been convinced to join in, and collectively they hold 42%. The government's stake, consisting of A shares it only can hold, has not changed since the publication of the 2009 articles of association. Equity injections are, however, not core to the growth strategy.

Even assuming FMO is successful in delivering the average return on equity of 4% it is aiming for, its debt funding programme will play a key role in delivering on its growth objectives. FMO's issuance currently stands at EUR 6 billion, and its funding need for 2023 stands at USD 1.5-2.0 billion.

Unlike Proparco, FMO resorts to direct access to debt capital markets for its funding needs. It does so, as described above, on the back of the AAA rating it largely derives from the Dutch government's explicit support. This credit rating was, unsurprisingly, not a prominent feature of the discussion of FMO's funding strategy, which is driven by the business's needs and overall strategy.

The strengths and limitations of the Dutch state's support are described in articles 4 and 5 of FMO's publicly disclosed agreement with the state (FMO, 2023<sup>[13]</sup>).

Equally interesting is the stipulation that this agreement can be cancelled with a twelve-year notice period, and that as a result, in practice FMO will not issue debt beyond 12 years. This is indeed reflected in FMO's funding strategy, which states a maximum tenor of 12 years.

A debt ceiling and a premium have been introduced in a new version of the agreement published on the 1<sup>st</sup> of July 2023 (FMO, 2023<sup>[14]</sup>). Article 7.1.1 of this new document stipulates – in Dutch – the calculation methodology, which includes a foreign exchange buffer. This debt ceiling has been set at EUR 16 billion for the next five years. The updated investment presentation does mention that “an excess amount, which is a highly unlikely event, does not void the guarantee” (FMO, 2023<sup>[15]</sup>). Article 8 of the new agreement also introduces a premium “as compensation for the State's exposure under the Maintenance Obligation and the Security Obligation”. Whilst the agreed quantum of this premium is not disclosed, the latest investor presentation promptly states that it “has an immaterial financial impact on FMO”.

FMO employs a matched funding strategy, whereby it seeks to align the duration of its liabilities with that of its assets. The average duration of its portfolio has decreased over recent years from 4.5-5 years to 4 years. FMO describes this trend towards shorter duration lending as demand driven.

The funding strategy can however react to market opportunities, and FMO secured longer-term funding in recent years to take advantage of low EUR interest rates. As a result, its EUR funding tends to be in the 4–5-year range whereas its - much larger – USD issuance tends to be in the 2–3-year range. Although FMO explains it is mostly active in long-term funding, its redemption schedule displays a much stronger skew towards the short term than AFD's. This is in line with the drop in the duration on FMO's lending assets.

As described in Figure 3.1, FMO is predominantly a USD lender. It does, however, as illustrated in Figure 3.2, issue bonds in an array of currencies, including those of some of the developing economies it is active in. As a result of this mismatch, FMO swaps much of the non-USD amounts it borrows in capital markets back to the USD. These hedging positions are subject to collateralisation mechanisms, and when, as was the case in 2022, the USD rises against these other currencies, it causes a collateral outflow. According to its 2022 Annual Report, “as a result of strong USD appreciation and interest rate movements, FMO had €473 million collateral outflow in 2022” (FMO, 2023<sup>[11]</sup>). Such outflows are in part met through the funding programme. It can thus be observed that FMO's funding needs are to an extent sensitive to currency markets movements, leading the bank to adopt a dynamic approach to funding plans.

The range of currencies FMO issues debt in is a distinct feature of its funding model. In contrast to AFD, whose EUR and USD issuance accounts for the vast majority of its programme, FMO issues significant

amounts in Swedish Kroners, British Pounds, Australian Dollars or indeed ‘local currencies’ in developing economies. Issuance in developed economies’ currencies is undertaken for diversification purposes and to take advantage of arbitrage opportunities, for example when the USD cost of funds of non-USD borrowing is lower than that direct USD issuance. There are however interesting additional angles to the issuance in local currencies.

Although FMO did, in 2021 and 2022, extend 10% of the aggregate value of its loans in local currency, the local currency component of its funding programme is not designed for matching purposes. The fact that debt issuance is a relatively quick process, whereas lending is a relatively longer process, means that matching would create a temporary currency risk exposure that FMO does not have the capacity to manage. This too is therefore largely swapped back to USD.

Beyond the benefits of diversification, this part of the issuance programme stems from a policy decision to be an actor in the development of local capital markets. By borrowing in these markets, FMO concurrently addresses its funding needs and delivers on its developmental mission.

It should be noted that TCX, a fund in which both FMO and the Dutch government invest (TCX, n.d.<sup>[16]</sup>), caters to a significant part of FMO’s swapping needs. Providing TCX with exposure to a DFI funding instrument, rather than DFI loans, FMO does help TCX with an opportunity to grow and enhance the resilience of its balance sheet.

A specificity of the manner in which FMO’s operations are funded is the recourse to a fund management model. FMO manages a range of funds, the majority thereof ‘for the risk of the Dutch government’. Apart from a 2.16% stake in the MASSIF fund, FMO acts as a fund manager for which it receives a fee. The risk is however ‘predominantly taken by the Dutch Government’ (FMO, n.d.<sup>[17]</sup>) and as a result, FMO does not include these in its financial statements. This model does allow FMO to undertake investments beyond its own risk appetite and are thus insulated from regulatory, prudential, and funding model considerations. In line with its 2030 strategy, this model also allows FMO to ‘pioneer, develop and scale’ markets.

## **Advantages & Disadvantages**

### *Advantages*

There are several advantages to FMO’s model, which combines meaningful credit support from its sovereign shareholder with an independent funding strategy based on direct access to capital markets.

The very explicit terms of the Dutch government’s support arguably mean that FMO’s credit rating may prove more resilient in times of stress than those of DFIs benefiting from implicit support on the part of their government. The inelasticity of its rating should in theory also mean, notwithstanding regulatory constraints, that FMO is able to adopt a relatively aggressive leverage policy without causing undue damage to its access to capital markets.

FMO’s ability to draft its funding strategy independently does mean that this can be more dynamic and reactive to market movements and demand patterns among its lender base. It allows FMO to choose to contribute to local capital markets development and to an enhanced capacity for the sector to hedge currency positions. With the issuance of Green, Social and Sustainability (GSS) bonds, FMO also contributes to the development of ESG bond markets.

The off-balance sheet management of government funds does in addition allow for high developmental impact programmes to be deployed without adverse consequences for regulatory capital consumption or funding costs. The Dutch government’s willingness to capitalise these funds is of course a key factor.

### *Disadvantages*

Size does, in all things capital, matter. The constraints emerging from the analysis of FMO's funding models are primarily linked to the size of its operations, whether it be the size of its funding programme or its capacity to manage currency risk. These constraints are of course relative and should be discussed on a comparative basis, for example with Proparco's model.

FMO's issuance does however tend to be focussed on relatively short maturities, and whilst an AAA rating is a fine thing to have, the cost of its debt will also be a function of the relatively small size of its bond issues and therefore of its relative ability to tap the more liquid end of debt capital markets. FMO's eligibility under the ECB's Public Sector Purchase Programme is a mitigating factor in that respect.

Standing alone does mean that FMO must manage its own currency exposure, and in addition to capacity constraints, recent years have been a painful reminder of the demands of collateral management. This, in addition to its regulated bank status, means that FMO likely needs to maintain relatively high levels of cash equivalents, limiting its ability to deploy its capital in pursuit of its developmental objectives. These dynamics notwithstanding, FMO's outsized liquidity buffer results in a low leverage level on a net debt basis and should at least be interrogated.

