

# The DFC's New Equity Authority

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## *Introduction*

On October 5, 2018, the United States passed an important piece of foreign policy legislation—the Better Utilization of Investment Leading to Development ([BUILD](#)) Act. The BUILD Act modernizes the United States' development finance institution—the Overseas Private Investment Corporation (OPIC)—and transforms it into a new agency called the U.S. International Development Finance Corporation (DFC). The BUILD Act provides several enhancements to the DFC such as a liability limit (“credit card limit”) of \$60 billion (doubling OPIC's \$29 billion maximum), a seven-year authorization, and new development finance tools, including local currency loans, first loss and loan guarantees (including in local currency), and, critically, equity investments. Although the DFC is an institution that seeks to catalyze vitally needed private-sector investments in low- and lower-middle income countries, it was not designed to simply be another development finance institution (DFI). In addition to a greater proposed focus on development impact, it is an agency embedded in the U.S. foreign policy and national security architecture.

The DFC began operations at the end of 2019, and among its revamped development finance tools is the ability to carry out equity deals, that is, investing in companies located in developing countries. By contrast, OPIC did not have the ability to make equity investments either directly into companies or indirectly through fund managers. OPIC could not work on an equal footing or a fully coordinated basis with our allies on complicated and larger projects. An inability to make equity investments also constrained OPIC in its capacity to make transactions in difficult places where few businesses can take on additional debt. However, the BUILD Act was silent on how these investments should be accounted for in the U.S. federal budget (the technical term is “scored”), which is now creating challenges in terms of both budgeting and winning support from the foreign aid community.

## *Equity Authority Under the BUILD Act*

Equity authority is the ability for the U.S. government to make investments into companies abroad either *directly*, by buying a percentage of the company, or *indirectly*, through funds that invest in those companies.

(“Equity” authority is not to be confused with “social justice,” another term used in development circles.) Under the BUILD Act, the DFC can now make equity investments as a minority investor in any entity or investment fund, as opposed to only being able to provide debt. Investments in equity are limited to (1) 30 percent of the total project and (2) a total limit of 35 percent of the DFC’s total investment exposure, up to \$21 billion.

## *Equity Investments and How DFIs Treat Them*

All the major DFIs make equity investments. Most DFIs do a [combination](#) of both investment strategies: they make direct investments and also invest indirectly in equity funds. Direct investing requires conducting all stages of the investment process internally, which requires the DFI to have strong institutional capacity, including quality staffing, industry expertise, often times the ability to place board members on the board of companies that the DFI invests in, and strong information systems, as well as some sort of local presence. Investing through equity funds means delegating the investment process to outside fund managers but also requires the DFI to pay fees and other forms of compensation to fund managers.

Equity investments have certain [characteristics](#) that distinguish them from other development finance instruments such as loans or guarantees. For equity investments, financial returns can be more volatile and are not predefined. Equity investors will share any potential risks and profits in the company. Cash flows from equity are “residual,” meaning they will depend on companies’ ability to first pay suppliers, workers, and taxes, as well as cover debt repayments. Returns also depend on the dividend policy of the company.

DFIs have invested on average about [20 percent of their portfolios](#) in equity, usually through well-diversified portfolios, both in terms of geography and in terms of the industries that the DFIs invest in. Among the largest bilateral DFIs, the [CDC Group](#) (United Kingdom) invested 18 percent of its portfolio in direct equity and 29 percent in intermediated equity in 2018, while [FMO \(The Netherlands\)](#) invested 31 percent of its portfolio in equity in 2018. Among the multilateral DFIs, the IFC in 2019 invested [\\$999 million](#) (or 11.2 percent of its commitments) in equity, while the EBRD invested [\\$177 million](#).

