Maximizing Development Impact of Canada's DFI

A policy paper on how Canada can draw on international best practice as it shapes its new Development Finance Institution

A report prepared for

CCIC CCCI

CANADA'S COALITION TO END GLOBAL POVERTY
ENSEMBLE POUR ÉLIMINER LA PAUVRETÉ DANS LE MONDE

Acknowledgements

This report was commissioned by CCIC as part of INAF 5489, a graduate course run by Robert Sauder at the Norman Paterson School of International Affairs at Carleton University. It was written by Alexandre Bilodeau-Bouchard, Kenneth Boddy, Chase McGowan and Cullen Schreiter. It was edited for publication by Fraser Reilly-King and Gavin Charles of the Canadian Council for International Co-operation (CCIC). CCIC wishes to thank Robert Sauder and his students for this collaboration.

July 2017

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This publication was produced with financial support from CCIC's institutional funders and our members. The opinions expressed in this report, however, do not necessarily represent the opinions of CCIC's members or its funders.

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Introduction

In Budget 2017, the Canadian government announced its intention to create a Canadian Development Finance Institution (DFI), initially capitalized at $300 million.[1] There are a number of multilateral, regional and bilateral DFIs that already fund projects in the developing world. This means there is a wealth of experience for Canada to learn from. This report aims to inform the creation of Canada's DFI by answering two primary questions: (1) what international best practices should Canada's DFI adopt? and (2) in what niche markets and in what way can Canada's DFI complement the existing development landscape?

There is also strong interest within the Government of Canada to explore new methods of aid delivery, as notably demonstrated during the government's International Assistance Review. This interest coincides with Canada's new focus on helping the poorest and most vulnerable, including activities such as building capacity and stability in fragile and post-conflict states and areas (hereafter "fragile states").[2] Key to any effort involving a DFI will be the ability of DFI investments to maximize development impact. This goal is prevalent throughout the report.

Context

DFIs fill the gap between traditional forms of aid and the work of private lending institutions. They are intended to address capital market failures in developing countries by providing finance to private companies. Bilateral DFIs can be fully state-owned, fully private, or somewhere in between. Using a variety of financial instruments (e.g., equity, loans, or guarantees), and lower levels of risk aversion, DFIs bring new capital into higher-risk and underserved markets. Rather than funding national-level projects, most DFI financing helps build-up small and medium-sized enterprises (SMEs). At the same time, DFIs aim to help companies, sectors and countries where they invest by promoting positive development outcomes and economic growth, providing technical assistance, and fostering higher environmental, social and governance standards.

DFI financing is not meant to replace private financing, but to augment and further catalyze private sector investments in developing economies. This means investments are usually steered away from markets that have easy access to capital and instead focus on countries facing capital constraints. For example, DFIs can promote stability in fragile states by driving new investment and economic growth.[3] At their best, DFIs promote socially equitable development and nurture private sector growth in developing countries. At their worst, DFIs do little more than channel investment towards preferred companies while pursuing donor nation interests overseas.

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[1] Government of Canada. "Building a Strong Middle Class: Budget 2017." http://www.budget.gc.ca/2017/docs/plan/budget-2017-en.pdf (accessed May 1, 2017). The (previous) government's intention to establish a DFI was originally announced in Budget 2015.

[2] Prime Minister of Canada, "Mandate Letter to the Minister of International Development and La Francophonie." (2015). http://pm.gc.ca/eng/minister-international-development-and-la-francophonie-mandate-letter (accessed April 26, 2017).

[3] Dirk Willem te Velde, "The Role of Development Finance Institutions in Tackling Global Challenges." London: *Overseas Development Institute* (2011): 5.

Literature Review

Mandate

While there are many examples of foreign mandates to draw from, Canada conducted its own early experiment with development financing in the form of the Canadian International Development Agency's Industrial Cooperation Program (1978-2012). Although the program disbursed more than $1 billion over its history, it is considered a failure, in part because it was only mandated to help Canadian firms.[4] Even today, some countries primarily use their DFIs to assist national firms operating overseas (e.g., Denmark and Italy).[5] However, most DFIs primarily aim to reduce poverty in developing countries.[6] The specific objectives of these DFIs usually encapsulate one or more of the following:

- Improving employment opportunities by growing businesses;
- Obtaining maximum development impacts;
- Maintaining long-term financial viability; and
- Leveraging private sector capital.[7]

In addition to the typical objectives of DFIs, some DFIs target regions and specific sectors of the economy. The CDC, for instance, focuses on South Asia and Africa.[8] The EIB considers climate change mitigation and adaptation as integral to its activities.[9] Finnfund, the Finnish development finance company, focuses on financing renewable energy, forestry and telecommunications industries.[10]

Governance

As with other corporate institutions, DFI governance aims to help build the trust necessary for creating long-term stability and integrity in the interest of stronger growth and greater inclusion.[11]

A total of 34 development institutions[12] are signatories to the International Finance Corporation's (IFC) Corporate Governance Development Framework, which aims to support sustainable economic

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4 "A Backgrounder on Canada's Development Finance Initiative." *McLeod Group.* May 15, 2016. http://www. mcleodgroup.ca/wp-content/uploads/2016/05/REVISED-McLeod-Group-Policy-Brief-16-DFI-UPDATED.pdf (accessed October 3, 2016).