### **Reflections**

FMO has demonstrably been ahead of the curve where risk transfer by bilateral DFIs is concerned. Notable initiatives ranging from the partial sale of a sub-debt portfolio to responsibility (FMO, 2016<sup>[18]</sup>) to the signature of a USD 500 million unfunded risk participation programme with MunichRe (FMO, 2019<sup>[19]</sup>) provided credit-based precursors to a more recent initiative, potentially leading to the transfer of private equity positions.

Given the resilient nature of its credit rating, these initiatives are more likely to find their roots in the management or regulatory capital constraints and in private capital mobilisation objectives than in funding model considerations.

As FMO embarks on a very ambitious growth path, there is however little doubt that there will be growing incentives to enhance risk-adjusted return on capital and to present debt capital market actors it will increasingly seek to tap with a proactive approach to risk management.

## **British International Investments (BII)**

Wholly owned by the Foreign, Commonwealth and Development Office (FCDO) on behalf of the UK Government and financed by equity alone, the UK DFI stands out in many respects. Its funding model theoretically provides its investment teams with a comparatively high level of flexibility.

*Is the opportunity cost inherent to an absence of debt on the liability side of the balance sheet justified on developmental grounds?*

### **Overview**

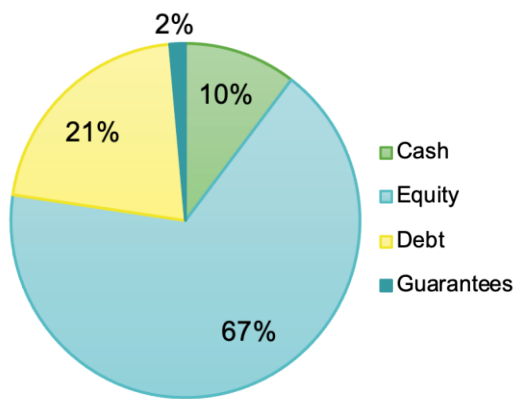
#### *Capital*

BII operates a simple funding model. It takes no debt and has no creditors. It is solely funded by equity, and has a single shareholder, the United Kingdom Government's Foreign, Commonwealth and Development Office (FCDO). To increase the size of its balance sheet, BII relies on two main sources – retained earnings and the issuance of new shares to FCDO.

Assets

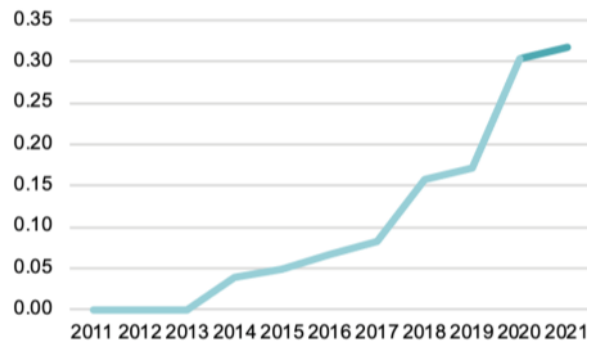
BII was until ten years ago largely an equity investor. It has progressively grown a lending programme, but as of the end of 2020, equity investments still accounted for approximately 70% of its portfolio.

Figure 2.27. BII's Asset Mix



Source: Based on calculations made using data published on the BII website (BII, n.d.[20]).

Figure 2.28. Debt to Equity Investments Ratio in BII's Asset Mix

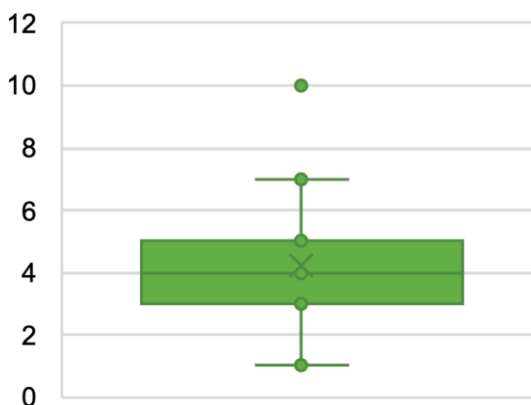


Source: Based on calculations made using data published on the BII website (BII, n.d.[20]).

It is worth noting that BII does not employ a fixed allocation mechanism between funding instruments, but rather seeks to identify the most suitable instrument for each opportunity.

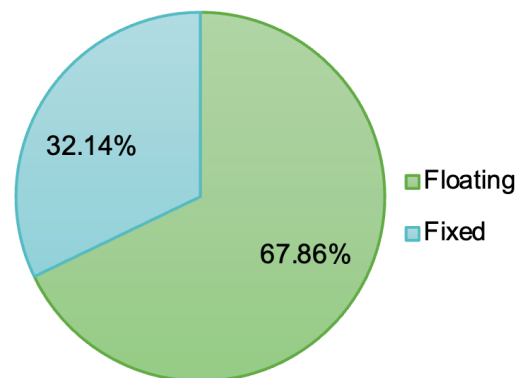
BII does provide relatively granular information pertaining to the tenor of its loans. As illustrated by Figure 2.29, loans extended in 2021 and 2022 were inscribed within a narrow 3-7-year range. Interestingly, 65% of the loans present on its balance sheet at the end of 2020 were extended on a floating interest rate basis.

Figure 2.29. Tenor of BII's Debt Investments



Source: Based on calculations made using data published on the BII website (BII, n.d.[20]).

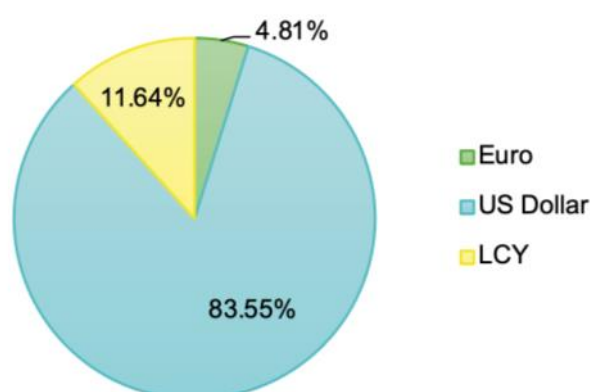
Figure 2.30. Breakdown of the Type of Interest Rates Applied to BII's Loans



Source: Based on calculations made using data published on the BII website (BII, n.d.[20]).

Although BII is funded in Pounds Sterling and does report in this currency, it is, in line with other DFIs studied here, a predominantly US Dollar lender. It is of course important to keep in mind that although many of the private equity funds it invests through are denominated and valued in USD, they typically invest in local currency. Its local currency funding allocations are proportionally the largest of the three DFIs studied.

**Figure 2.31. Currency Mix of BII's Debt Investments**



Source: Based on calculations made using data published on the BII website (BII, n.d.<sup>[20]</sup>).

### **Funding model**

Whilst none of the funding models studied here present any daunting levels of complexity, BII's is by far the simplest.

Its features include:

- A single shareholder
- No leverage
- No dividends
- No asset management operations

The absence of any debt on the liabilities side of its balance sheet leaves BII with two avenues to grow the size of its portfolio:

1. Retained earnings
2. The issuance of new shares to FCDO

BII has to date never paid a dividend to its owner, thereby adding any retained earnings that might have been available to its equity base. Absent equity injections, and notwithstanding grants it may receive from FCDO from time to time, this is BII's organic growth vector.

