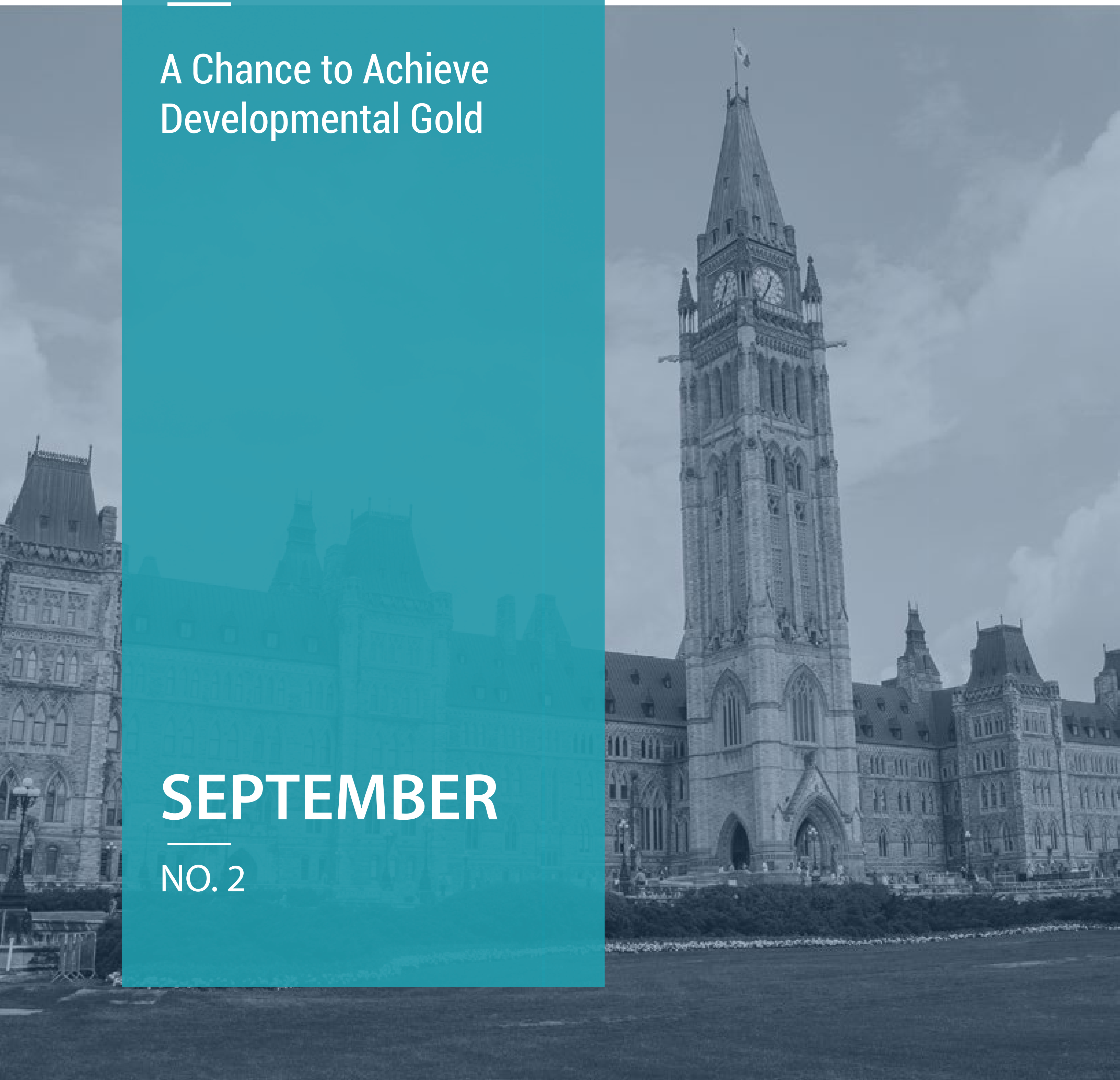
cowater INTERNATIONAL INC. | WHITE PAPERS

Canada's Development Finance Institution

A Chance to Achieve Developmental Gold



SEPTEMBER

NO. 2

The Birth of Canada's Development Finance Institution

While Global Affairs Canada compiles inputs from its wide-ranging International Assistance Review consultations and moves to integrate resulting changes to Canada's international assistance priorities into the 2017 federal budget, it is timely to underline the importance of getting one change right in particular: the birth of Canada's Development Finance Institution, or DFI.

Currently existing more or less only on paper within Export Development Canada[1] (EDC), our DFI has the potential, like Penny Oleksiak at this summer's Olympic Games, to defy expectations and achieve unexpected international results from a very young age. To realize this potential, like any successful athlete Canada's DFI needs to establish a clear plan of preparation. In the DFI's case, this means having the proper structure and governance in place to lay the conditions for the equivalent of Olympic gold: catalyzing good private sector projects in developing countries while achieving a high degree of development impact.

As the only G7 country without a DFI, Canada has the opportunity to incorporate the best and most relevant elements of what has worked for other DFIs around the world, and to avoid what has not. While all that might seem obvious, getting the formula right is tricky and the wrong choices could easily lead the new institution on a path that, for example, replicates private sector capacity or has little or no significant impact in scaling up private sector activity in developing economies, which are the ultimate goals. We believe there are three main areas the DFI needs to "get right" in order to succeed: governance, development impact, additionality and mechanisms for involving the private sector in its investments.

1. The Development Finance Initiative, as it is known around Ottawa, was announced in the 2015 federal budget with a $300 million capital allocation, but to date few details about its governance, structure or strategy are known.

Governance

The DFI's governance model should ensure it has both the autonomy and expertise to make suitable investments in the international development sphere.