5 Maria Jose Romero and Jan Van de Poel. "Private Finance for Development Unravelled: Assessing how Development Finance Institutions Work." *European Network on Debt and Development* (2014): 15.

6 Ibid. 15

7 te Velde, "Role of Development Finance," 5.

8 CDC, "Our Mission." http://www.cdcgroup.com/What-we-do/Our-Mission/ (accessed November 7, 2016).

9 "Fact Sheet: EIB and Private Finance for Development." *European Network on Debt and Development*, http://www.eurodad.org/files/pdf/53be74bf3eb41.pdf (accessed November 7, 2016).

10 EIB, "Leading Development Finance Institutions Launch Corporate Governance Framework to Support Emerging Markets." http://www.eib.org/infocentre/press/news/all/leading-development-finance-institutions-launch-corporate-governance-framework-to-support-emerging-markets.htm (accessed November 19, 2016).

11 OECD. "G20/OEDC Principles of Corporate Governance". http://www.oecd-ilibrary.org/docserver/download/2615021e.pdf?expires=1479700253&id=id&accname=guest&checksum=F642FD1D0F5D1E2C6A71C5DF05E0639C (accessed November 20, 2016).

12 Proparco. "10th Annual DFI Corporate Governance Conference." http://www.proparco.fr/jahia/webdav/site/proparco/shared/ELEMENTS_COMMUNS/PROPARCO/Evenements/Corporate_Governance_Conference_Overview.pdf (accessed November 20, 2016).

development in emerging markets.[13] The Framework includes a set of guidelines for sound DFI governance, and signatories must report on its implementation to ensure compliance.[14] The Framework includes a guidebook that discusses how DFI governance can better contribute to value creation in investee companies.[15] The Framework also includes a Corporate Governance Progression Matrix detailing best practices, which promote a board of directors composed of a majority of independent directors; an audit committee composed entirely of independent directors; and a complaint registration system for shareholders to properly resolve corporate disputes.[16] In addition to this Framework, the G20/OECD principles of corporate governance[17] emphasize that DFI boards should engage in ongoing training, self-evaluation, and have an appropriate mix of backgrounds and competencies.[18]

As an example, the European Bank for Reconstruction and Development (EBRD) has a corporate governance model that includes a board of governors, a board of directors, various board committees with different expertise, management committees, and an administrative tribunal.[19] EBRD has also implemented its own code of ethics and has a Chief Compliance Officer to ensure the code is followed. EBRD also uses a strong operational risk system.[20]

The German DFI, the Deutsche Investitions und Entwicklungsgesellschaft (DEG), is a member of the Framework's DFI Corporate Governance Working Group, and its structure provides an good example of diversified governance that takes many interests into account. It is composed of a management board and a supervisory board. The management board is led by three individuals who each focus on different developing regions and bring a unique set of expertise to the organization.[21] They report to the supervisory board, which includes several ministers, business units that focus on lending in Germany and other European countries, and subsidiaries that focus on international lending.[22] The DEG is regularly evaluated by KfW Bankengruppe.

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[13] International Finance Corporation. "Leading Development Finance Institutions Launch Corporate Governance Framework to Support Emerging Markets." http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/corporate+governance/news/leading+development+finance+institutions+launch+corporate+governance+framework+to+support+emerging+markets++leading+development+finance+institutions+launch+corporate+governance+fra (accessed November 20, 2016).

[14] World Bank Group. "Corporate Governance Development Framework, A Framework for Integrating Corporate Governance into Investment Operations." http://cgdevelopmentframework.com/wp-content/uploads/2015/02/Corporate-Governance-Development-Framework.pdf (accessed November 20, 2016)

[15] Working Group for the Corporate Governance Development Framework. "Guidebook for Development Finance Institutions on Nominating Members to the Board of Investee Companies." http://cgdevelopmentframework.com/wp-content/uploads/2016/09/Guidebook-for-DFIs-on-Nominating-Members-to-the-Boards-of-Investee-Companies.pdf (accessed November 20, 2016).

[16] International Finance Corporation. "Corporate Governance Progression Matrix". http://www.ifc.org/wps/wcm/connect/5d50f40048582e928221ebfc046daa89/CGMatrix.pdf?MOD=AJPERES (accessed November 20, 2016).

[17] OECD. "G20/OECD Principles of Corporate Governance". https://www.oecd.org/corporate/principles-corporate-governance.htm (Accessed November 26, 2016).

[18] *Ibid.* 1.