However, the way that these DFIs account for equity investments are not comparable to the United States’ federal budgeting process. Both the IFC and EBRD make equity investments and account for investments using standard accounting principles on their balance sheet ([net worth](#)). In 2009, the IFC set up a wholly owned subsidiary—the Asset Management Company (AMC)—so that third parties can invest alongside the IFC in specific companies. According to findings from a recent [IDB report](#), the IFC and EBRD continuously update the value of their equity positions, which guides decisions on how to rebalance their portfolios. Equity investments are riskier than loans and have no predefined return; their value is volatile and difficult to establish if there are no recent market transactions for the same equity instrument. Therefore, DFIs need specialized capabilities and sophisticated valuation models to assess the fair value of investments, develop scenarios, and classify investments according to their expected future upside. This role is carried out by portfolio management units and are complemented by risk management staff that monitor public markets and the value of investees and comparatives. Proper valuation is important because this can affect the financial statements of the DFI and is subject to external audit. Therefore, DFIs have to possess the expertise and processes in order to properly value these equity stakes.

## *Equity Authority Is an Important U.S. Foreign Policy Tool*

Under OPIC, the United States was restricted in the deals it could finance. There were many transactions in low-income and fragile states that would have advanced national security or foreign policy goals where

OPIC could not help at all or could not help in a fully adequate way. OPIC also could not work in equal partnership with other allied countries that have DFI investors, especially in cases where the investors were DFI-supported equity investment funds. As a non-equity investor in predominantly equity deals, OPIC often required special arrangements that other investors resented and sometimes refused to allow. This lack of equity authority made it difficult for other allies to work with the United States. For example, OPIC could only provide loans and political risk insurance products. Equity authority gives the DFC an added tool for development impact and enables the DFC to align its financing with other like-minded partners and better compete with China in the developing world.

Projects funded by the DFC aim to enhance local market-based economies by helping develop the private sector. In this regard, the equity tool provides added flexibility for the DFC to support earlier stage businesses or businesses in sectors where debt financing does not make sense. Many companies in the developing world are at the incubator stage. Such companies have small balance sheets with limited capacity to assume additional debt and, moreover, may want a “true partner” investor as their company grows. Therefore, equity may be preferred over alternate forms of financing.

Additionally, the equity tool provides the DFC a better chance to partner with U.S. allies and like-minded institutions and to leverage private capital to developing countries. In the past, OPIC was restricted by the financing terms for the loans and guaranteed products it provided. OPIC was only able to participate in deals on a senior basis (i.e., paid first in the event of a loss) or on a *pari passu* basis (i.e., on an equal footing) with other senior debt. This made it more difficult for other development finance institutions (DFIs) to co-invest with OPIC.

### *The Current Challenge with Equity Authority*

With the BUILD Act, the DFC was required to seek funding every year for a number of additional activities, including equity investments and technical assistance. The new DFC “competes” for these funds with regular diplomatic activities and traditional foreign aid activities, such as providing HIV/AIDS medicines, democracy promotion, and responding to humanitarian emergencies. The overall budget “pie” for international affairs activities has not grown, but instead the new DFC is seen as “taking” money from a fixed pot, creating the beginnings of a zero-sum game with other stakeholders. The amount of money that the DFC “takes” is driving some of the issues. For example, the Trump administration proposed a 21 percent cut to the overall diplomacy and development budget for FY 2021 and then in essence added what is a new budget line of \$700 million to help pay for the new DFC. If funding of this scale (or higher) is required every year for the DFC to use its equity authority effectively, this will further exacerbate the pressure on the budget and worsen the dynamics of a zero-sum game.

When the BUILD Act was passed, the legislators did not detail how equity investments would be treated in the U.S. federal budget. The legislators did not devise a particular approach for accounting for equity investments because they wanted to avoid the precedent of creating a new regime just for the DFC. For budgeting purposes, equity investments are currently being scored (or “treated”) on a 1:1 cash basis. So, \$100 dollars of equity is “booked” as if it was a \$100 grant out of the foreign aid budget. Similar to grants, the money has to be budgeted upfront as a “loss,” but unlike a grant, if there is a financial return from these investments, the money flows back to the U.S. Treasury and therefore cannot be used for future equity investments by the DFC. Although equity investments carry higher risk than other financing instruments, the U.S. government could also potentially make money in the future from such positions. Typically, at most DFIs, equity investments take 5 to 10 years from when the investment is made before the DFI recoups its money or earns any profits. So, any equity investments made by the DFC today will not be

recouped for 5 or more years. With this type of scoring, the resources that the DFC allocates for equity investments need to be appropriated every year, and any money the DFC makes from these investments has to be returned and reappropriated, without giving the DFC any benefit for returning money to the Treasury.

