FRESH IDEAS ABOUT BUSINESS IN EMERGING MARKETS
EMCompass

www.ifc.org/thoughtleadership
NOTE 52 • APRIL 2018

Crowding-In Capital: How Insurance Companies Can Expand Access to Finance

Development institutions, governments, and the investment community have been exploring ways to increase private capital flows to support critical development projects in emerging markets. A new financing mechanism applies the risk-bearing capacity and know-how of insurance companies to allow these companies to take what are, in many cases, their first insurance exposure to markets and counterparties. This innovative credit insurance solution, which we call "Credit Mobilization," is being pioneered to provide long-term funding to developing country banks, and may offer significant potential for scale-up and replication.

The Sustainable Development Goals approved by the members of the United Nations provide ambitious targets for global, sustainable development. Achieving these targets by 2030 will require substantial know-how and resources, potentially reaching into several trillions of dollars per year. This is well beyond what governments can provide on their own and will require a significant contribution by the private sector and private investment to succeed.[1]

International banks have traditionally been major financiers of private-sector projects in developing countries, and continue to be a major source of capital. However, since the 2008 global financial crisis, these institutions have grown more cautious about cross-border exposures, especially for longer tenors. International banks' cross-border claims on emerging markets remain at under 50 percent of their peak pre-crisis levels.[2] A broader base of funding is clearly needed.

A major alternative to international bank finance is funding from institutional investors. This investor class includes a wide range of entities, from sovereign wealth funds, pension funds and endowments, to hedge funds, mutual funds, and insurance companies. As a group, institutional investors control over $70 trillion of funds in developed markets. Institutional investors based in emerging markets currently hold between $4 trillion and $5 trillion in assets and are seeing considerable growth.[3]

With low yields in developed markets, many institutional investors are seeking higher-yield opportunities. For example, many pension funds are allocating more of their funds to "alternate" investments beyond the traditional developed country bond and stock markets, to include high-yield products, private equity, emerging markets, and other investments. The increased appetite among

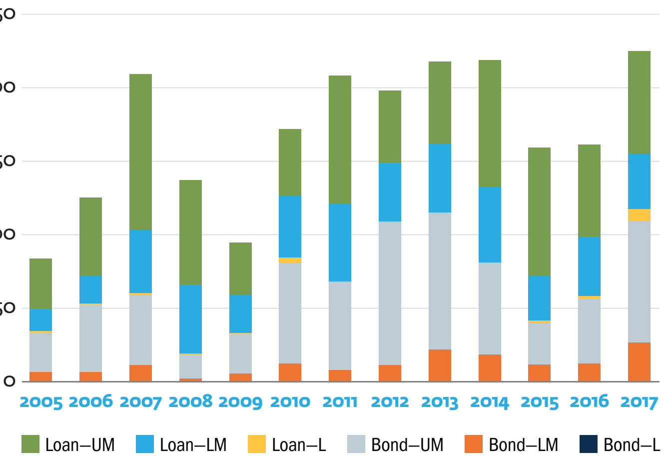

FIGURE 1 Emerging Markets International Bond and Syndicated Loan Issuance by Corporations, Excluding China (in $bn)

Source: IFC and Dealogic. L=Low Income, LM=Lower Middle Income, UM=Upper Middle Income. For maturities greater than one year. Includes only products marketed to international investors.

institutional investors for emerging market investments has coincided with and helped support rapid growth in the issuance of bonds from emerging markets (Figure 1). Institutional investors have exhibited a strong desire for debt instruments from emerging market financial institutions in particular.[4]

Still, there remain substantial limitations for emerging market companies to obtain funding from institutional investors through the bond market or through other means. Only the largest and most sophisticated firms have access to international bond markets. Also, local bond markets have developed in any significant way in only a few countries. At the same time, direct lending by institutional investors to private companies in emerging markets is virtually non-existent. For smaller companies in higher-risk markets, the information costs render investments by institutional investors prohibitively expensive.

Institutional investor interest in developing countries is primarily driven by a search for higher yield. To that end, large portions of these investors' asset allocations are directed to higher returning asset classes such as equities. On the debt side, notwithstanding the general search for yield, many investors have a preference (often driven by regulatory requirements) in their core investment strategies for investment-grade products. Since many emerging market investments remain below investment grade, this can limit the amount of funding available.