The issuance of new shares to its owner FCDO is managed through a promissory note system. Shares are essentially issued to FCDO on a regular, scheduled basis. Instead of a cash injection from FCDO to BII, these operations do in a first instance result in the issuance of a promissory notes. According to the original business case (UK Government, 2017<sup>[21]</sup>):

*"Funds will be lodged at the Bank of England by means of PNs to be drawn down by BII within an agreed encashment schedule (agreed between BII and FCDO and set out expected dates for the drawdown of funding tranches)."*

This presents a number of advantages for both parties. FCDO gets to immediately log the full equity injection as Official Development Assistance (ODA) with the OECD Development Assistance Committee (DAC) statistical system using the institutional method but does not immediately part with the cash. BII does as a result have certainty of funding, particularly given that the timing and amounts for promissory notes is planned over multiple years. It can thus confidently engage with the market and build capacity but does not need to hold unseemly levels of cash on its balance sheet.

## ***Advantages & Disadvantages***

### *Advantages*

Having thus far opted for the simplest of funding models, life at BII should be comparatively simple.

Having a single shareholder means that BII can focus its energies on delivering against a single set of objectives, on a single reporting line. Whilst there is little evidence that the non-sovereign minority shareholders of other bilateral DFIs have exacting demands, they do presumably require some level of additional administrative efforts.

The absence of debt itself has its advantages. BII has no credit rating to maintain, no need for a capital adequacy framework, and no Assets & Liabilities Management (ALM) to perform. Not only is risk management thus simplified, but BII's risk tolerance should in theory be considerably higher than its leveraged peers abroad.

Absent the requirement to match the maturities of assets and liabilities, BII should in addition be in a position to take on longer investment horizons. This is certainly exemplified by its equity positions, the direct component of which is by definition not self-liquidating. As discussed above, BII does not appear to offer significantly longer-dated loans than its peers.

Beyond the financial freedom, this equity-only model affords BII, and means the financial management of its operations requires fewer human resources, potentially allowing for lower operating costs, or at least the deployment of resources towards mission focussed workstreams.

### *Disadvantages*

*This simple funding model is however not without its challenges.*

BII can as noted only derive growth from retained earnings and equity injections from FCDO. Profitability is particularly unpredictable in the markets BII operates in, making retained earnings an unreliable factor. As for equity injections, and despite the very real advantages of the promissory notes system, the wheels of government do tend to turn at a measured, if sometimes majestic, pace, for example prior to 2015 BII did not receive equity injections for a considerable amount of time. In the future there can in addition be no guarantee that the flow of capital will be equally reliable over the long term. The lack of access to capital markets thus means that BII has relatively little control over its growth path.

Perhaps less intuitively, the disclosure and licensing requirements linked to participation in the debt capital market are a form of control for its participants. By being exempt from the controls and rigours that the debt capital market demands, BII may suffer from a relative lack of financial discipline.

There is of course an additional currency risk element to this specific model. Notwithstanding earnings from its portfolio, a significant reliance on a Pound Sterling source of funding is an issue for an almost entirely non-sterling investor and lender. The ability to raise debt capital in the currencies it invests or lends in, particularly in USD but also in local currency, would allow BII to mitigate this currency risk.

## **Reflections**

BII is not unique in its adoption of an equity only model. Its geographic footprint, the size of its equity base, and the size and expertise of its teams do however make the challenging of the status quo of particular interest.

BII does argue that it is taking advantage of its funding model to intervene in the riskier segment of the spectrum than some of its comparably sized debt-funded peers. This includes supporting vehicles capable of mobilising local institutional investors, as is for example the case with Growth Investment Partners Ghana<sup>7</sup>. The increasing lending component of its portfolio does however suggest some level of debt funding may be a sensible option.

Not only does the absence of a debt issuance programme mean that BII cannot mobilise private capital through the sector's most tried and tested instrument, but, in combination with the absence of significant regulatory oversight, there is relatively little incentive for BII to engage in exit-mobilisation or risk transfer.

Tapping debt capital markets, particularly the green, social and sustainability (GSS) bond market, could not only allow BII to significantly increase the scale of its footprint but could make it more reactive to market developments. This would add a third arrow to its balance sheet growth quiver.

BII's current funding model does genuinely afford it a comparatively high level of flexibility. Whilst it would be legitimate to seek to establish whether this is fully utilised, the unique additionality potential BII enjoys should not be too readily forfeited for the lure of leverage-induced volume.

# 3 Synthesis

## Give me a lever

The comparison of bilateral DFI funding models should *inter alia* seek to answer one question: how much development finance gets deployed per monetary unit of taxpayer equity? And since cash is not the sole relevant measure in any investment scenario, how much risk is taken in the pursuit of sustainable development?

### ***A crude measure***

A readily observable, if somewhat crude, measure of the amounts of development finance bang per taxpayer buck delivered by each of the two leveraged funding models is obtained by calculating the ratio of each DFI's portfolio to their respective equity base. The former includes all on-balance sheet exposure, including funded guarantees, but excludes off-balance sheet items. The latter includes all equity and retained earnings.

As Figure 3.1 shows, Proparco deploys more per unit of equity than FMO. A first improvement to this calculation should, however, be to recognise that Proparco and FMO derive an unequal proportion of their equity capital from non-governmental sources.

It is necessary to take into account the fact that AFD, though 100% owned by the French government, is itself significantly leveraged. Proparco sources 100% of its debt from AFD, and that it in addition is in receipt of guarantees from AFD equivalent to nearly 30% of its loan book. All Proparco's capital, apart from the 20% of its equity held by third parties, is provided by AFD. Through a simplifying assumption and in recognition of the fact that AFD sources 77% of its liabilities from borrowing in capital markets, this component of Proparco's own liabilities is then adjusted to reflect the indirect mobilisation effect of AFD's debt.

Once thus adjusted, the ratios of the leveraged DFI's portfolio to the equity held, either by the government or by an entity wholly owned by government (in which case it is adjusted for this entity's sources of funding), deliver an even more striking contrast. This is illustrated on Figure 3.2.

Figure 3.1. Portfolio/Equity Ratios



Source: Created by CDFS.

Figure 3.2. Portfolio/Government Equity Ratios



Source: Created by CDFS.

The 'gap' between FMO and Proparco is narrower than in Figure 3.1 given the higher percentage of the latter's equity held by AFD (circa 80%) and the 'dilution' of the leverage by the government owned equity of AFD on its debt. FCDO being the sole shareholder of BII, the ratio for the UK pair remains unchanged. This may be a crude measure, but there is no denying the picture it paints.

An interesting factor is that the non-government equity holders of Proparco and FMO do shine by their discretion. There is very little in the way of communication on the part of Dutch and French commercial banks around their holdings in their respective national development finance institutions. One could be forgiven for thinking they do not spend much time thinking about them. If these shareholders are as undemanding as they appear to be, the simplification argument of FCDO's sole ownership would be weakened, and non-governmental sources of equity should arguably be considered. It must, however, be noted that AFD has, as discussed, been the main provider of additional equity capital to Proparco, and that there is no evidence of appetite for additional equity rounds on the part of the banks that own 42% of FMO. Non-government shareholders may therefore be an undemanding but unreliable source of equity capital.

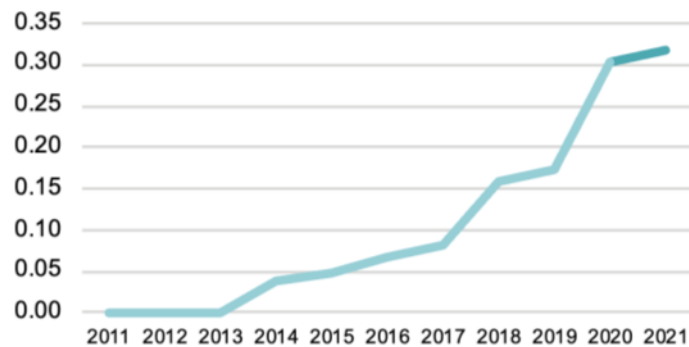
### ***But is it really all about money?***

As suggested in the CDFS Short Read published in November 2022 (CDFS, 2022<sup>[22]</sup>), cash is in isolation an imperfect measure of effort in any investment scenario. Risk must be considered. As described above, its 100% equity funding model means that BII enjoys comparatively higher levels of flexibility and should be able to take more risk than leveraged DFIs and therefore presumably lead to more significant or at least complementary development impact.