[19] European Bank for Reconstruction and Development. "Corporate Governance." http://www.ebrd.com/corporate-governance.html (accessed November 20, 2016).

[20] *Ibid*. 13.

[21] KfW Bankengruppe. "Corporate Governance Report 2014." https://www.kfw.de/PDF/Unternehmen/Verantwortung-und-Corporate-Governance/Corporate-Governance/PCGK-DEG-für-2014-2.pdf (accessed November 2, 2016).

[22] Eurodad. "Fact Sheet DEG (Germany) and Private Finance for Development". http://www.eurodad.org/files/pdf/53be75764add2.pdf (accessed November 12, 2016).

Development Impact

The Paris Declaration on Aid Effectiveness (PD) and the Accra Agenda for Action (AAA) promote country ownership of development. principles, including donor alignment with country strategies and systems, donor harmonization in order to improve this alignment and reduce transaction costs, and accountability between both donors and partner countries.[23] Donors must strive to collaborate with the recipient countries to implement programs that will not only have direct development impacts, but also strengthen capacity building.

Impacts from development programs, especially those targeted towards social change, are often indirect and take time to settle within a country's cultural fabric, so they can be difficult to perceive. Results-based management only works to the extent that results are measurable. Moreover, measuring development is often subjective; different actors may perceive development in different ways. In 2011, an independent auditor evaluated the IFC and concluded that less than half of its projects presented evidence of poverty reduction.[24] The IFC's plans to reduce poverty and the impacts of many of its projects were deemed unclear.

The most recent performance evaluation (November 2015) of the UK's Commonwealth Development Corporation (CDC) measured the following indicators to assess development impact: (1) increase in jobs, revenues, profits, and taxes paid by investee businesses; (2) number and performance of first-time fund investments; (3) ability to instill sound environmental, social, and governance practices in fund managers and investee businesses; (4) benefits of fund strategy as opposed to direct investments; and (5) ability to mobilize third-party capital.[25] These are easily measurable indicators. While poverty is indirectly measured as a rise in GDP, poverty reduction as an indicator in itself is not measured.

Additionality

There are three related types of additionality: financial, value, and development additionality. Financial additionality is often considered the most important for DFIs. The OECD Development Assistance Committee defines it as "finance extended to companies in countries and regions where the private sector would not invest in developmental projects without official support."[26] Value additionality, meanwhile, refers to the skills, knowledge, and capabilities that the public sector brings to the table by engaging in a partnership with private firms. Finally, development additionality refers to the extra development outcomes achieved through partnership, often measured as new jobs created or taxes collected.[27] A focus on development additionality ensures that investments target areas where they can have the greatest development impact.

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[23] Overseas Development Institution. "Global Fund: Allocation Strategies and Aid Effectiveness." 2010. https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/6052.pdf (accessed November 19, 2016)

[24] IEG World Bank. "Assessing IFC's Poverty Focus and Results." http://ieg.worldbankgroup.org/Data/reports/ifc_poverty_full_eval.pdf (accessed November 12, 2016).

[25] CDC. "What was the impact of CDC's fund investment from 2004 to 2012?" http://www.cdcgroup.com/Documents/Evaluations/Impact%20of%20funds.pdf (accessed November 8, 2016).

[26] OECD-DAC Working Party on Development Finance Statistics, "Implementation of the Principles of ODA Modernization on Private-Sector Instruments." *DCD/DAC/STAT* 1, (2016): 4.

[27] Canadian International Development Platform. "Understanding Additionality." http://cidpnsi.ca/wp-content/uploads/2016/05/ Additionality-DFI-brief.pdf. (accessed October 11, 2016).

Multiple sources agree that additionality (financial, value and development) should be considered as a prerequisite for DFI-financed projects.[28] For example, DEG and FMO (the Dutch DFI) require projects they finance to demonstrate both financial additionality and value additionality related to environmental, social and governance (ESG) outcomes.[29] However, financial additionality can be notoriously difficult to measure and assess due to the absence of counterfactual cases. Furthermore, high financial additionality (measured as a high leverage ratio) may indicate a DFI is distorting the financial market or that the DFI has lost control over a project; a lower level of additionality may indicate limited involvement of private partners (see Annex 1).[30]

The leverage ratio of a DFI is a related concept to financial additionality. This ratio indicates the degree of private relative to public investment. A leverage ratio of 3:1, for instance, indicates that three private dollars are invested for every public dollar spent. Leverage ratios offer a good example of the difficulty of measuring financial additionality. The CDC, for instance, has a leverage ratio of 5:1 for its investments.[31] The European Bank for Reconstruction and Development (EBRD) has a leverage ratio of 1:1.[32] At first blush, it may seem that the CDC is better at unlocking private investment, which may indeed be the case. But a high leverage ratio can also indicate that a DFI is distorting the market by displacing private sector finance, which would have supported a project even without public sector involvement.[33] Moreover, a high leverage ratio means that a DFI may have less control over a project and less ability to steer a project toward preferred development outcomes.

