THE CANADIAN CHAMBER OF COMMERCE
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Proposal for a Canadian Development Finance Institution

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connect!

In 2013, the Government of Canada announced it was merging the Canadian International Development Agency (CIDA) with the Department of Foreign Affairs and International Trade. Bringing diplomacy, trade, development together under one roof is a challenging endeavor, but will ultimately make Canada's foreign relations more coherent and collaborative. To complement the streamlining of operations and agenda-setting, the government should create new policy tools that can be deployed towards shared objectives. It is therefore time to revisit the long-standing idea of establishing a Canadian development finance institution (DFI).[1] This document outlines the case for such an institution and details the products and services, investment strategy and organizational features it needs to be effective.

Why does Canada need a DFI?

A made-in-Canada DFI would drive private sector growth in developing countries and help Canadian companies and investors expand their presence in the world's fastest growing markets. These priorities were highlighted in the 2013 Speech from the Throne[2] and subsequent Global Markets Action Plan.[3]

A better tool for poverty reduction

Business and economic development go hand-in-hand. Over the past two decades, private sector-led growth has driven 90 percent of job creation in developing countries and pulled hundreds of millions out of poverty.[4] By 2012, foreign direct investment (FDI) in these countries exceeded official development assistance (ODA) by a factor of 60.[5] Accelerating these private capital flows will be difficult, but instrumental to the next wave of poverty reduction.

Traditional ODA remains crucial to fund the public goods, social services and policy reforms that lay the foundations for economic growth. However, the impact on private investment flows is indirect at best. That is where DFIs come in. These institutions directly finance business activity, often coupled with technical assistance and administrative support. They play the role of catalyst, coordinating the involvement of companies, commercial banks, investors and non-governmental organizations (NGOs) that otherwise would not be able to undertake such ventures.

Although Canada supports multilateral DFIs, such as the World Bank's International Finance Corporation, it is the only G7 country without a similar national institution. As a result,

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[1] Asia Pacific Foundation of Canada. "The Case for a Canadian Development Finance Institution." *Canada Asia.* February, 2001.

[2] Canada will "help the world's neediest by partnering with the private sector to create economic growth in the developing world" and develop a "comprehensive new plan to assist Canadian businesses as they expand abroad." Johnston, Hon. David. "Seizing Canada's Moment: Prosperity and Opportunity in an Uncertain World." October, 15, 2013.

[3] Referencing the "aggressive" competition faced by Canada in international markets, the Plan promises to ensure that "all diplomatic assets of the Government of Canada will be marshalled on behalf of the private sector." Department of Foreign Affairs, Trade and Development. *Global Markets Action Plan: The Blueprint for Creating Jobs and Opportunities for Canadian through Trade.* Government of Canada. 2013.

[4] Kim, Jim Yong. "Building a Movement to End Poverty." *Foreign Policy.* June 27, 2013

[5] World Bank. *Financing for Development: Post-2015.* October, 2013. p. 23

Canadian aid officials trying to engage the private sector at home and abroad have to rely on contracts, grants or other forms of contributions. Lengthy approval processes, complex requirements and opaque selection criteria mean these tools are not suitable to the way most companies do business. CIDA Inc, a program that sought to make them more user-friendly, with limited success, was disbanded in 2012.

In this context, nearly 80 percent of Canadian ODA goes directly to foreign or multilateral aid agencies—a ten point increase over the past four years.[6] Canada is missing out on the goodwill, experience and relationships that come from having homegrown development programming. It is also more difficult to ensure that aid reflects national values and interests.

A DFI is the most cost-effective way to augment Canada's contribution to global poverty reduction. After initial overhead and capital, DFIs generally borrow at sovereign rates, enabling them to make a profitable return on their portfolios and to reinvest the earnings. In 2012, the national DFIs of France, Germany, Italy, Britain, Japan and the United States all generated a net profit. [7] As a self-sustaining entity, it would complement rather than take away from the current ODA budget.