Comparing developmental bang per governmental buck on a cash basis across the three DFIs is therefore not satisfactory. Whilst a necessarily complex risk-weighted assessment is beyond the scope of this initial study, it is perhaps useful to note that the Basel III revised standardised approach to credit risk weights for example assigns a 100% risk weight to exposure to BB+ to B- credit but a 400% risk weight to speculative unlisted equity. A risk-weighted picture may thus be a very different one.

BII has undoubtedly historically taken a great deal more equity risk as a percentage of its portfolio than either FMO or Proparco. Until 2013, it was in fact almost exclusively an equity investor. Its funding model, and its inherent limitations in terms of leverage, are arguable justified by its ability to play a unique role in the provision of much-needed equity capital in a development finance sector otherwise traditionally focussed on lending.

As illustrated in Figure 3.3 however, BII has over the last decade aggressively developed its lending activity, thereby gradually reducing the strength of this argument. As BII becomes relatively less exposed to equity risk, it may wish to consider the opportunity to introduce some level of leverage. BII does in fact volunteer that 'a modest amount of balance sheet leverage can be compatible with a composition of investment weighted towards riskier equity.' (BII, n.d.<sup>[23]</sup>)

**Figure 3.3. Ratio of Debt to Equity in BII's Portfolio**

Source: Based on calculations made using data published on the BII website (BII, n.d.<sup>[20]</sup>).

On a different note, intuition would suggest that a higher level of leverage should translate into a more prudent approach to lending.

ODI's December 2022 "An exploration of bilateral development finance institutions" (ODI, 2022<sup>[24]</sup>) business models' working paper takes a look at the CET1<sup>8</sup> ratio of FMO and DEG and finds that FMO "may possibly present the lowest risk level among the studied DFIs".

There are significant limits to the ability of observers to accurately assess the risk management of financial institutions, particularly where there is limited transparency and consistency in public reporting practices.

In any case, the objective should not be to second-guess the work of DFI professionals. Developing an ever-improved understanding of risk to allow for the optimisation of balance sheets within evolving sets of constraints is an activity financial institutions across capital markets have long dedicated considerable time and resources to.

The question should therefore rather be whether shareholders ought to equip bilateral development finance institutions with additional resources and expertise to push the boundaries of how much risk they can take in the context of their specific constraints and importantly, of the need they seek to address.

### DFI access to debt capital markets is not always straightforward or possible

More risk, more leverage, more everything. There is an off-putting predictability to the recommendations regularly and spontaneously made to development finance actors by well-meaning observers.

Whilst much seems to argue in favour of bilateral DFIs tapping debt capital markets for the means of their growth, several real-world factors stand in the way of this apparently straightforward course of action.

- Some bilateral DFIs are simply barred from borrowing by the laws they were created through or the legal documents that led to their incorporation. Norfund's statutes for example clearly state that it may not 'raise loans' (Norfund, 2016<sup>[25]</sup>). BII's 2017 articles of association do on the other hand suggest that one of its objects is to 'to borrow or raise money by any method and to obtain any form of credit or finance' (BII, 2017<sup>[26]</sup>).
- If an institution sits entirely on the balance sheet of its parent government, then so will the debt it accumulates. Credit rating agencies are quite apt at seeing through layers of entities. So are investors.
- The well-documented pipeline issue that puts the brake on development finance deployment may get worse as leverage reins in risk appetites just as it increases the amounts available for lending.

Governments, parliaments, treasuries, and sundry ministries will have their say before laws, mandates and instructions allow for an individual DFI to make its government-owned equity riskier and add to the national debt pile.

Debt issuance is potentially a powerful instrument of private capital mobilisation for development finance institutions. Wherever it is applied, leverage will come at a cost to donor countries. Whether a treasury borrows to inject equity, a larger, more diversified parent taps capital markets and passes on the proceeds or a DFI strikes out on its own debt issuance journey, the challenge is to establish which model best positions the DFI to deliver on its mission within its own, often unique set of constraints and opportunities.

## Big is beautiful

*Size does, in all things capital, generally matter.*

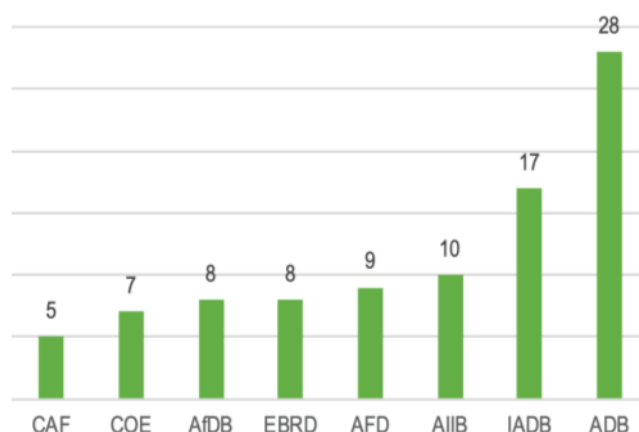
This principle applies to DFI funding models, particularly where they seek to tap debt capital markets.

### **Debt issuance dynamics**

Debt capital markets are vast, and home to large actors, whether they be institutional asset owners or the fund managers that build products for them. Having large funding needs is a competitive advantage. The two issuers analysed for the purpose of this work are FMO - which borrows for itself - and AFD - which borrows for its group, including Proparco.

AFD's annual issuance is roughly nine times that of FMO. Figure 3.4, sourced from AFD's investor presentation for March 2023, shows that AFD is amongst the largest issuers in the development finance space. At just over one billion Euros per annum, FMO does not figure on this chart.

**Figure 3.4. Expected 2023 Funding Programs of Development Banks (€ billion)**



Source: Based on calculations made using data published in AFD's Presentation to Investors (AFD (Proparco), 2023<sup>[9]</sup>).

This is important for several reasons, linked to as many factors relevant to an issuance programme. The cost of debt is of course key, but so is the ability to build resilient access to capital markets from a diversified lender base.

Credit risk is of course a key component of the pricing of debt instruments by capital markets. But it is not the only one. As is the case for any other market, the price of debt is arrived at through the meeting of supply and demand. Investors value liquidity, which itself is a function of size and of the diversification of

the investor base. The size of AFD’s funding programme means that it is well positioned to act as a liquidity provider. In recognition of this, it has sought to raise ‘the issue size of its bonds to EUR 2 billion’ and to use ‘TAPs to rise the size of existing bonds to EUR 2 billion’ (AFD (Proparco), 2023<sup>[9]</sup>). Being able to issue in large sizes does in itself open the doors to a wider universe of investors who may not be able to participate in small bond issues.

The importance of these factors is best illustrated with a real-life example. Both FMO and AFD issued a 5-year USD bond in 2021. AFD’s was 2 billion in size, FMO’s was 500 million.