Thus, a key challenge for increasing the flow of debt finance to emerging markets is to develop a range of innovative financing vehicles that can match the structuring, risk, and return requirements of various investors with viable developing country projects.

The Credit Mobilization Solution: Providing a Project Pipeline for Insurance Companies

The global insurance industry provides a solution. This group of companies has a deep understanding and appetite for various types of risk. Unlike most institutional investors, insuring risk is central to these companies' business models. Credit insurance is a growing segment within the risk portfolios of insurance companies, and it can provide attractive diversification for them by providing risk assets that are distinct from those in their core businesses of weather, life, and other non-financial risks. In many cases, however, insurance companies lack a pipeline of financial assets to insure, aside from short-term supplier credits in developed countries.

IFC has developed a structure that gives insurers access to high-quality, long-term credit risks in emerging markets. This structure "mobilizes" the critical risk-bearing capacity of the insurance companies and connects it with the project development, structuring expertise, and funding capabilities of IFC. The Credit Mobilization solution yields a new funding mechanism that is initially being used to support emerging market banks, with enormous potential for scale-up and replication in other sectors, notably infrastructure.

IFC Builds Out a Successful Syndications Platform to Expand Financing Options for Emerging Market Banks

IFC's Credit Mobilization initiative uses an existing syndications platform developed to bring investors into a portfolio of IFC projects. The platform, launched in 2013, is the Managed Co-Lending Portfolio Program (MCPP)[5]. While IFC has had tremendous success in channeling investors into single projects, bringing in over $60 billion in additional funding alongside its own investments over the past six decades, the MCPP allows IFC for the first time to deploy private capital across its emerging market debt investments on a portfolio basis.

MCPP investors passively participate in IFC's future senior-loan portfolio, and IFC also participates in each project. Project appraisal, approval, commitment, and supervision are delegated to IFC. IFC's knowledge of local clients and market conditions, coupled with its project origination capacity and proven track record, help overcome investors' challenges of sourcing viable investment opportunities in developing countries. The fact that IFC maintains a share of each investment for its own account ensures that its decisions align with the interests of investors. Together, these aspects of the MCPP structure have contributed to its success: the program has grown from an initial investment of $3 billion by the People's Bank of China to a $7 billion platform with eight global investors.

While the original format provided an opportunity for institutions with funds to invest directly in IFC projects, the MCPP has now been further developed to allow participation in an IFC-originated portfolio on an unfunded risk-sharing basis using Credit Mobilization.

The first successful application of the Credit Mobilization initiative is the MCPP Financial Institutions facility, which began operations in October 2017. MCPP Financial Institutions involves a partnership with two insurance companies, Liberty Specialty Markets and Munich Re, to bring in $1 billion of unfunded credit risk exposure that will support $2 billion of IFC senior loans to developing country financial intermediaries (Figure 2). Mobilizing third-party funding for these beneficiaries from other banks has been a challenge in the past, but this solution enables IFC to leverage a new set of partners to increase access to capital for the financial sector.

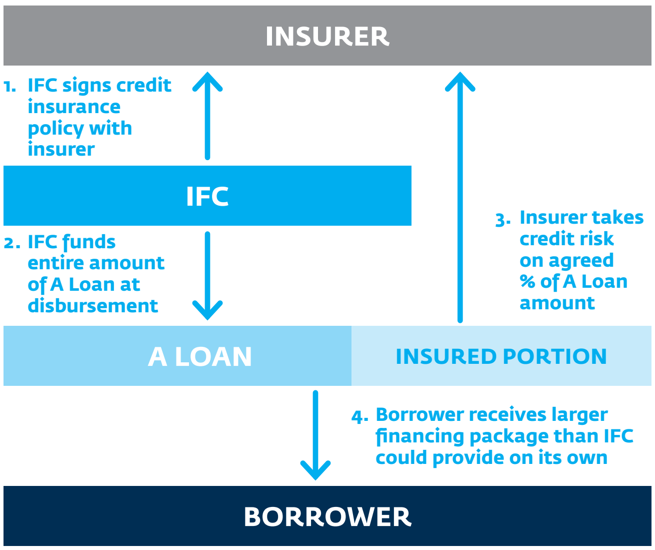

FIGURE 2 Sample Credit Mobilization Structure

Source: IFC

For the individual loans financed through MCPP Financial Institutions, IFC provides all the capital, though a pre-agreed percentage of the risk is borne by the insurance companies, which receive a fee for this coverage. The fee is covered by the loan interest spread, so that the charge to the end user remains at market rates. This reduces IFC's total capital requirements for the loans, allowing IFC to provide additional capacity to financial intermediaries to lend to small and medium enterprises, women-owned businesses, climate-change projects, and other critical market segments. Credit Mobilization will support IFC lending in all its countries of operation, including some of the poorest, where banks currently have limited access to capital.

