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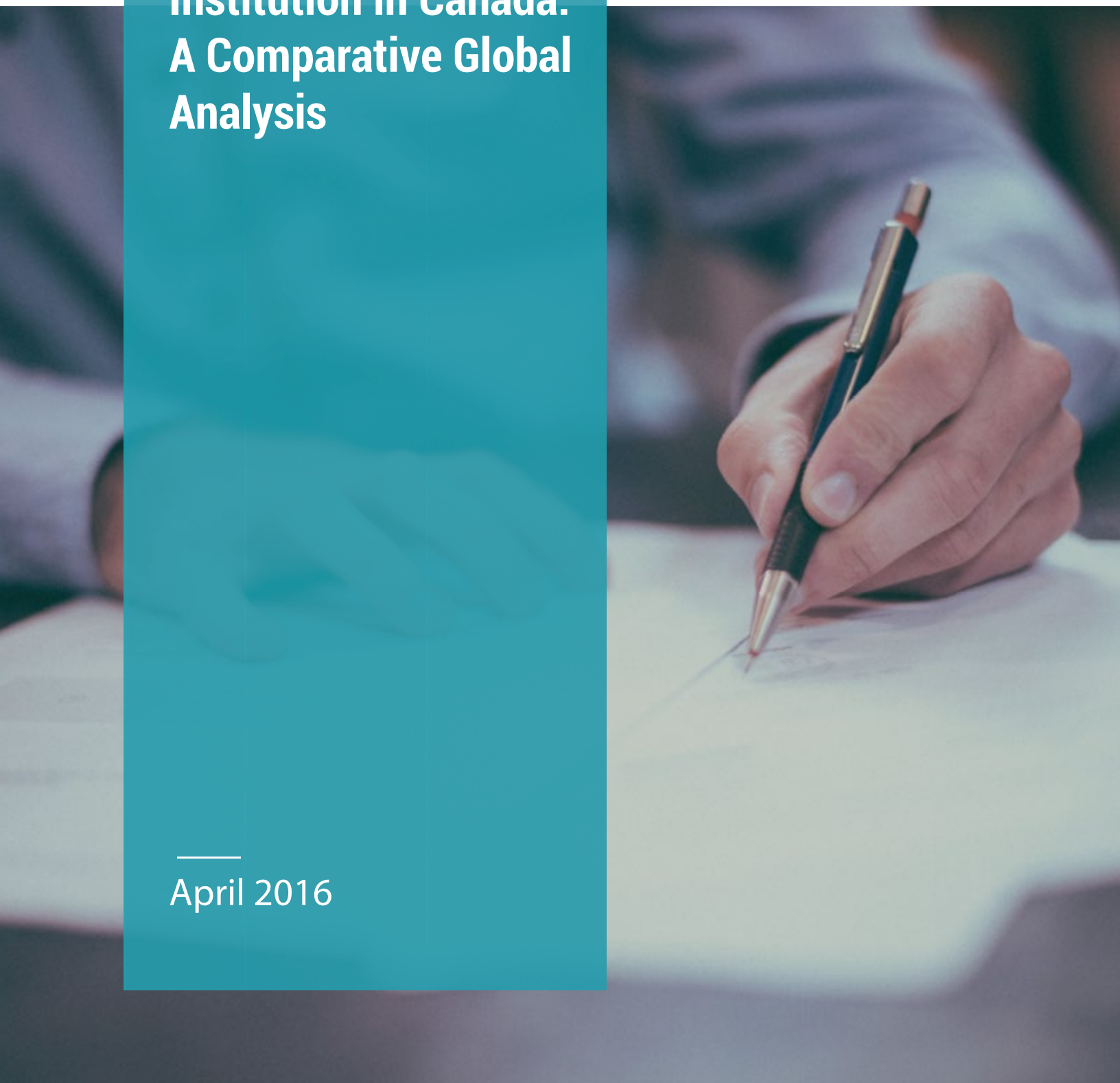
# Proposal for the Creation of a Development Finance Institution in Canada: A Comparative Global Analysis



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# Executive Summary

Development Finance Institutions (DFIs) fill an important gap between public aid and private investment through the provision of finance and technical assistance to the private sector in developing countries. DFIs use a commercially-driven model that seeks to achieve both developmental impact and financial self-sustainability. They complement Official Development Assistance (ODA) and provide a value-added service as a result of their ability to take on higher risks than private sector providers, while at the same time focusing on capacity development.