Role and Involvement of the Private Sector

Numerous factors must be considered when dealing with the role of the private sector in development finance. Private sector involvement in development should build on and contribute to established development effectiveness principles (developing country ownership of priorities, inclusive development partnerships, transparency and accountability, and a focus on results). It should also align with and support the Sustainable Development Goals, including by sharing risk and minimizing debt, ensuring transparency, showing additionality and ensuring good corporate practice.[34] Private partnerships should also consider cross-cutting development themes, such as closing gender gaps and environmental

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[28] Cowater, "Canada's Development Finance Institution: A Chance to Achieve Development Gold." http://www.cowater.com/wp-content/uploads/2016/07/Cowater-White-Paper-No2-September-11.pdf (accessed November 6, 2016); Romero and Van de Poel, 16; Mathieu Vervynckt, "Monitoring and Evaluation at Development Finance Institutions." *European Network on Debt and Development*, (2015): 3, http://www.eurodad.org/files/pdf/1546442-monitoring-and-evaluation-at-development-finance-institutions.pdf (accessed October 5, 2016).

[29] "Fact Sheet: DEG (Germany) and Private Finance for Development." *European Network on Debt and Development*, http://www.eurodad.org/files/pdf/53be75764add2.pdf (accessed October 5, 2016); "Fact Sheet: FMO (Netherlands) and Private Financing for Development." *European Network on Debt and Development*, http://www.eurodad.org/files/pdf/53be75e54baeb.pdf (accessed October 15, 2016).

[30] Dirk Willem te Velde, "How can Public Climate Finance Most Effectively Leverage Private Capital? The Role of Development Finance Institutions." *Overseas Development Institute*, https://www.odi.org/sites/odi.org.uk/files/odi-assets/events-presentations/834.pdf (accessed November 5, 2016).

[31] te Velde, "How can Public Climate Finance?"

[32] Ibid.

[33] Romero, 25.

[34] United Nations. "Sustainable Development Goals." *Sustainable Development Knowledge Platform*. (2015). https://sustainabledevelopment.un.org (accessed April 26, 2017).

sustainability.[35]

The UK's Department for International Development (DfID) is one example of a public development institution that heavily invests in the private sector. DfID has significantly increased its investment in private sector firms (from £68m in 2012 to £580m in 2015) through loans, equity investments, and guarantees. However, it has been criticized for lacking strategic oversight, clear objectives, and additionality in its plans to engage with private partners.[36] The private sector's commercial interests were criticized for not being in line with DfID's objectives for poverty reduction.[37]

Transparency and Accountability

DFIs have struggled with full information disclosure, in part due to desires for secrecy among commercial partners.[38] This has spurred the creation of the Global Transparency Initiative (GTI), a civil society movement advocating for enhanced transparency in international financial institutions (IFIs). GTI's Transparency Charter for International Financial Institutions has become an important framework to assess and guide DFI transparency policies. It advocates for automatic disclosure and dissemination of comprehensive information about the inner workings of DFIs.[39]

Pressure from civil society and elsewhere has yielded action by IFIs as well. To promote accountability and international comparisons, 25 institutions have signed a memorandum of understanding agreeing to a harmonized set of 38 "HIPSO" indicators.[40] This approach is meant to help develop best practices, but remains limited in that the set of indicators currently excludes qualitative indicators.[41]

The International Aid Transparency Initiative (IATI) Standard, a framework for reporting international development activities, is another potential solution with diversified buy-in. Several DFIs (e.g., FMO, CDC), NGOs (e.g., the Red Cross), and other public sector groups (e.g., the International Development Research Centre) are already compliant with IATI, which entails publishing aid information online and linking it to an accessible registry.[42] While the terminology and other structural elements of IATI (at least as currently designed) may not be well-suited for all types and sizes of organizations,[43] it does represent a step towards harmonized transparency.

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[35] Oxfam. "Delivering sustainable development: A principled approach to public-private finance." https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/dp-delivering-sustainable-development-public-private-100415-en.pdf (Accessed November 19, 2016).
[36] Independent Commission for Aid Impact. "DfID's Private Sector Development Work." http://icai.independent.gov.uk/wp-content/uploads/ICAI-PSD-report-FINAL.pdf (Accessed November 8, 2016)
[37] *Ibid*. 25.
[38] Romero and Van de Poel, 6.
[39] Global Transparency Initiative, "Transparency Charter for International Financial Institutions: Claiming our Right to Know." 2, http://www.ifitransparency.org/doc/charter_en.pdf (accessed November 6, 2016).
[40] HIPSO, "Indicators." https://indicators.ifipartnership.org/indicators/ (accessed November 6, 2016).
[41] Canadian International Development Platform. "Ensuring Transparency and Accountability in Canada's Development Finance Institution." http://cidpnsi.ca/wp-content/uploads /2016/05/Transparency-and- accountability-DFI- brief.pdf (accessed October 11, 2016).
[42] International Aid Transparency Initiative, "IATI Standard." http://iatistandard.org/ (accessed November 7, 2016).
[43] Sarah Johns. "Has the aid transparency standard come of age?" *The Guardian*. https://www.theguardian.com/global-development-professionals-network/2014/jan/30/iati-aid-transparency-standard-maturing (accessed May 1, 2017).