Moreover, this type of scoring restricts the leveraging power of this tool. In the case of loans or guarantees, these instruments are scored based on an estimated repayment rate, meaning that a very small amount of resources can potentially leverage higher investments. For a loan, for example, a [\\$50 million appropriation](#) could potentially leverage \$1 billion in investments if the default rate and other cost factors of the loan are estimated at 5 percent of the investment value.

The administration's budget request for equity authority was significantly increased from \$150 million in FY 2020 to \$450 million for FY 2021. In low-income countries, investment opportunities are typically smaller in scale, between \$5 and \$10 million per investment; therefore, \$450 million would give the DFC the capacity to conduct a large number of small deals. However, these transactions take time, are much harder to arrange, and do not have the same leveraging capacity as larger deals made through investment funds. (Alternatively, the DFC could be investing in many funds, but the DFC would not be able to play a predominant role in such investments.) In lower middle-income and upper middle-income countries, the size of the deals is larger, and because these investments are budgeted on a 1:1 cash basis, \$450 million would not be enough money for the DFC to successfully use its new tool. For example, the DFC would not be able to finance a large undertaking such as a port or a similar infrastructure project.

Increasing the budgetary resources for equity while holding the size of the overall pie the same would not solve the problem, as it will exacerbate the tensions among stakeholders who “compete” for this money. Increasing the appropriation for equity would mean that the money would be coming from other areas of the international affairs budget (or “150 account”), meaning other agencies would lose out, as international affairs and foreign aid are currently competing for resources in a zero-sum game. Given the Trump administration's budget proposals for foreign aid cuts in the last four years, many stakeholders see the DFC as potentially taking even more money away from their budgets than already proposed by the administration. With the current scoring method, it looks like it could do so, but in reality, a diversified portfolio of equity investments is likely to earn back all of the money invested, plus a profit. One proposal to deal with the dynamics above is to “modify” the way that the money allocated to equity by the DFC is scored. If the way that equity is accounted for in the budget is not modified, this will become a perennial problem in every budget cycle and create significant animosity toward the DFC within the foreign aid community, leading to reduced support for the DFC in the coming years.

## *Examples of the U.S. Government Making Equity-like Investments*

There are some examples of where the U.S. government makes equity investments that can provide some insights to the scoring issue. One of them is in [In-Q-Tel \(IQT\)](#), a strategic investment company that makes venture capital investments in start-ups which develop technologies needed for national security. IQT teams analyze companies' business plans, commercial potential, and management teams. Based on their assessment, IQT identifies a company, invests in them, adds board members, provides consulting advice to improve company operations, and makes introductions to key players in the intelligence community; then, when the company is bigger and more successful, InQTel sells its stake in the company. To fund these projects, the U.S. government gives IQT a budget allocation to invest. IQT also gets money from private investors. The technologies developed by IQT portfolio companies are then used by the government agencies which requested the technology. IQT investments are scored by the U.S. government as a grant.

The U.S. General Services Administration ([GSA](#)) is an independent agency that centralizes procurement for the federal government: it supplies and manages products, facilities, and services that federal agencies require to carry out their duties. It receives only 1 percent of its funding through congressionally appropriated funds; the remainder is covered through the revenue gains from the products and services it provides. The GSA has an Acquisition Services Fund (ASF), which is a revolving fund made up of GSA's reimbursable revenue from all of its business portfolios. Because the funds are coming directly from GSA profits, the GSA does not have to get appropriations from Congress for its ASF. ASF revenues are determined by "[deducting the costs of goods and services sold against the cost of operations](#)."