In the absence of a DFI, Canada currently lacks the ability to: a) finance the deployment of private sector Canadian expertise and investment capital to commercial projects in developing countries; b) benefit from profitable returns on investments in social enterprises that promote positive developmental impacts; and c) promote the expansion of Canadian companies and industry to a wider array of markets abroad. A Canadian DFI would support the attainment of international developmental objectives, while at the same time laying the groundwork for enhanced future trade and investment opportunities.

The experience of eight international DFIs (United Kingdom, Germany, Japan, United States, France, Italy, Sweden and Switzerland) reveals several key observations and findings to be considered when establishing a Canadian model. Common elements amongst the DFIs examined include that they are: a) wholly or majority publicly-owned; and b) aim at generating jobs and growth in developing countries through private sector partnerships. Differences observed were noted in: a) mandate, strategic priorities and focus; b) primary services offered; and c) governance structure.

A. Mandates for DFIs in terms of emphasis on either national interests or developmental impact do not necessarily correlate with challenges in attaining financial self-sustainability. Rather, challenges in achieving financial self-sustainability are tied foremost to the level of risk present in the investment portfolio and the effectiveness of governance in investment operations.

B. DFIs that promote national interests (US, Japan, Italy, Switzerland) as part of their mandate generally identify small and medium size businesses as a priority, along with a streamlined approval process to assist these companies.

C. Partnerships - cooperation between DFIs (e.g. DFI networks and partnerships) creates synergies, shared best practices and potential for larger investments and developmental impacts. Two key findings associated with DFI partnerships include:

i. The development of a common approach to addressing corporate governance risks and opportunities in investment operations ("Corporate Governance Development Framework"); and

ii. Establishing common indicators for measuring developmental impact. This allows DFIs to look at projects across institutions with a set of common metrics in order to more effectively measure and compare the outcomes of commercially-driven developmental initiatives. Common indicators also assist clients by reducing their reporting burden and costs.

D. Development impact measurement indicators - the most widely-used indicators include: job creation; environmental protection; and building local capacity. Harmonized Indicators for Private Sector Operations (HIPSO) - a harmonized set of 27 core indicators for 12 different sectors has been created among 25 international DFIs

E. Value-added services – technical assistance – DFIs may provide their clients with technical assistance, such as consultancy services, feasibility studies and training in order to strengthen their capacity in governance, management and financial administration (i.e. capacity building).

F. The provision of technical assistance is prevalent in European DFIs service offerings and is generally co-financed by clients, requiring a contribution from the client ranging between 25% - 50% of the costs. However it is not a service offered by the Overseas Private Investment Corporation (OPIC) in the United States which is one of the world's largest DFIs (in terms of investment portfolio).

i. Members experience generally correlates with the DFI's mandate and/or priority sectors of investment.

ii. A high correlation between investment portfolios that emphasize the "financial sector" and boards with private sector

iii. members from financial institutions;

iv. Public members generally have expertise in social and economic developmental impacts;

There was no observed correlation between board size and ability to achieve financial self-sustainability.

## Context

**DFIs occupy an important intermediary space between public aid and private investment through the provision of finance and technical assistance in developing countries.**

Private sector investment is essential to economic growth due to its effectiveness in creating businesses that provide employment, earn profits and generate tax revenue. However, the private sector in developing economies often lacks sufficient or cost-effective access to capital and long-term financing. In this regard, DFIs occupy an important intermediary space between public aid and private investment through the provision of finance and technical assistance in developing countries.

The activities of DFIs result in additionality as they complement, rather than substitute, official development assistance (public aid). Despite sharing the common objective of promoting positive developmental impact, DFIs are distinct from public aid in that they work on a commercially-driven model, which relies on profitable investments in order to create and strengthen sustainable businesses and institutions. Their performance is generally dependent upon a clear and focused mandate, robust corporate governance standards with independent boards, proper performance assessment criteria, appropriate lending and risk management strategies, as well as financial self-sustainability.[1]

## The Importance of Creating a Canadian DFI

Canada remains the only G7 nation without a DFI to provide risk capital to the private sector in developing countries. Consequently, Canada lacks the ability to:

- Finance the deployment of private sector Canadian expertise to commercial projects in developing countries
- Catalyze additional investment to the private sector in developing economies
- Deploy mechanisms to promote technical assistance to commercially-oriented projects in emerging markets
- Benefit from profitable returns on investments in social enterprises that promote positive developmental impacts
- Promote the expansion of Canadian companies and industry to a wider array of markets abroad

Ultimately, the benefit of creating a DFI in Canada rests in the ability to support the attainment of international development objectives, while at the same time laying the groundwork for enhanced future trade and investment strategies in developing countries. This notion was acknowledged in the Government of Canada's 2015 Economic Action Plan, where it was announced that such an institution would be established and housed within Export Development Canada (EDC).