**Figure 3.5. Sample Bond Issues**

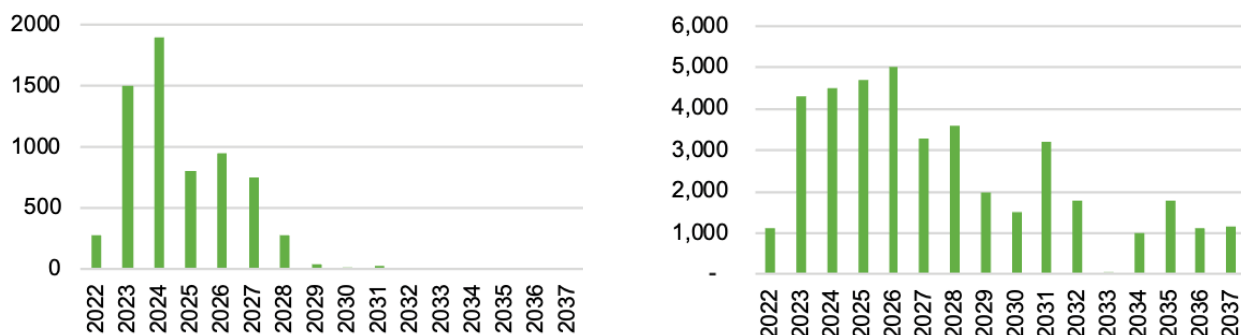


Source: Based on calculations made using data published in AFD Benchmarks publication (AFD (Proparco), 2021<sup>[27]</sup>) and FMO’s Investor Presentation (FMO, 2023<sup>[15]</sup>).

As discussed above, FMO enjoys a AAA credit rating, whereas AFD holds an AA credit rating. As illustrated in Figure 3.5, the coupon on AFD’s bond was lower than FMO’s. The timing of the issues was not perfectly aligned, and there is no suggestion that this will systematically be the case, but notwithstanding small differences in reoffer prices, it is useful to keep in mind that credit ratings do not simply translate into a fixed interest rate schedule.

Bond investors do seek to build portfolios of instruments across maturities and have idiosyncratic needs for specific currencies. Having a large issuance programme allows issuers the flexibility to satisfy these needs by targeting underserved sections of the yield curve or to offer issues in an array of currencies. Figure 3.6 contrasts the redemption profiles of FMO and AFD.

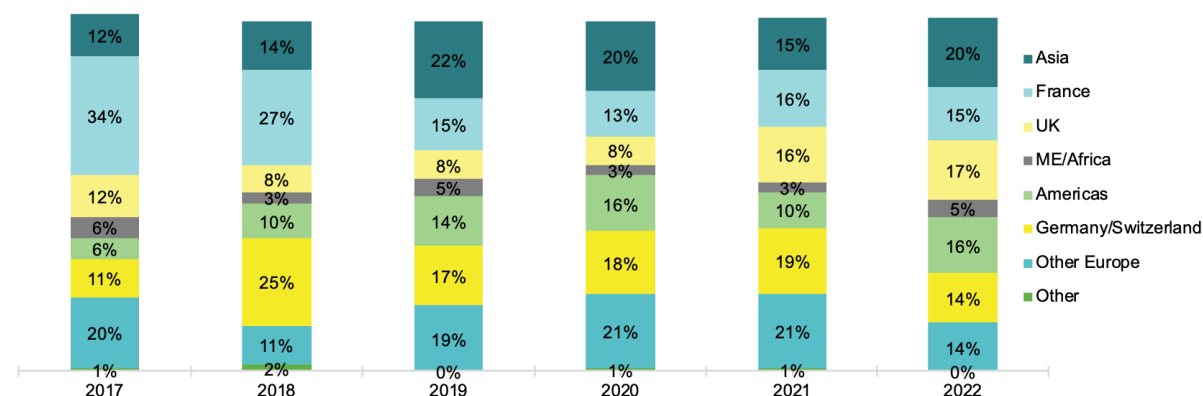
**Figure 3.6. Redemption Profiles, FMO (Left) vs AFD (Right) (€ million)**



Source: Based on calculations made data published on the FMO website (FMO, n.d.<sup>[11]</sup>) and on Proparco’s website (AFD (Proparco), n.d.<sup>[5]</sup>).

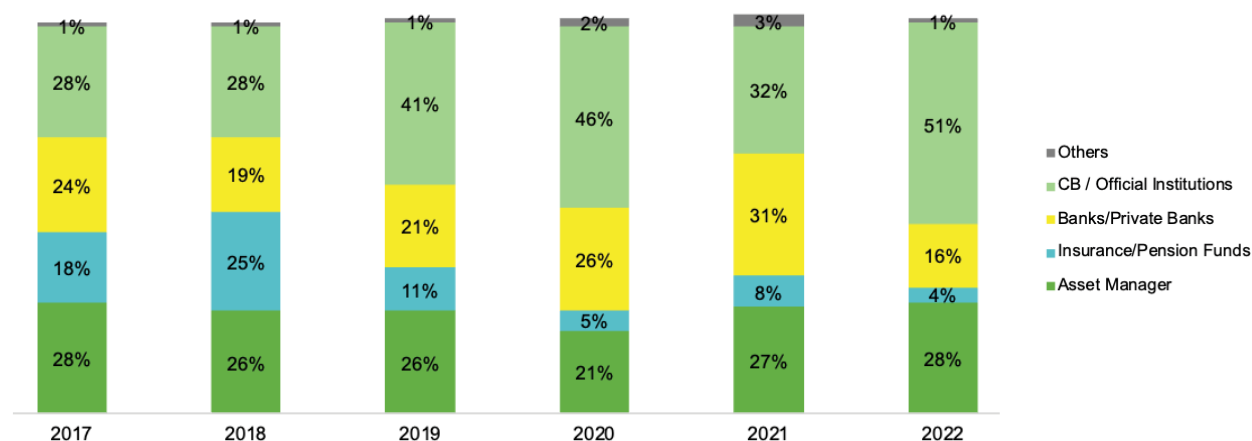
The law of eggs and baskets does apply to debt capital markets access. Building a lender base across geographies and categories of investors provides protection against specific circumstances, making capital less readily available in a specific segment of the market. Figure 3.7 and Figure 3.8 illustrate how AFD is able to do so.

**Figure 3.7. AFD Debt Issuance Breakdown by Geographic Region**



Source: Based on calculations made using data published in AFD's Presentation to Investors (AFD (Proparco), 2023<sup>[9]</sup>).

**Figure 3.8. AFD Debt Issuance Breakdown by Investor Type**



Source: Based on calculations made using data published in AFD's Presentation to Investors (AFD (Proparco), 2023<sup>[9]</sup>).

### ***Mutualised services***

Debt issuance on capital markets is a highly intermediated process, with syndicates of banks being mobilised to place bonds with investors. The market operations teams at both FMO and AFD are in fact quite small, and equivalent in size. Economies of scale mean, where available, that resources can be focussed on the unique value proposition of development finance institutions.

### ***A function of integration***

The benefits of large-scale funding programmes and of mutualised services are plain for all to see, and there is no suggestion here that they have escaped the notice of DFI management teams anywhere. They

are available as a function of the level of integration of DFIs with their governments or with a larger development finance entity.

There does not always exist within a country's development system of institutions a larger entity that its bilateral DFI could be integrated into or share its funding function with. FMO does enjoy strong, explicit support from the government of the Netherlands, but is a very clearly separate entity. Proparco is highly integrated within AFD, which is itself 100% owned by the French state. It is however at arm's length with the French treasury, even if credit ratings agency and investors alike largely assume that support would be forthcoming should AFD run into trouble.

Whilst it may not be possible to revisit these long-established models, they provide valuable lessons for those who may consider mandating their own DFIs with initiating debt capital markets issuance programmes.

### The Green, Social and Sustainability (GSS) Bonds opportunity

As already highlighted, AFD and FMO actively tap debt capital markets to fund their activities. Both issue bonds of various size and duration, denominated in an array of currencies. Increasingly, both have been accessing the debt markets through Green, Social and Sustainability (GSS) bonds.