Another example of where the U.S. government makes equity investments is enterprise funds; these, however, have been scored as grants, as there was no expectation that these funds would generate significant returns at the time of their creation. So, \$100 of investments by enterprise funds were allocated at \$100 of what looked like grant money out of the foreign aid budget. President George H.W. Bush created the original 10 enterprise funds, which were designated to help support the private sector and encourage development in Eastern and Central Europe following the dissolution of the Soviet Union. The 10 funds [received](#) a total of \$1.2 billion from the U.S. government and [attracted](#) an additional \$9.8 billion in private investment capital. Twenty years later, the enterprise funds returned \$400 million to the U.S. Treasury and \$1.3 billion to create long-term legacy institutions. Similarly, the Obama administration also created two legacy funds following the Arab Spring. In 2013, the U.S. government [gave](#) the Tunisian-American Enterprise fund a grant of \$60 million and the Egyptian-American Enterprise Fund a grant of \$120 million. These enterprise funds have a long investment horizon and will likely invest for another decade.

## *Some Possible Solutions to Scoring Equity Investments Going Forward*

The challenge of scoring equity investments for the DFC is a current problem that may require several corrections over time. There are potentially two solutions to this challenge: (1) applying credit reform act principles or (2) setting up a revolving fund for equity.

### **1. APPLYING FEDERAL CREDIT REFORM ACT PRINCIPLES**

A possible solution to the scoring issue would be to apply the principles of the 1990 [Federal Credit Reform Act](#) (FCRA) to equity investments. The FCRA provides a blueprint on how to report the costs and risks of the federal government's credit (loans and loan guarantees) programs. The FCRA requires scoring credit programs using the [net present value](#) of the expected lifetime costs to the government. The net present value of an investment is the difference between the present value of cash inflows and the present value of cash outflows over time. In the case of loans and loan guarantees, this cost to the government, which is also referred to as "[subsidy cost](#)," is calculated as the difference between the net present value of the estimated outflows by the government (such as the loan disbursements and claims from lenders) and the estimated inflows to the government (such as the loan repayments, interest payments, fees, and recoveries on defaulted loans) over the life of the loan, excluding administrative costs. A discount rate is used to determine the net present value of estimated cash flows. Agencies generally have to update the subsidy costs every year to reflect changes, such as the way the loan actually performed and its expected future performance.

Under this approach, equity investments would be similarly scored to the way a loan is scored. The DFC would only be appropriated an amount to cover the estimated cost of the equity investments. This kind of scoring would take into account the return on equity investments over time, as well as potential losses, fees, dividends, and other factors. However, equity investments have different financial characteristics than a loan, this would require starting out with a loan model and making certain adjustments. One key



assumption would entail estimating the “end date” of equity investments, as the timing for reflows from an equity investment may not be as definitive as for loan repayments.

The most effective way to incorporate this type of scoring would be through an amendment of the BUILD Act. Although there is resistance to opening up the BUILD Act again, the amendment would likely be enacted through a consolidated or omnibus appropriations bill or be incorporated into a continuing resolution. Important benefits to amending the BUILD Act would include (1) messaging to the rest of the foreign aid community that the new DFC will not take away from their budgets and (2) avoiding setting a strong precedent for other U.S. government programs that currently score equity at 100 percent.

## **2. SETTING UP A REVOLVING FUND FOR EQUITY**

A second possibility would be for the DFC to set up a large revolving fund for equity. The fund must be large from the start, as at some point, there would be too many equity investments but not enough returns. If we assume an average 10-year cycle on equity, the fund would need money for all the years in between until it realizes its first return. To reduce risk, any equity losses by the DFC would be taken from the DFC's corporate capital account. The DFC has a capital account with the Department of Treasury that contains [\\$5.9 billion of cumulative results of operations](#), which OPIC had built up over its many years of existence and about half of which is used to cover the contingent liability of the political risk insurance that the DFC inherited from OPIC.

In order to cover a substantial annual equity investment program, the DFC corporate capital account would likely need significantly more unencumbered funding than it currently holds. For example, if the DFC were to make \$1 billion a year in equity investments, the unencumbered portion of the corporate capital account would be entirely disbursed in about three years, meaning that no further equity investments could be made for the subsequent seven years, without additional appropriations. A revolving fund would therefore simply kick the problem of crowding out other international affairs funding a few years down the road rather than solve it.

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