Niche Markets

The Association of European Development Finance Institutions (EDFI) outlines some patterns with respect to sectoral spending in their 2015 flagship report. Amongst all European DFIs, spending was concentrated most heavily in the financial sector (30%) and infrastructure (29%).[44] Other investments were focused on industry/manufacturing (16%), agribusiness (8%) and other industries (17%).[45] A large number of investments, particularly in infrastructure, were allocated towards green technologies and renewable power generation. EDFI reported that €6.17 billion has been allocated towards investments directly related to climate mitigation since 2009.[46] These types of investments not only represent a significant portion of EDFI spending, but also, more importantly, mark a new trend amongst DFIs.

Many DFIs aim to invest in markets facing capital constraints to supplement rather than replace private investors. In some cases, DFIs have explicit mandates that prohibit them from placing competing bids against private firms.[47] According to the World Bank country income classifications, DFI capital is best allocated to low-income countries, where there is limited access to financial markets. However, only 25% of DFI funding goes to low-income countries, with as much as 35% going to upper middle-income countries, such as China and India, which do not face the same constraints on access to capital.[48] This has led to criticism of DFI investment practices.[49]

The EDFI report also highlights EDFI investment in priority states. These are states that have underdeveloped markets and face real capital constraints. They mostly include least developed countries (LDCs) found in the African, Caribbean and Pacific (ACP) group of states. In their 2014 Annual Report, EDFI noted that the ACP states made up 29.8% of total investments and about 25% of all new investments.[50] There is, again, continuing criticism of significant investment in states with developed financial sectors, such as India and China. For DFIs to be effective, it is suggested that they need to focus more heavily on LDCs.[51]

Policy Considerations

DFI investments are most useful when they align with the interests of developing countries and complement traditional forms of aid

Effective DFIs bring new tools to the fight against poverty while ensuring that developing countries have a voice. Unfortunately, DFI mandates often reflect the politics and goals of donor countries rather than the needs of developing countries.

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[44] EDFI. *2015 Flagship Report.* http://www.edfi.be/publications/all.html (accessed November 20, 2016).
[45] Ibid.
[46] EDFI. *Investing in Greener Technology 2015.* http://www.edfi.be/publications/all.html (accessed November 16, 2016).
[47] Thomas Dickinson. *Development Finance Institutions: Profitability Promoting Development*. OECD. http://www.oecd.org/dev/41302068.pdf (accessed November 16, 2016).
[48] Romero, María José. A Private Affair: Shining a Light on the Shadowy Institutions Giving Public Support to Private Companies and Taking over the Development Agenda. Report. European Network on Debt and Development. 2014.
[49] Ibid.
[50] EDFI. 2014 Annual Report. http://www.edfi.be/publications/all.html (accessed November 20, 2016).
[51] Romero, A Private Affair.

One concern is that tension may exist between different elements of a DFI's mandate. For example, a focus on maintaining financial security may lead to risk aversion and limit DFI willingness to enter risky markets. Another issue is the trade-off between development-related objectives and financial objectives. As publicly funded and development-oriented institutions, most DFIs prioritize strong development outcomes in their mandates and differentiate themselves with their focus on additionality. Yet, a strong case can be made that DFIs must also be cognizant of long-term financial solvency and stability. After all, DFI investments are not meant to replace ODA, nor should they be mistaken with corporate welfare. This suggests that significant efforts may be required to ensure that DFI investments complement existing ODA and, more broadly speaking, that the Canadian DFI complements the development-related activities of Global Affairs Canada (GAC).

One approach to striking an appropriate balance is to continue to rely on ODA to purchase public goods (e.g. vaccinations) in developing countries, while using the DFI as a tool to crowd-in private sector investments to build economies and marketplaces for private goods that have strong development externalities (e.g., improved electrical grids). This model would see a clear division of focus between, on the one hand, sustained (or growing) ODA to support core public goods that will not be reliably, affordably, or efficiently provided by the market and, on the other hand new impact through a DFI that can help overcome financial barriers to entry faced by small-scale private-sector economies.