GSS bonds map the use-of-proceeds to assets or projects that are pursuing sustainable, social, or environmental goals. At a global level, annual GSS bond issuances stood at EUR 702 billion compared to USD 8.3 trillion (EUR 7.9 trillion) overall bond issuance in 2022 (Refinitiv, 2023<sup>[28]</sup>). However, GSS bonds have been growing significantly in the past years, increasing by an average annual rate of 72% from 2014-2021 (OECD, 2023<sup>[29]</sup>).

Whilst it is true that GSS bonds constrain the fungibility of their proceeds, issuers such as AFD and FMO are presented with a number of potential benefits. Among these are attracting a more diversified and larger investor base and deriving reputational advantages by demonstrating a commitment to the Sustainable Development Goals (SDGs). There have also been in some cases, particularly in OECD bond markets, pricing benefits compared to the issuance of plain vanilla bonds, although this phenomenon is not consistently observed across issuer type and characteristics and has yet to be documented for DFIs. However, when a GSS bond is issued with a higher price than a non-labelled bond, thereby placing it inside the yield curve of the issuer's own outstanding debt, the pricing differential is referred to as a 'greenium' or 'socialium' (Climate Bonds Initiative, 2021<sup>[30]</sup>). For example, twin bonds issuances of a labelled and vanilla bond, as employed by the German and Danish government in 2021 and 2022 respectively, suggested a small but statistically significant 'greenium' for European countries (Ando et al., 2022<sup>[31]</sup>).

Both AFD and FMO have been racking up their GSS bond issuance. In the case of AFD, one of the most recent Sustainable Bond issuances was in January 2023, raising EUR 1.5 billion and offering a final spread of +51 basis points over the OAT curve. In this particular case, the bond did not show a greenium. However, high demand was demonstrated by the profile of investors with Asset Managers taking 38% of the allocations, Banks 37% and Central Banks & Official Institutions 14%.

According to its 2023 Investor Presentation (AFD (Proparco), 2023<sup>[9]</sup>) (AFD (Proparco), n.d.<sup>[32]</sup>), AFD will grow its SDG Bond Issuance program, making use of its Sustainable Development Analysis & Opinion Mechanism (AFD (Proparco), 2023<sup>[33]</sup>). The framework employs an "impact by design" approach that selects loans according to their actual contribution to the SDGs. Early signs are encouraging and in 2022, SDG bonds made up approximately 50% of AFDs funding. As part of this framework, AFD has agreed to ensure an amount equal to the net proceeds of the SDG bond portfolio will be tagged to a portfolio of eligible loans.

Meanwhile, FMO has issued four sustainability bonds in EUR (500 million each) and one in SEK (2.7 billion). It has also issued two green bonds, one in USD (500 million) and one in SEK (1.5 billion) (FMO, 2023<sup>[34]</sup>). For the purposes of comparison, FMO's sustainability bonds can be considered as equivalent instruments to AFD's SDG bonds.

According to the sustainability bonds allocation report, FMO has allocated USD 1.91 billion to eligible green and inclusive projects as of December 2022, against a total sustainability bond outstanding of USD 1.91 billion. According to the FMO Sustainability Bonds Newsletter, 70% of the sustainability bond proceeds go to green and 30% to social projects (vs 80% green and 20% social previously) (FMO, 2023<sup>[34]</sup>). This move to more social projects reflects interest amongst the bond investor and issuer communities in creating positive impact through social causes.

In 2022, FMO had funding needs of about USD 1 billion. Against this, FMO issued one 3-year USD 500 million benchmark bond, including private placements in LCY and USD. The latest GSS bond issuance was in October 2022, when FMO priced a successful EUR 500 million 5-year fixed rate sustainability bond (no-grow). The bond offered a coupon of 3.000% and a spread of -12bps.

Based on FMO's Investor Presentation of March 2023 (FMO, n.d.<sup>[35]</sup>), there is a significant push to tap the GSS bond markets based on a clearly established Sustainability Bonds Framework (SBF), with issuance of GSS bonds. As its funding needs grow, FMO is planning to accelerate its sustainability bond issuance due to a strong pipeline into year-end and an outflow of cash collateral. According to FMO's SBF, the proceeds of bond issuance will only be used for the financing or refinancing of eligible green and social projects, or to repay a note issued under the SBF, as per the bond use of proceeds clause.

### ***Advantages & Disadvantages***

GSS bonds have demonstrated their ability to mobilise institutional investors that would not otherwise necessarily hold exposure to developmental or sustainable assets in developing countries. They thereby serve to educate an investor class that increasingly desires ESG and SDG assets but not always direct developing country exposure. Investors could acquire such exposure indirectly through DFIs' debt issuance.

The issuance of GSS bonds, where the assets are tied to the bond, may limit balance sheet flexibility, and potentially increase exposure. Typically, the underlying projects' cash flows are in local currency, often creating a financing mismatch where hedging needs to be used. Moreover, the majority of bonds issued are in hard currency (OECD, 2023<sup>[29]</sup>). GSS bonds have also been the target of greenwashing accusations (Fatica and Panzica, 2021<sup>[36]</sup>; Reclaim Finance, n.d.<sup>[37]</sup>). To continue tapping their potential, it is therefore important for these concerns to be addressed - for example via strong, harmonised impact measurement and reporting strategies that contribute to the credibility of the market and investors' confidence.

Sustainability-linked bonds, which are more fungible than GSS bonds as they are not tied to particular projects or assets but rather to the achievement of predetermined sustainability objectives, have yet to be utilised by DFIs.

### ***Reflections***

There is growing investor interest to hold ESG and SDG aligned investments. This is evidenced by the growing issuance of GSS bonds and often the premium investors are prepared to pay for accessing this debt, with issuers benefiting from the resultant greenium. Thanks to ongoing investor interest in green and social debt products, issuers have been able to attract new investors which can contribute to improved debt pricing. However, for a demonstrable greenium to develop across issuances, DFIs and MDBs would need to grow investor interest around their green and social activities, while ensuring robust credit risk.

Both AFD and FMO are responding to the market interest in GSS bonds and as highlighted, have in place GSS bond funding strategies. Those DFIs that can raise debt capital should seize on the strong market signals, as this allows capital to be mobilised within their own financial and regulatory systems. In tandem, this is a goal many OECD governments have in place in respect to sustainable market developments of their own financial systems (AFT, 2021<sup>[38]</sup>). GSS bonds issued by DFIs can allow institutional investors to contribute to the SDGs in developing countries while benefiting from strong credit ratings. Few public or quasi-public issuers offer such an opportunity.

Using the GSS bond market, MDBs and DFIs can effectively raise capital and attract institutional investors that typically are attracted to sustainable bond issuances. Given the experience and risk management abilities of MDBs and DFIs as they relate to developing countries, these institutions are well placed to facilitate the development of GSS bonds in their home markets, as well as the global development of sustainable finance.

By educating investors and providing sustainable financial leadership, such efforts at widening the investor base should ultimately result in an increase in GSS bond issuances, overall but also - and importantly - in developing countries where local capital mobilisation needs to occur.

Elements relating to the broader GSS bond market – such as policy and regulatory factors, sentiment, and financing trends – will continue to shape its overall impact. Still, for those DFIs able to make use of debt capital markets and effectively manage in-house factors such as funding strategies and shareholder equity cushions, GSS bonds hold significant and increasing promise.

## Funding models in times of mobilisation

Development finance institutions are increasingly encouraged to transcend the current perimeter of their operations through the mobilisation of capital markets. This includes co-investment and risk transfer from their balance sheets, either through securitisation or recourse to credit insurance markets. The potential of their funding models as mobilisation tools should not be underestimated. Neither should the incentives for these dynamics generated by their funding models.