1. Pietro Calice, "Development Finance Institutions: Unlocking the Potential," African Development Bank Group (Working Paper - 2013), 19.

# Existing DFI Models

While there are various models of DFIs, a common element among them is that they are generally publicly owned and partner with the private sector to generate jobs, growth, profits and poverty reduction.
Differences in the models of DFIs include factors such as:

- Strategic priorities and focus (emphasis on national business and economic interests versus developmental impact) and primary services offered (risk capital, technical assistance and business advisory services).
- Governance structure (board of directors - size and member composition)
- Shareholder composition (solely owned by the national government or the government as a majority shareholder along with private sector shareholders)

The wide array of existing DFI models suggests that there is no single structure more conducive to financial self-sustainability or developmental impact than another. Rather, the success of DFIs is largely dependent on their ability to fulfill their respective mandate through strong corporate governance standards that ensure suitable lending and risk management practices.

# Mandate

Due to their role as the primary or often sole shareholder, governments have a particular interest in ensuring that DFIs fulfill their mandate according to an explicit set of operational objectives and financial performance targets. In setting their mandate and mission statements, some DFIs have placed the promotion of national business interests as the primary factor in considering developmental projects, while others focus rather on impact and development-oriented outcomes.

DFIs that have established the promotion of national business and economic interests as an explicit priority include:

- The Overseas Private Investment Corporation (OPIC) in the United States, which is mandated by statute to only support projects that directly involve U.S business interests.[2]
- The Japan Bank for International Cooperation (JBIC), whose man date explicitly stresses the importance of downstream advantages for Japanese companies, as well as for the national economy as a whole.

2. Foreign Assistance Act of 1961 (P.L. 87–195) section 231. American small businesses are an OPIC priority, comprising on average 80 percent of projects supported by the agency annually.

- Italy's Società Italiana per le Imprese all'Estero (SIMEST), whose mandate is to promote foreign investment by Italian companies and to provide technical and financial support for investment projects.[3]

The primary disadvantage associated with this type of mandate is that these DFIs risk foregoing otherwise attractive investment opportunities, in terms of profitability and potential for positive developmental impact, by constraining themselves to investing predominantly or solely in projects in which their domestic industry is directly involved.[4] In contrast, DFIs that place the attainment of developmental impact as their foremost raison d'être include:

- The United Kingdom's Commonwealth Development Corporation (CDC), which holds job creation in Africa and South Asia as their primary objective
- France's Société de Promotion et de Participation pour la Coopération Economique (PROPARCO), whose mandate advocates for the creation of sustainable and innovative businesses in developing economies
- Germany's Deutsche Investitions und Entwicklungsgesellschaft (DEG), which seeks to improve living standards in developing countries through long-term financing and advice

**It appears that challenges in achieving financial self-sustainability are tied foremost to the level of risk present in the investment portfolio.**

Regardless of their mandated development priority, all of the above referenced DFIs consistently achieved strong financial results and are self-sustaining. Examples of financial performance include:

- OPIC generated a net deficit reduction of $358 million for the US government in 2015[5]
- JBIC realized a net income of 126,187 million yen in 2015.[6]
- SIMEST has had stable revenues, a positive net income, and a positive return on equity over the past 5 years (e.g. net income totalled 45.8 million euros in 2014).[7]
- CDC has not received new capital from the UK government in more than 20 years and reported in 2014 a total return after tax of £420.2m.[8]
- PROPARCO has maintained a positive net income over the last eight years (e.g. €40.9 million in 2014).[9]
- DEG realized a net income of €168.9 million in 2014

Thus, it can be observed that mandates for DFIs in terms of emphasis on either national interests or developmental impact do not necessarily correlate with challenges in attaining financial self-sustainability. Rather, it appears that challenges in achieving financial self-sustainability are tied foremost to the level of risk present in the investment portfolio (see: Sweden, SWEDFUND).[10]

3. The objective of JBIC, as set forth in its statutory law, is to "contribute to the sound development of Japan and the international economy and society."
4. EDC-GAC DFI study tour Washington January 2016 final report – notes that OPIC's statutory requirement to involve US companies in every transaction has been "a considerable burden for them."
5. OPIC 2016 Congressional Budget Request.
6. JBIC Annual Report 2015.
7. SIMEST Annual Report 2014.
8. CDC Annual Report 2014.
9. PROPARCO Annual Report 2014.
10. SWEDFUND's strategic sustainability target for financial viability – not met. Target: "average return on equity before tax shall exceed the average interest rate for Swedish government debt over one year. Return shall be measured over rolling seven-year periods." Average return on equity, opening balance, over 7 years (-2.36%).