New Initiative Benefits Borrowers and Insurers Alike

The Credit Mobilization initiative offers borrowers in emerging markets a significant new source of hard-to-source, long-term debt funding, as well as the potential to obtain more of it, more efficiently, and at lower cost. Initially, this funding will arrive in the form of larger loans available from IFC, with part of the borrower's credit risk covered by the participating insurance company. The credit-risk structure also presents a simplified operational relationship for borrowers. With the ability to get larger amounts of capital through a single transaction with one lender, borrowers are likely to see cost reductions.

Insurance companies, too, benefit from the innovative structure and access to a unique pipeline of emerging market projects. The Credit Mobilization structure allows insurers to engage with IFC through the insurance side of their businesses rather than the investment side. For some companies, the insurance side may provide a better strategic match of risk appetite and expertise to support IFC activities.

Credit Mobilization also presents insurers with exposure to a new set of risk assets (non-OECD financial risk), with potential for risk diversification, while also providing good returns. It utilizes IFC portfolio diversification for geographic pooling and exposure to a much wider set of countries than could be obtained via direct investments. IFC has existing relationships with over 400 emerging market commercial banks. Furthermore, the initiative utilizes IFC's expertise and track record in selecting projects and structuring and mitigating risks, including extensive experience in addressing environmental, social, and corporate governance issues. It provides a broad platform for insurers' participation in projects that address poverty alleviation and the Sustainable Development Goals. This fulfills important strategic goals for many companies, including corporate social responsibility.

The long-term objective for Credit Mobilization is to introduce new participants into emerging markets and create an environment where insurers allocate ever greater portions of their risk appetite to impact investments. With the knowledge and experience gained while leveraging IFC's origination capacity, insurers will become more comfortable with greater exposure to underserved countries and sectors. The hope is that, over time, this will lay the groundwork for further investments in other forms.

Market Opportunity: A Successful Model Offers Potential for Replication and Expansion

The credit insurance market is expanding rapidly, with growing potential for participation from companies interested in increasing their exposure to alternative risks. The global insurance industry's capacity for private non-payment credit insurance grew more than sevenfold from 2003 to 2015 (Figure 3)—an indicator of increasing appetite. IFC's partners express growing interest in working with investment teams to underwrite an ever-expanding pool of development projects. Insurance companies have started to hire more bankers who understand credit and can successfully engage with emerging market risk.

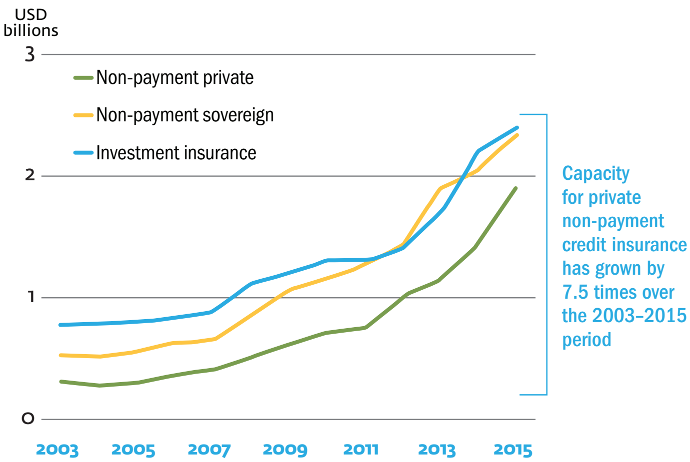

FIGURE 3 Annual Credit Insurance Market Capacity for Single-Exposure Risk, 2003–2015

Source: Marsh

Within IFC, the pilot facility of the Credit Mobilization initiative has been targeted toward portfolios of U.S. dollar denominated senior loans to banks, but the structure is correspondingly applicable in other economic sectors. As an important indicator of the scale-up potential of Credit Mobilization, in 2018 IFC has already launched a $500 million MCPP facility with Swiss Re to provide critical infrastructure finance investments for power, water, transport, and telecommunications improvements in developing countries. Credit insurance has also been used at IFC for individual transactions and with trade insurance, indicating significant scope for different uses. Future facilities will seek to leverage insurance companies' risk capacity to support greater financing for emerging market agribusiness, manufacturing, and services firms and expand into other products, institutions, and currencies.