To start, the DFI's governance model should ensure it has both the autonomy and expertise to make suitable investments in the international development sphere. Sitting within the commercially-oriented Export Development Canada (EDC),[2] there is naturally a challenge to ensure the new institution has sufficient autonomy and suitable strategic direction to allow it to achieve what we hope will be its core mandate: development impact. While EDC is a highly successful and self-sustaining crown corporation with essential expertise in lending, investing, capital markets and risk management, its strategic direction and operational priorities differ in critical ways from a typical DFI. EDC writes much of its business on commercial terms and is consistently very profitable as a successful export credit agency.

Further, EDC is most comfortable lending at the senior/secured level in a project, and almost always demands pari passu terms[3] to other lenders, meaning it is fundamentally a market follower rather than market leader. In contrast, the DFI should specifically exist in order to take risks the private sector will not; to target countries EDC may not lend or invest in; and to help build private sector risk appetite by catalyzing good projects in these new frontier markets.

Consequently, it will be important that the new DFI's governance and operations be made distinct from the mainline EDC business and philosophies and be independent from EDC's current Board, which is accustomed to overseeing a very different type of business and risk profile. The DFI's Board should be composed of individuals from the public and private sector and, critically, of people with deep experience in the design and financing of international development projects and Official Development Assistance (ODA) best practices. This would mirror best practices of the world's most successful DFI's, almost all of which have their own Boards made up of a mix of private and public sector members.[4]

2. The decision to initially house the DFI within EDC was made, among other reasons, to leverage EDC's capabilities in lending, investment, risk management and back office management and to avoid the significant cost of creating this capacity from scratch for the new institution.

3. Pari pasu terms in finance mean one has equal rights of payment or seniority.

4. DFI Research Findings Chart - Governance

Development Impact

The DFI's Board should ensure two clear tests are carried out for every DFI project: development impact and additionality.

Second, the DFI's Board should ensure two clear tests are carried out for every DFI project: development impact and additionality. Development impact for the DFI could be measured by the number of people lifted out of poverty, reached by new social or economic infrastructure, or whose livelihoods have improved as measured by a set of clear and objective results such as increased disposable income. Baseline assessments will need to be conducted and business objectives calibrated and directed to achieve these developmental goals.

More specifically, if a proposed investment has only limited or weak prospects of furthering social or economic development in the country to which it would be directed, this investment should not be approved. By pursuing this path, Canada would be joining DFIs in the UK (CDC), Germany (DEG) and France (PROPARCO) by putting development impact at the core of our DFI's mandate[5] Another important way to achieve development impact while taking on a suitable degree of risk would be to limit DFI investments to countries eligible to receive Official Development Assistance as per the Organization for Economic Cooperation and Development (OECD).

Most such countries, particularly those in low-income and lower-middle income categories such as Ethiopia and Ukraine, respectively, remain at the high end of risk tolerance ratings for commercial lenders and therefore lack access to affordable financing needed for investments in social and economic infrastructure, innovative new businesses, and research and development that can move their countries up the human development ladder. Moreover, given the comparatively unsaturated nature of these frontier markets from a foreign investment perspective and the scale of existing latent demand, potential development and financial returns are much higher than in traditional markets, particularly those outside of the ODA list.

5. Cowater Report: Proposal for the Creation of a Development Finance Institution in Canada: A Comparative Global Analysis

Additionality

> **Seek out and structure only those transactions that have the highest impact.**

With respect to additionality, this concept applies when private sector capacity does not exist for the type of risk being underwritten in question. Demonstrated additionality should be considered a prerequisite for approving each investment the DFI makes, supported by a governance model that will help the DFI seek out and structure only those transactions that have the highest impact by avoiding saturated sectors that already attract sufficient capital and carry lower developmental returns on investment.

Over time, Canada's DFI would then develop a diversified portfolio of investments promising a high development impact representing a manageable degree of risk.

This will not be easy and risks should and will always be a factor, but with the appropriate experienced staff in place overseen by a mixed independent Board, Canada's development community can have confidence that projects will be originated and structured to meet these tests and that our DFI's portfolio of projects (the institution's aggregate assets) remain financially self-sustaining.

Involving the private sector

Canada should look to build into its DFI investments a technical assistance (TA) mechanism.

To mitigate some of the risk associated with the approach recommended above and to bring to bear private sector innovation, Canada should look to build into its DFI investments a technical assistance (TA) mechanism through which Canadian expertise could be deployed to ensure the recipients of such investments have the skills and support needed to maximize promised developmental returns. Indeed, a review of several European DFIs indicates that the cost of the TA provided is generally co-financed with its clients, requiring a contribution from the client ranging between 25% - 50% of the costs (see Table 1 below).[6]

Similarly, regional development banks such as the Asian Development Bank and Inter-American Development Bank also regularly pair TA initiatives of upwards of USD 1 million with its large-scale loans to member countries and their sub-national governments. These projects are focused on both building the service delivery and revenue generation/management capacity of recipient institutions to supplement the development impact of the loan, and on better ensuring that financial obligations will be paid off by borrowers in accordance with agreed timelines.

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

6. Cowater Report: Proposal for the Creation of a Development Finance Institution in Canada: A Comparative Global Analysis

Development Impact

Like any Olympic prospect standing on the starting blocks of their career, there are no guarantees that Canada's DFI will be a major international success. But by following the preparatory approach outlined above benchmarked to and learning from global best practices and experiences, Canada's DFI will have a real opportunity to strike development gold over the long-term.

As noted by fellow Canadian Olympic swimmer Katarine Savard about her teammate Ms. Oleksiak's early prospects in Rio, "when you have a lane, you have a chance." This DFI is Canada's chance to change the way our country practices development for the better while increasing Canada's impact across the developing world.