## DFI Partnerships

Cooperation between DFIs (e.g. DFI networks and partnerships) creates synergies and potential for larger investments and developmental impacts. Particularly in Europe, a high degree of collaboration and partnerships exists between DFIs and their networks. These collaborative arrangements provide several benefits including:

**Particularly in Europe, a high degree of collaboration and partnerships exists between DFIs and their networks.**

- Sharing of best practices through the establishment of networks and working groups (Association of European Development Finance Institution – 15 members)
- Establishing common indicators for measuring developmental impact (Harmonized Indicators for Private Sector Organizations - HIPSO)
- Developing a common approach on how to address corporate governance risks and opportunities in DFI investment operations ("Corporate Governance Development Framework"[11] - a common platform for evaluating and enhancing governance practices in investee companies).
- Providing the ability for DFIs to pool their capacities on transactions that exceed the capacity of the individual organizations.
    - For example, Germany's DEG established in 2011 the so-called "friendship facility" together with two EDFI members, the Dutch FMO and the French PROPARCO. This initiative was founded in order to offer even larger deals in certain circumstances than would be possible alone, up to 90 million euros and thus create the opportunity for more significant development impacts.

## Corporate Governance

Independent boards, with robust corporate governance standards are key elements for the successful and effective operation of a DFI. Key roles of the Board of Directors include approving business plans and strategic investment projects, loan and guarantee pricing policies, as well as any transactions liable to have a significant effect on the DFIs' results, balance sheet or risk profile.

11. http://cgdevelopmentframework.com/wp-content/uploads/2015/02/Corporate-Governance-Development-Framework.pdf

## Composition and Size of the Board of Directors

DFIs have Board of Directors which range in size from as low as three members (Germany DEG) to as large as 24 members (France – PROPARCO, 16 Directors and 8 Observers). A large number DFIs have mid-sized Boards comprised of seven or eight Directors (e.g. UK – CDC, Italy – SIMEST, Switzerland – SIFEM, Sweden - SWEFUND).

The majority of DFIs have Boards which are comprised of a combination of government and private sector members. The existence of private sector investment expertise, knowledge of and development experience is often used to supplement the executive team and government representatives.

## Performance Assessment Criteria & Development Impact Measurement

Depending on the scope of their mandate, DFIs assess their performance and measure their developmental impact using various criteria. Nevertheless, some of the most widely-used indicators include:

- Job creation (increased labour productivity, poverty reduction, reve nues/taxes paid, gender equality)
- Environmental protection (reduction of emissions, increased use of renewable energy)
- Building local capacity (best practices in businesses and government, technology diffusion, increased access to financial services)

Notably, several DFIs have been working towards the development of common indicators to ensure consistency and comparability. Specifically in 2013, 25 International Finance Institutions signed a memorandum with the goal of facilitating learning from each other and easing the reporting burden on shared private sector clients. As a result of the collaborative efforts of these organizations, a harmonized set of 27 core indicators for 12 different sectors was created. These indicators along with a list of the 25 organizations are available for review on the Harmonized Indicators for Private Sector Operations (HIPSO) website.[12] Adoption of standardized indicators by multiple DFIs will also allow for more efficient reporting by these DFIs.

"Better Data for Smarter Investments - Shared standard indicators will provide development institutions with an aggregate data set to help facilitate collaboration and learning among development practitioners and institutions, and help IFIs to better understand the impact of their investments."[13]

12. https://indicators.ifipartnership.org/
13. https://indicators.ifipartnership.org/about/

## Primary Sectors for Investment

The majority of DFIs prioritize the development of the financial sector (institutions and practices), renewable energies, infrastructure and manufacturing. The emphasis on the financial sector is particularly apparent, as evidenced by the fact that it accounts for nearly 50 per cent of the portfolios of the DEG, PROPARCO and SIFEM respectively.

The fact that investment is concentrated in similar sectors, particularly in the area of renewable energies where several DFIs have similar strategic orientations, has resulted in increasing challenges for many DFIs as they compete for a limited good deals.[14] This contributes to the "crowding out" effect prevalent in these developmental efforts.

Other sectors of investment focus include: Health (OPIC, CDC); Agribusiness (CDC, SIMEST); Education (CDC); Technology (OPIC); Transport (SIFEM); and Telecommunications (OPIC, JBIC, SIFEM).