Canada's DFI can maximize development impact by being integrated within Canada's existing development efforts

The Canadian DFI must focus on and work with Canadian development priorities and expertise. This means actively interacting with GAC and with government policy as a whole to focus its investments in ways that will effectively supplement other government initiatives. An effective example of this is the Finnish Fund for Industrial Cooperation (FINNFUND) because, as an organization, they respond to and invest in the same key areas as the government of Finland. This means they invest heavily in green technologies and telecommunications.[52] For a Canadian DFI, this would mean focusing on existing government priorities, such as gender equality and women's rights or health care initiatives. Both of these issues can be addressed by, for instance, investing in LICs and fragile states where these issues tend to arise and be compounded.

Additionally, there must be a degree of communication between Canada's DFI and GAC. Similar to the CDC, Canada's DFI could regularly meet and share information with officers from GAC and use GAC's knowledge base to support the DFI's decision making process.[53] Should Canada's DFI choose to invest in LICs or fragile states, Canada's DFI could be supported by GAC's efforts where it focuses on state-building in these countries. This would allow the DFI to attract private investment through the increased perception of stability, thereby decreasing investor risk.

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[52] Annual Report 2015. FINNFUND. http://annualreport.finnfund.fi/2015/en (accessed November 26, 2016).

[53] "Corporate Structure." CDC: Investment Works. http://www.cdcgroup.com/Who-we-are/Corporate-structure/ (accessed November 8, 2016).

<u>Canada's DFI may benefit from a governance structure outside of EDC</u>

The planned Canadian DFI will be a wholly owned subsidiary within Export Development Canada (EDC). In 2015, the Government of Canada amended the *Export Development Act* to enable EDC to provide development financing "in a manner that is consistent with Canada's international development priorities."[54] This generated debate over whether the DFI should be forced to adhere to the *Official Development Assistance Accountability Act*. The Act, which governs the administration of all Canadian ODA, would oblige the DFI to target poverty eradication, ensure that the perspectives of the poor are incorporated into decision-making, and focus on human rights considerations.[55] Those in favour of adhering to the Act believe the DFI should follow the same rules applied to other Canadian ODA. Those opposed suggested that DFIs serve a different function than ODA and therefore should follow different rules.[56]

EDC itself is not a development institution: it lacks the necessary institutional focus on and knowledge of development principles and practice. A DFI operating out of EDC would be severely – and, from a development effectiveness perspective, problematically – constrained by EDC's requirement to work only with Canadian companies.

Canada's DFI will likely require its own governance structure to be effective.[57] For example, the DFI could have its own board, which would be in charge of making final decisions surrounding investments and goals, ensuring that these goals are being met, and maximizing development impact.

<u>An ambitious Canadian DFI could maximize development impact by attracting much-needed investment not just to LICs, but to fragile states</u>

DFIs increase investor security by entering uncertain markets themselves and reducing the cost and risk of entry for private investors.[58] They also possess the knowledge and tools for working in difficult environments that commercial banks do not.[59] Canada's DFI could increase the comfort level and deploy the tools to attract private investment where it is most needed. One area of significant need, where development impact can be maximized, is fragile states.

Fragile states suffer from conflict, security and political issues that result in weak governance capabilities and vulnerability to internal and external shocks.[60] Assisting fragile states would have a significant development impact, in line with Canada's priority areas, as these states are associated with increased

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[54] Government of Canada, "Export Development Act (Amendments Not in Force)." http://laws.justice.gc.ca/eng/ acts/E-20/nifnev.html (accessed November 7, 2016).

[55] James Munson, "Aid groups split over mandate of new development financing institution." *iPolitics*, May 12, 2015, http://ipolitics.ca/2015/05/12/aid-groups-split-over-mandate-of-new-development-financing-institution/ (accessed November 7, 2016).

[56] Ibid.

[57] Canadian International Development Platform. "Canada's Development Finance Initiative: Making it Happen, Getting the Details Right." http://cidpnsi.bbdp6cmt4ou6bl.netdna-cdn.com/wp-content/uploads/2016/05/DFI_ report_May12edit2.pdf (Accessed November 11, 2016).

[58] Giordano, Thierry & Ruiters, Michele. "Closing the development finance gap in post-conflict and fragile situations: what role for development finance institutions?" *Development Southern Africa* 33, no. 4 (2016): 569-570.

[59] *Ibid.* 571.

[60] *Ibid*. 564.

regional instability, the spread of disease and refugee crises. However, these states are often not provided effective aid because of high risk to investments, a focus on state-building, or the donor's strategic interests.[61] While private sector involvement can improve stability and economic growth, incentives to do so may be low and risks may be high.[62] Canada's DFI could address this lack of incentives by entering the market itself and providing technical assistance and guarantees to private enterprises.

Since fragile states are often politically and economically opaque, Canada's DFI must be willing to collect sector and region specific information to develop assessment tools to understand and overcome risks.[63] This high degree of engagement means the cost of operating Canada's DFI would be higher.