### ***Debt as a mobilisation instrument***

The measurement of private capital mobilisation by DFIs has thus far been focussed on amounts mobilised at the individual transaction level. Notwithstanding the fact that, here again, the risk dimension is too often ignored, funding mobilised from capital markets through the issuance of debt instruments – or indeed through non-government equity stakes in DFIs – should also be considered.

When an investor buys a bond issued by FMO, it becomes exposed to some of the risk of FMO's portfolio, and FMO is deploying the resulting capital to a series of individual transactions. This intermediated exposure is worthy of recognition.

DFI and MDB issuance on debt capital markets is arguably not only the most tried and tested, but also one of the most promising avenues for the mobilisation of capital markets. It is however important to keep in mind that:

- When acquiring a DFI issued bond or another form of senior debt, an investor is taking on a relatively low share of the risk of the DFI's assets.
- As debt is issued and the balance sheet becomes more highly leveraged, the level of risk taken on by the equity component of the DFI's liabilities increases. As a result, the 'effort' consented by the owner of this equity, to use ODA parlance, increases, the equity it has provided has become riskier.

In contrast to the issuance of bonds and senior debt, which give lenders exposure to the DFI's entire portfolio, sheltered by equity and potentially by the support of the government shareholder, securitisation backed issuance would allow DFIs to provide exposure to a specific pool of loans, or to a specific risk tranche of the DFI's portfolio. This may reduce leverage and transfer more risk – as well as a higher return – to capital markets participants.

Credit insurance may deliver a similar risk transfer, but does not result in the issuance of a security and is traditionally restricted to relatively few specialised actors, and therefore offers a different mobilisation opportunity.

### ***Debt as a mobilisation driver***

Debt-driven leverage brings financial institutions closer to the boundaries resulting from the combination of regulatory, prudential and credit rating frameworks. As a result, risk transfer, whether it be delivered through participation in credit risk insurance markets or through securitisation, has traditionally been used by financial institutions as a balance sheet optimisation tool.

It is for example used to enhance risk-adjusted return on capital (RAROC). This is calculated as:

$$RAROC = \frac{(PTI - ECL)}{\text{Capital charge}}$$

Where:

*PTI = Pre-Tax Income – Revenues – Cost of debt – Operating costs*

*ECL = Expected Credit Loss as per IFRS 9*

*Capital charge = calculated as a function of Risk Weighted Assets*

In a synthetic securitisation scenario for example, the capital charge is reduced as a result of the reduction of risk weighted assets, and the PTI is reduced by the spread paid out to the protection seller. The resulting change to the RAROC illustrates the enhanced profitability. A more complete depiction of these mechanisms is included in Eighteen East's SDC Framework report.<sup>9</sup> It can also be used to solve headroom issues when limits linked to maintaining credit ratings or to regulatory frameworks preclude the DFI from making new loans. This was, for example, the rationale behind the African Development Bank's Room 2 Run synthetic securitisation<sup>10</sup>.

As demonstrated by the above-mentioned transaction, the limits derived from credit rating agencies' models are a relevant motivation for multilateral development banks, adamant as they are that their AAA rating must be protected. Where bilateral DFIs are concerned however, the fact that their credit rating is a function of the perceived solidity of the support they receive from their government shareholder as well as of the strength of their balance sheet means that this is less likely to prove a powerful incentive for the use of risk transfer instruments.

The RAROC motivation is in theory relevant. Whether a risk transfer operation is attractive will, however, depend on the cost benefit analysis the equation above serves to deliver. The spread paid out to the protection seller is a key input. How narrow this spread is will be, among other elements, a function of the data available for analysis. The better the risk is understood, the more aggressive the pricing will be. Conversely, where little data is available, the protection seller is bound to adopt a conservative stance and to build a buffer by charging more, thereby making the transaction unattractive.

Headroom issues linked to internal or regulatory concerns are however directly relevant. This is for example evidenced by Proparco's recourse to AFD guarantees to address such limits. There do exist precedents for the use of risk-transfer techniques within the bilateral DFI world, and indeed within the sample selected for this work. FMO did for example in 2019, enter a risk sharing framework agreement

with Munich Re (FMO, 2019<sub>[19]</sub>). This is however an ex-ante risk transfer scenario. It may well address headroom issues going forward but is unlikely to help with existing constraints.

There are several factors to keep in mind when assessing the suitability of risk transfer initiatives for bilateral DFIs:

- Sizeable, diversified pools of assets are typically needed to successfully structure such transactions. This is driven by (a) commercial factors, including economies of scale and the minimum size requirements of institutional investors, and (b) regulatory factors linked to, for example, the European Union's Securitisation Regulation 2017/2402.
- Beyond the RAROC calculations, the fact that the risk transferred will take time to redeploy means there is likely to be a significant negative impact on profitability.
- Risk-transfer is a relatively complex aspect of capital markets, and bilateral DFIs may not be universally equipped with the know-how required to successfully execute it. Procuring external expertise may represent a costly hurdle.

Not specific to DFIs are the sometimes-punitive risk-weights mandated by frameworks such as Basel for atypical securitisation scenarios.

There are also individual DFI specific factors to consider. For example, the harmonious balance of the AFD/Proparco matched funding system may be upset by risk-transfer initiatives. In fact, since much of the risk is managed at the AFD level, these concepts may only apply to the small part of its lending book Proparco manages on its own balance sheet. This in turn would likely fall foul of the size and diversification requirements of risk transfer transactions.

### ***The equity question***

A strong argument can and should be made for the use of private equity as a development finance tool. Its use is, however, linked to challenging financial realities. As discussed, DFIs in the sample are 'funding' private equity portfolios with equity capital. Most relevant frameworks take a dim view of unlisted equity positions, assigning high risk weights. This is particularly the case if those are deemed exotic, which most DFI private equity investments undoubtedly would be.

Direct private equity investments, unlike their debt equivalents, have no built-in, guaranteed exit scenario or investment horizon. There may not be a buyer at all at any given point in time. Intermediated investments through private equity limited partnerships provide the illusion of a self-liquidating instrument, but the reality is that they have no more ability to provide certainty. Whilst not enough has been written on this uncomfortable topic, 'zombie funds' laden with assets that cannot be sold, are a reality of the DFI private equity practitioner's life and encumber balance sheets.

The delivery of high developmental impact through equity financing therefore does come at a high cost in terms of capital velocity, regulatory limits headroom, and eventually funding costs and leverage potential. The incentive to recycle capital through exit-mobilisation should therefore be commensurately higher where equity portfolios are concerned. There are, however, significant hurdles to this process.

Private equity funds are not designed to facilitate the sale of participations. Limited partnership agreements often require the consent of the general partner, and at times of all the other investors before a sale can be executed. Confidentiality clauses make the sharing of information difficult. The valuation of private equity portfolios is notoriously closer to art than it is to science. The process itself is perceived as long and arduous and where an intermediary is involved, the inefficient nature of this market allows for a culture of hefty fees.

The secondary market for the wider private equity sector has however experienced significant growth over the last decades. Should the incentives prove high enough, there is little doubt that the comparably small

pool of potential sellers could overcome their initial reluctance, and with it the obstacles standing in the way of market building.

In the meantime, however, DFIs should increasingly ask themselves whether their balance sheet is the right place for private equity portfolios. FMO has demonstrated the feasibility and the rationale for off balance sheet, managed funds. Not only would an off-balance sheet approach help solve regulatory capital and leverage issues, but it could act as a facilitator for the mobilisation of private capital through the advent of a model where DFIs seek to mobilise private capital into equity vehicles not through co-investment but through the sharing of their considerable expertise and know-how.