## Technical Assistance

DFIs may provide their clients with technical assistance, such as consultancy services, feasibility studies and training in order to strengthen their capacity in governance, management and financial administration (i.e. capacity building). Several European DFIs have implemented these capacity building services as part of their business service offerings. A review of several European DFIs indicates that the cost of the technical assistance provided is generally co-financed with its clients, requiring a contribution from the client ranging between 25% - 50% of the costs.

*A table[15] showing European DFI technical assistance fund characteristics is noted below:*

Table 1: **European Development Finance Institutions Assistance Fund Characteristics Peer Overview**

| | IMO Netherlands | DEG Germany | BIO Belgium | PROPARCO France | OeEB Austria | Norfund Norway |
|---|---|---|---|---|---|---|
| TA Fund Active Since | 2006 | 2005 | 2004 | 2008 | 2008 | 2000 |
| Average Volume per. Year (EUR) | 6,700,000 | 2,100,000 | 1,455,000 | 1,000,000 | 11,300,000 | 3,800,000 |
| Average Number of Projects per. Year | 70 | 39,7 | 51 | 01 | 84 | 0 |
| Average Contracted Amount per. Project | 135,000 | 52,900 | 97,000 | 150,000 | 808,000 | 63,000 |
| Funding Range (EUR) | 15,000-1,000,000 | 10,000-193,000 | 10,000-300,000 | 10,000-400,000 | Project Specific | 8,000-400,000 |
| Minimum Client Contribution | 25-50% | 50% | 25% | 25-50% | 20-50% | No Fixed % |

*Source: BIO, DEG, FMO, Norfund, OeEB, PROPARCO, 2011* - www.proparco.fr

While the provision of technical assistance is relatively common in European DFIs, it is not a service provided by all DFIs. OPIC for instance, which is one of the largest DFIs in terms of investment portfolio, does not provide this service to its clients.

14. EDC European DFI Study November 2015 – Lessons learned (E. Grall)
15. "Technical Assistance, a development tool serving the private sector," Private Sector & Development – Proparco's Magazine No. 11, July 2011.

# Options for a Canadian DFI to Consider

**Governance Structure and Size**

- Board of Directors Composition (Members from private industry and government)
- Size of Board (Mid-size 7 members)
- Other governance committees (e.g. Audit Committee, Investment Advisory Committee, Risk Advisory Committee etc.)

**Mandate and Strategic Priorities**

- Financial Returns (Self-Sustaining) and Developmental Impacts
- Mandatory promotion of national business and economic interests (Japan and US) or Nationality neutral (United Kingdom, France)
- Promotion of Small and Medium Sized Enterprises (SMEs) similar to US, Japan and Sweden along with a streamlined approval process.
- Define primary sectors of investment (Build upon those areas where Canada has a competitive advantage/expertise and could effectively contribute to developmental impacts)
- Define primary geographic areas for investment (Explore under-served areas with high opportunity)
- Define investment condition, principles and criteria (See PROPARCO and SWEDFUND).
- Identification of primary services to be offered in addition to Financing
  Technical Assistance – Capacity building activities. Define what services would be offered as part of the technical assistance and the minimum level of client contributions.
  Business Advisory Services (Additionality & Mobilization of private sector players into transactions)
- Priorities should flow from a long term vision, and need should be sheltered from short term policy changes

**Partnership opportunities to obtain synergies and share best prac tices (e.g. partner with other DFIs, DFI networks, Fund Managers etc.)**
**Risk Profile, Management Framework and Principles**

**Potential Investment Sizing of a Canadian DFI (Look at other G7 DFIs to determine average annual commitments relative to their country's private capital flows to developing countries and to their national GDPs.)**

- Once investment sizing is determined, consideration could also be given to recommending an organization size of the DFI (i.e. number of full-time equivalents)
- On average, the 6 existing G7 DFIs provide annual commitments equivalent to about 3.3% of their country's private capital flows to developing countries and about 0.024% of their national GDPs. For a prospective Canadian DFI, that implies annual commitments of between CAD $350mn and $500mn.[16]

**Performance Assessment Criteria & Development Impact Measurement**

- Simplified performance measurement framework
- Use of a selected number of common indicators (e.g. HIPSO indicators) to measure development impact and allow for a comparison on developmental impacts between DFIs.

16. http://www.parl.gc.ca/Content/HOC/Committee/412/FINA/WebDoc/WD6615327/412_FINA_PBC2014_Briefs/EngineersWithoutBordersCanada-e.pdf
http://www.parl.gc.ca/Content/HOC/Committee/412/FINA/WebDoc/WD6615327/412_FINA_PBC2014_Briefs/EngineersWithoutBordersCanada-e.pdf

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