Macro-level goals are as important as micro-level

With regard to measuring development outcomes, macro-level evidence (across an entire economy) can provide a better estimate of additionality than the project-centric financial additionality measures usually employed by DFIs.[64] For example, macro-level evidence indicates that DFIs can significantly increase overall investment in post-conflict countries, contributing to a "peace dividend."[65] In Uganda's post-conflict period after 1992, European Investment Bank (EIB) investments catalyzed private finance, leading to significantly higher levels of investment in the country.[66] Utilizing macro-level evidence can help generate an aggregate measure of DFI impact to enable the development of a comprehensive impact narrative.

One drawback of this approach is that local, on-the-ground impacts may be obscured and causation can be difficult to determine. Nevertheless, emphasis on assessing macro-level impacts for each of the three forms of additionality is particularly important if one acknowledges that DFIs have a crucial role to play in addressing global challenges, including those presented by fragile states. Macro-level goals and evidence should therefore be valued and assessed alongside (though never to the exclusion of) local and/or micro-level results. Including macro-level impact in a DFI's monitoring and evaluation (M&E) framework (see more on M&E below) will generate a higher-level picture of a DFI's effectiveness.

Use of secrecy jurisdictions undermines development

Secrecy jurisdictions, sometimes called tax havens, allow corporations to benefit from activities carried out elsewhere while being exempt from normal standards of corporate reporting.[67] Corporations are able to shift profits from subsidiaries in developing countries to parent corporations in secrecy jurisdictions with lower tax rates.[68] Secrecy jurisdictions are used by DFIs because they increase project additionality in the sense that private investors can realize higher returns with a reduction in the cost of taxes,

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[61] *Ibid.* 567 & 572.
[62] *Ibid.* 574-576.
[63] *Ibid.* 574-576.
[64] te Velde, "Role of Development Finance," 5.
[65] *Ibid.* 5-6.
[66] *Ibid.* 13.
[67] Bracking, Sarah. "Secrecy jurisdictions and economic development in Africa: the role of sovereign spaces of exception in producing private wealth and public poverty" Economic and Society 41, no. 4 (2012): 617
[68] *Ibid.* 621.

especially when they invest in high-risk projects.[69] Secrecy jurisdictions are also considered to offer a large degree of stability as they allegedly have superior governance structures and better political and legal systems.[70]

However, these jurisdictions undermine the capacity of developing countries to gather taxes.[71] Furthermore, secrecy jurisdictions can empower local elites, thereby increasing inequality and harming anti-corruption efforts and attempts to strengthen the rule of law.[72] The negative effects of secrecy jurisdictions would be compounded in fragile states, where there are already existing issues with government and governance structures. Overall, the use of secrecy jurisdictions by Canada's DFI would run contrary to the objective of political and economic development in the countries where it works. Since domestic resource mobilization (e.g. tax collection) by developing countries is key to sustainable development, tax avoidance runs contrary to the core development objectives of a DFI.

Canada's DFI may be subject to rent-seeking

There are rent-seeking tendencies associated with DFI operations. The provision of below market financial products, such as low interest or subsidized loans, benefits well-to-do clients, increases reliance on loans, discourages frugal actions and self-sustainability and encourages fraud.[73] There is also the potential for the internal workings of the DFI to be subject to rent-seeking. In a context where the DFI is capable, and permitted, to operate with marginal oversight and experience, consistent losses in the name of "development,"[74] vested political and bureaucratic interests may act to prevent changes in the scope, scale and importance of the DFI.[75] The potential for rent-seeking highlights the need for a culture of built-in transparency. Existing transparency frameworks used by other DFIs can serve as a baseline (not a ceiling) for a Canadian DFI.

Canada's DFI can avoid issues of rent-seeking by operating as a "second tier" institution

A DFI could specialize in offering secondary products, like technical assistance and filling knowledge gaps, while leaving the provision of financial products to private financial institutions.[76] The premise here is that private institutions can deliver finances more efficiently and thereby avoid broader rent-seeking tendencies.[77] However, the mandate of most DFIs is inherently riskier than private sector institutions, meaning that partner institutions in the private sector might not reach the target risk level. It is not clear that state-sponsored or –subsidized technical assistance or knowledge provision would be additional, or that these services are well-suited to being provided by an institutional structure designed to direct financial investment.

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[69] *Ibid.* 622 & 625.
[70] *Ibid.* 623.
[71] *Ibid.* 621.
[72] *Ibid*. 630.
[73] Yaron, Jacob. "State-owned development finance institutions (SDFI): The political economy and performance assessment" Savings and Development 30, No. 1 (2006): 47.
[74] *Ibid.* 52.
[75] *Ibid.* 55.
[76] Bracking, "Secrecy jurisdictions and economic development in Africa", 53.
[77] *Ibid.* 53.

Should the Canadian DFI decide to operate on a second-tier, it must evaluate and assess the degree of risk taken by its partner institutions.[78] This is not only to ensure increased transparency and cost-effectiveness, but so that the funds it provides reach its target audience and conform to adequate ESG standards.