## A word on regulation

This report is specifically focussed on the analysis of funding models, at the exclusion of the regulatory frameworks bilateral DFIs are subjected to. Unsurprisingly in a financial institution context, it is however impossible to ignore the regulatory elephant in the room. It is abundantly clear that many of the constraints felt by DFI professionals in the delivery of their mission have at least as much to do with regulatory limits – where these exist – as they have with funding models.

Subjecting bilateral DFIs to a regulatory or supervisory regime, whether it be those normally applied to banks or otherwise, does have benefits. It certainly yields a much higher level of transparency than where no such arrangements are in place. Still, it must be remembered that the rules devised to rein in the profit-maximising, risk-taking instincts of commercial financial institutions may well prove counter-productive when applied to institutions tasked with acting as trailblazers in our common quest for sustainable development.

DFIs do not have depositors. They may well be deemed to be of systemic importance, and enforcing prudent risk management rules is therefore justified, but time and resources should be deployed to establish whether a differentiated approach should be considered.

## 4 What now?

Bilateral development finance institutions have built up capabilities, expertise and networks that increasingly position them as major actors in the development finance space alongside multilateral development banks. The mobilisation agenda is increasingly on the minds of policymakers, with the focus likely to shift to bilateral DFIs. In an environment where public funding may become constrained, the mobilisation of private capital and the optimisation of their balance sheets are indeed increasingly necessary to ensure that the potential of bilateral DFIs is realised in full and in line with agreed development targets.

It is both difficult, and ultimately not important, to understand why the debt capital markets issuance programmes of DFIs and MDBs have to date not been recognised as a legitimate mobilisation instrument. The reality is that leverage has always been at the core of financial institutions business models, and that those tasked with the delivery of just and sustainable economic development for all should, as their purely commercial counterparts do, seize its opportunity.

A funding model that leverages taxpayer-funded equity by providing investors with simple instruments they have always used as the building blocks for their portfolios may be seen as a straightforward and time-efficient way to mobilise private capital. GSS bond market dynamics could provide DFIs with an opportunity they are uniquely positioned to seize. Leverage does, however, of course increase the risk taken on by shareholders and cannot be ramped up *in infinitum*. Here again, financial institutions have long resorted to risk transfer techniques in support of an 'originate to distribute' model, in support of a model that focuses on their core value proposition rather than solely on their capital. And this DFIs must also consider.

Reflections should inform decisions pertaining to the optimal model for equity investment programmes. Off-balance sheet solutions should be explored and their potential to deliver a combination of regulatory capital benefits and mobilisation efficacy analysed. Private equity investing and lending are fundamentally different endeavours and thus are seldom found under the same roof. It may in fact be argued that the teams responsible for their delivery should be equipped with differentiated frameworks and incentives.

The predominance of hard currencies both in terms of raising capital and deployment has long been identified as a chink in the development finance armour. The provision of local currency funding is key for development impact and could facilitate the mobilisation of local capital. There should be a concerted effort to explore the potential to do more local currency activities.

The differentiated funding models analysed for the purpose of this report do provide for rich learnings. They are also representative of a system of national institutions that are in many aspects of their operations limited by their scale. Leverage may provide a partial answer. How leverage is acquired should be determined with the benefits of size kept in mind.

Ultimately, however, it is through ever-closer collaboration that DFIs can reap the rewards of the successful harnessing of capital markets. Together, their combined portfolios can offer the size and diversification efficient risk transfer transactions require. Together, small institutions can hope to benefit from the very tangible benefits of large-scale, regular issuance programmes. Together, they can tap, beyond their own 'turf', an investor universe vast enough to provide the basis for a successful market-building exercise. Together is of course easier said than done, and civil society must continue to investigate, challenge and support DFIs on the path to greater collaboration.

# 5 Conclusion

- Bond issuance, by providing investors with instruments they are familiar with and can readily incorporate into their portfolios, may well be one of the most effective means of private capital mobilisation. It offers investors the means to contribute to sustainable development with the benefit of the unique know-how DFIs have developed over decades. The growing interest in GSS bonds reinforces its attractiveness.
- Bilateral DFIs should therefore in theory at least consider the possibility of leveraging their balance sheet, while examining any effect on potential development impact. As donor countries assess this opportunity, existing funding models may provide them with valuable insights, particularly when deciding whether to have their bilateral DFI access debt capital markets directly or through a larger, more established issuer.
- There can be no question that trade-offs exist. Whether they are enforced by regulators, credit rating agencies or prudent risk management, leverage creates constraints. Equity investments are for example an important component of the DFI product offering, but the inescapable reality is that private equity funds and leverage through capital markets debt issuance are unlikely balance sheet bedfellows. Most risk-weighted assets frameworks are punitive of private equity positions and the above-mentioned constraints will close in faster on those maintaining sizeable allocations to this asset class on their balance sheets.
- To ensure that the development finance system of institutions continues to be able to provide scarce equity capital to businesses across the developing world, government decision-makers at DFI shareholders will therefore face choices.
- In an ideal world, collaboration among DFIs would ensure that individual institutions make use of the most appropriate funding model to take on specific and complementary segments of the demand for funding, thereby adding the benefits of specialisation to those of a complete product offering.
- There is an inherent risk to a wider adoption of a leveraged model by bilateral DFIs. The frameworks that guide the activities of financial institutions were designed to channel behaviours towards alignment with desired objectives. The 'laws' of leveraged finance are as a result normative. In a context where the scarcity of bankable opportunities is already flagged as a key issue, converging funding paths delivering higher volumes of available financing risk leading to the same, already overcrowded pipeline.
- This report is therefore not suggesting that there exists a single optimal funding model, or that leverage should be universally or uniformly applied. It rather proposes that a greater level of co-ordination amongst DFI shareholders needs to be introduced to ensure that there is complementarity across the offering of individual DFIs, and that their funding models are calibrated accordingly.
- The OECD and CDFS stand ready to facilitate further policy work and discussions around this topic.

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## Notes

<sup>1</sup> Publicly available financial information refers to the published Annual Reports of Proparco, FMO and BII and relevant data from each DFI's website.

<sup>2</sup> Information on this concept can be found at <https://www.finance-fair.org/en>

<sup>3</sup> Publicly available loan information from Proparco/AFD Group website.

<sup>4</sup> Information regarding supporting financial inclusion in Madagascar can be found at <https://www.proparco.fr/en/carte-des-projets/ab-mada-efsd-covid>

<sup>5</sup> Information regarding supporting financial inclusion in Burkina Faso can be found at <https://www.proparco.fr/en/carte-des-projets/acep-bf-efsd-covid>

<sup>6</sup> Information regarding supporting financial inclusion in Georgia can be found at <https://www.proparco.fr/en/carte-des-projets/credo-efsd-covid>

<sup>7</sup> Information on BII's launch of pioneering investment platform to boost funding for SMEs in Ghana can be found here <https://www.bii.co.uk/en/news-insight/news/british-international-investment-launches-pioneering-investment-platform-to-boost-funding-for-smes-in-ghana/>

<sup>8</sup> The Bank for International Settlements definition of capital in Basel III can be found at [https://www.bis.org/fsi/fsisummaries/defcap\\_b3.pdf](https://www.bis.org/fsi/fsisummaries/defcap_b3.pdf)

<sup>9</sup> The EighteenEast, Sustainable Development Certificate Framework Report can be found here <https://www.18eastcapital.com/#:-:text=Sustainable%20Development%20Certificates%3A%20Framework%20Report>

<sup>10</sup> Information on the African Development Bank Room2Run Transaction can be found at <https://www.afdb.org/en/news-and-events/african-development-bank-and-partners-innovative-room2run-securitization-will-be-a-model-for-global-lenders-18571>