Moreover, the structure could be replicated by other multilateral development banks, enlarging the pool of eligible financing into the tens of billions of dollars. Credit Mobilization also has the potential over time, as countries develop, to directly support credit to banks, funds, and other companies, bypassing multilaterals entirely and providing credit insurance directly to facilitate finance through capital markets or syndicated loans.

Credit mobilization is not a silver bullet for channeling capital to developing markets, but it is an important and growing approach. Much will be learned by pioneering these new initiatives—in terms of finding good matches among different parties with respect to structures, risk profiles, and pricing—that can lead to successful financing solutions.

Conclusion: Credit Mobilization Can Be One Piece of the "Billions to Trillions" Puzzle

Facilitating private investment in developing countries is a core component of the World Bank Group's strategy to reduce poverty, create shared prosperity, and accomplish the Sustainable Development Goals. The World Bank Group's 2030 vision calls for the institution to "leverage the full range of its capability to expand and create markets where private capital has been less forthcoming."[6] Reaching the financing scale required to implement the Goals will require moving from billions in development aid to trillions of financing, and leveraging the private sector will be essential to achieving this ambitious vision.

While great strides have already been made by the community of multilateral development banks to identify new sources of capital and unlock financing that remains on the sidelines, large amounts of untapped risk-bearing capacity remain that could be applied to capital deployed in emerging markets. Successfully mobilizing this risk appetite for development objectives calls for new structures that can connect the holders of capital and those institutions able to bear risk with emerging market beneficiaries in search of financing to sustain their operations and pursue growth.

The Credit Mobilization initiative provides a pioneering model for enabling a new class of institutional investors to expand their exposure to emerging market risk. By facilitating the greater flow of capital to developing countries under the risk cover of partner insurance companies, Credit Mobilization has significant potential for replication and scale-up.

Over the long term, it offers the promise of local capital market development by introducing new participants to emerging market finance and fostering new linkages between developing country firms and international financial institutions. The impact of greater finance for emerging markets will be an increase in productivity, jobs, wage growth and poverty reduction—and greater likelihood of realizing the Sustainable Development Goals.

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ACKNOWLEDGMENTS

The authors would like to thank the following colleagues for their review and suggestions: James Smouse, Principal Investment Officer, Financial Institutions Group – Latin America & The Caribbean, IFC; Matthew Huggins, Principal Counsel, IFC; Morten Lauridsen, Principal Economist, Thought Leadership, Economics and Private Sector Development, IFC; and Thomas Rehermann, Senior Economist, Thought Leadership, Economics and Private Sector Development, IFC.

ADDITIONAL EM COMPASS NOTES ABOUT MOBILIZING CAPITAL

Please also refer to the following EM Compass Notes: *Crowding-In Capital Attracts Institutional Investors to Emerging Market Infrastructure Through Co-Lending Platform* (Note 53); *Masala Bond Program–Nurturing a Local Currency Bond Market* (Note 30); and *Mobilizing Private Climate Finance—Green Bonds and Beyond* (Note 25).

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1 World Bank, International Monetary Fund. 2015. "From Billions to Trillions: Transforming Development Finance." Washington, DC.

2 World Bank. 2018. "Global Financial Development Report 2017/2018: Bankers Without Borders." Washington, DC.

3 World Bank, IMF, OECD. 2015. "Capital market instruments to mobilize institutional investors to infrastructure and SME financing in Emerging Market Economies: report for the G20." Washington, DC.

4 Ibid.

5 See Mapila, Kopo, Morten Lauridsen and Carl Chastenay. 2017. "Mobilizing Institutional Investments into Emerging Market Infrastructure". EM Compass Note 36, IFC.

6 World Bank. 2016. "Forward Look: A Vision for the World Bank Group in 2030." Washington, DC.