Canada's DFI can increase transparency by having an effective M&E system while being accountable to local stakeholders

DFI accountability is significantly spurred by the presence of a strong monitoring and evaluation (M&E) system to measure and assess the development impact of DFI activities. One of the most notable systems is the Corporate-Policy Project Rating (GPR) developed by the DEG and also used by 15 other DFIs.[79] The GPR is an index system combining four benchmark indicators: long-term project profitability, development additionality, value additionality, and return on equity for the DFI.[80] Projects are assessed *ex ante* and *ex post* as well as during the project cycle. Although useful, one of the weaknesses of the GPR is that evaluation results are rarely integrated into the lesson learning process.[81]

DFI accountability to local communities is important. Various mechanisms exist for listening to local communities, including independent complaint mechanisms. Canada's DFI could follow the example set by the FMO. The FMO's independent complaints mechanism is particularly noteworthy as it was drafted in consultation with Amnesty International, Oxfam, and other NGOs.[82] DEG later adopted the same independent complaints mechanism with the purpose of ensuring a right to be heard for adversely affected parties.[83] This mechanism is supported by a three-member independent external panel of subject specialists to hear and process complaints.

Recommendations

Canada's DFI should be mandated to maximize its development impact in low income countries and fragile states

The primary mandate of the Canadian DFI should be international development in low-income countries and fragile states. In focusing on development impact, financial, value and development additionality should be pre-requisites for projects the DFI finances. In pursuing financial additionality, Canada should avoid the use of secrecy jurisdictions. Canada's DFI should also leverage Canada's comparative advantages, such as bilingualism and multiculturalism, to create value additionality in countries where Canada invests, and could focus on advancing gender equality and women's rights (by investing in women-led SMEs) – complementing its new feminist international assistance policy.

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78 *Ibid.* 53.

79 Vervynckt, "Monitoring and Evaluation at Development Finance Institutions," 2. Other evaluation systems are the Development Outcomes Tracking System (DOTS) used by the IFC and the Results Management Framework (ReM) used by the EIB.

80 DEG, "Corporate-Policy Project Rating." https://www.deginvest.de/DEG-Englische-Dokumente/About-DEG/ Our-Mandate/Detailed-GPR-Description.pdf. 1 (accessed November 6, 2016).

81 Vervynckt, "Monitoring and Evaluation at Development Finance Institutions," 5.

82 "Fact Sheet: FMO," 3.

83 "Fact Sheet: DEG," 3.

Canada's DFI should meaningfully engage with public and private stakeholders

The DFI should work closely with and listen to developing country governments, civil society organizations, and other stakeholders, in line with development effectiveness principles, to ensure that DFI projects promote development and facilitate business growth. The DFI should seek to create a sense of ownership amongst the recipients of its investment, and align its investments with democratically determined development priorities within developing countries. The DFI must also work closely with the private sector to ensure development outcomes are maximized – that principles of development effectiveness and additionality are understood and accepted, and that institutional structures are aligned to prevent rent-seeking and the use of secrecy jurisdictions.

Canada's DFI should foster a culture of built-in transparency

At all times, Canada's DFI should comply with the IATI Standard reporting protocols and the Transparency Charter for International Financial Institutions. Canada should also utilize the established GPR methodology in its M&E system. However, over time, it should consider adapting this methodology to better fit the priorities of the Canadian DFI. Macro- and micro-level factors and impacts should always be assessed as part of the DFI's M&E, and transparency and accountability should wherever possible be extended to the local level.

With respect to the disclosing of information, Canada's DFI should sign on to and comply with the HIPSO indicators rather than create its own. At the same time, Canada should contribute to and learn from current efforts to develop qualitative indicators. GAC could play a valuable role in creating and validating these qualitative indicators, which would complement the conventional quantitative indicators used by DFIs. The DFI's success or failure in achieving its goals, relative to these indicators, should be published and made available to the public. Third party audits should be conducted to ensure the DFI is coherent with other Canadian development aid, is being fiscally responsible and is yielding a positive development impact. Finally, the DFI should also have an independent complaint mechanism for stakeholders modeled after the FMO's.

Canada's DFI should stand alone

Canada's DFI should be insulated from political pressure and governmental aversion to risk. Regardless of where Canada's DFI is formally located, it should not be accountable to EDC. It should be held to a different standard than the EDC: the DFI should be allowed to invest in non-Canadian businesses and have higher standards for its impact outside of EDC's guidelines. The DFI must have its own board of governors, composed of officials from the government, the private sector and civil society. This board should make final decisions surrounding investments, setting development goals and ensuring development goals are being met. The DFI should become a signatory to IFC's Framework and follow the best practices in the G20/OECD principles of corporate governance. However, despite its standalone status, Canada's DFI must effectively engage with GAC and other Canadian partners to gain access to fundamentally important development knowledge. In other words, both institutional independence and meaningful partnership should be hallmarks of the Canadian approach to development finance.

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