Management Response to McKinsey Impact Assessment

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U.S. International Development Finance Corporation

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DFC is pleased to announce the completion of an independent evaluation of the effectiveness of DFC's political risk insurance and reinsurance (PRI) products in mobilizing private capital. Most foreign direct investment (approximately 65 percent) continues to flow to high-income, politically stable countries. The G7 Impact Taskforce identified real and perceived political and macro-economic risks as key constraints to private investment in lower-income countries. One of DFC's core objectives is to help mitigate those risks to enable private sector investment that achieves positive development impacts in the countries that need it the most.

In this comprehensive assessment of DFC's PRI program, the primary goal was to assess the effectiveness of PRI in mobilizing private capital by analyzing a portfolio of 14 DFC PRI-supported projects. These projects represent about 20 percent of the value of DFC's total political risk portfolio and span ten countries and five sectors.

DFC commissioned McKinsey & Company (McKinsey) to conduct the assessment. McKinsey's assessment included a literature review of the PRI market, an analysis of DFC's competitive position within the market, and a critical review of the private capital mobilization impact of the 14 projects.

The assessment concluded that DFC's PRI product is a highly effective tool for mobilizing private capital. Across the 14 cases analyzed, DFC's total exposure of about $1.2 billion directly mobilized nearly $2 billion in private sector capital. That is $1.60 in private capital mobilized for every $1 of insurance exposure. In addition to the direct capital that was mobilized, most of the DFC projects reviewed were in industries nascent to the countries, which have high levels of macroeconomic and political risk. As such, these projects have significant expected "second order private capital mobilization effects." This refers to situations where investments in DFC-supported projects result in new capital investments in additional projects after the initial investment was made — primarily through demonstration effects, infrastructure improvements, and regulatory and institutional improvements.

The study also gleaned some important lessons and recommendations that will enable DFC to more strategically and effectively use its PRI product to mobilize private capital, as well as better measure and articulate these impacts. DFC is planning to take action to address the following five priority areas identified in the study:

Target high-impact segments that match DFC's strengths. The assessment concludes that DFC's PRI program is well positioned to drive foreign direct investment in several high-impact segments: projects that create new markets in the host country; projects requiring long tenors, such as large-scale infrastructure and climate finance projects; and projects in the riskiest and most fragile markets. The study found that DFC has a market share of more than 30% of PRI in countries with a sovereign rating of CCC+ and below.

- DFC is developing a targeted strategy for expanding the PRI product in the sectors and markets that build on DFC's prior success and that will have the most impact, beginning with the most immediate need: Ukraine. The strategy will align with DFC's emerging agency-wide priorities.

Build out go-to-market capability. The study reveals that DFC is seen as passive in its PRI deal sourcing, limiting the PRI activities to investors already familiar with DFC. The study recommends that DFC take steps to improve its visibility in the market by educating potential clients on DFC's broadened eligibility requirements, promoting its claims avoidance advocacy capabilities, and strengthening its image as an agile and private sector-friendly organization.

- DFC will work to improve its visibility in the market by building business development capacity. This includes hiring dedicated business development staff and developing business development tools and training that will strengthen DFC's outreach to potential clients, headquarters and overseas staff, and other development agencies and development finance institutions.

Crowd in private insurers through reinsurance. The study recommends that, as part of its strategy, DFC establish a streamlined approach to source reinsurance through private insurers. DFC is perceived in the insurance market as a potential and trusted target of reinsurance from private insurers. Willingness amongst private insurers to provide reinsurance to DFC is high, as it allows them to enter riskier markets and to benefit from DFC's claims avoidance advocacy. Moreover, reinsurance can be used as a tool for "crowding in" private insurers in cases where investors are insisting on using a public insurer.

- DFC is developing clear and transparent processes to solicit facultative reinsurance from private reinsurers to improve operational efficiency, satisfy DFC's additionality requirement to "crowd in" private reinsurers, and mitigate risk to DFC.

Build internal capacity of DFC's PRI underwriting and support team. The assessment recommends that DFC build on its reputation as an efficient and private sector-friendly insurance underwriter by fully investing in its PRI underwriting and support teams and eliminating roadblocks in the diligence process.

- As part of its PRI growth strategy, DFC will ensure all avenues of funding for the program's expansion are explored and resourced appropriately — including in support offices. Further, DFC conducted an external assessment of its internal processes with the goal of increasing efficiency across its operations and is taking action to address improvements.

Recognize second-order private capital mobilization effects when evaluating projects. The study recommends that DFC consider additional options in its methodology for calculating direct private capital mobilization for PRI and to provide a holistic and comprehensive picture of the full capital mobilization impact of its portfolio, including second-order capitalization effects.

- DFC will periodically review its methodology for how direct private capital mobilization is calculated for PRI and implement any needed improvements. In addition, DFC is conducting a follow-on evaluation of the demonstration effects of selected renewable energy projects to obtain a deeper understanding of how and when DFC can reliably anticipate, measure, and communicate DFC's contribution to second-order private capital mobilization and market impacts.

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