Supporting Canadian business in high-growth markets

A lack of development finance tools in Canada is holding back business too. Only one-and-a-half percent of Canada's FDI stock is located in developing countries in Asia and Africa—by far the lowest share among G7 countries.[8] This is despite having resources and competitive advantages that could make a significant contribution to poverty reduction. Canada's leading pension and insurance funds are well-placed to finance long-term investments. Canadian companies have advanced technology and expertise in high-need areas such as energy, mining, cleantech, IT, microfinance, agri-food and infrastructure, among others. Failure to capitalize on these opportunities is leaving businesses and the broader economy over-exposed to traditional markets with limited growth prospects.

Canadian businesses have few options to fund projects in developing countries. The risks and uncertainty of returns mean that private capital markets are often unable to finance them—at least not on affordable terms. Export Development Canada (EDC), a crown corporation, offers some limited financial instruments to support overseas investments. Yet the agency's mandate is to promote exports, not investment or economic development, and it must do so at market rates.[9] The lack of specialized financing and risk-sharing is putting Canadian companies at as competitive disadvantage—not just with respect to peers from other developed countries, but also relative to new players from emerging markets. Since 2000, China is estimated to have

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[6] Canadian Chamber of Commerce. *Turning it Around: How to Restore Canada's Trade Success*. May, 2014. p. 23.

[7] Haga, James & Brett House. "Considerations in Creating a Canadian DFI." Centre for International Governance Innovation. 2014. (forthcoming)

[8] UNCTADstat

[9] EDC typically prices its financial products based on similar transactions in private markets. A less common alternative is to use the OECD consensus rules, which set minimum rates and maximum tenors depending on sector and jurisdiction.

made official financial commitments of over $75 billion in Africa—much of this to support investments by their companies.[10]

Some Canadian companies and investors have successfully worked with foreign and multilateral DFIs. But the majority have no experience with these institutions and lack the relationships to facilitate their involvement. Many national DFIs are required to work with domestic companies, or on projects that meet their government's foreign policy priorities. A 2011 study of private sector engagement across seven multilateral development banks found that Canadian companies lagged counterparts in countries like France, Spain and the Netherlands by a wide margin.[11]

A homegrown DFI is a win-win opportunity to close the financing gap for Canadian investments in the markets of the future, while stimulating sustainable economic growth and job creation in the places that need it the most.

What should a Canadian DFI look like?

The design of a DFI can be divided into three dimensions: products and services, investment strategy, and organizational features. The following is a blueprint for an institution that would meet the needs of both development policy and Canadian business.

Products and services

The core function of a Canadian DFI is to offer financial products on quasi-market terms to complement and support private investment in developing countries. This means taking on risk at more attractive rates and tenors than what is currently offered by EDC and the International Finance Corporation. It should be willing to back projects even when risks are not fully known or measurable, which is often the case in early stage investments, underserved markets or when quasi-sovereign entities, such as local public utilities, are involved.

It needs to be flexible enough to offer different instruments according to project needs: equity, loans, insurance or guarantees, blended instruments like mezzanine debt, and other forms of structured finance. While this financing would be catalytic—as opposed to comprehensive—the DFI should be prepared to put up to several hundred million dollars into a single transaction, particularly for larger projects in the infrastructure sector.

In addition to financing, it should provide additional services that bridge information gaps and lower transaction costs. These include market intelligence, due diligence and the coordination of multiple parties, including NGOs, host governments and other private and public lenders. It should also help build capacity of customers, end-users and local officials to negotiate and

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[10] Strange, Austin; Parks, Bradely; Tierney, Michael; Fuchs, Andreas; Dreher, Axel & Vijaya Ramachandran. "China's Development Finance to Africa: A Media-Based Approach to Data Collection." Center for Global Development. p. 24

[11] Foreign Affairs and International Trade Canada. *Summative Evaluation of the Aid Market Support Network*. Office of the Inspector General. 2011. p. 41.

administer business opportunities. These services could be done in-house or through grants to clients or third parties.

It is important that the DFI be user-friendly and responsive to private sector needs. Products and services should be able to be rapidly deployed to accommodate short timelines and unforeseen changes in market conditions or project requirements. It should also be easy for businesses to propose ideas and dialogue with DFI officials.

Investment strategy

Investment decisions should be guided by three general principles: long-term development impact, environmental sustainability and financial self-sufficiency. Within this broader framework, the DFI should target sectors where Canadian businesses have unique capabilities that are not being utilized to their full potential, although its support should not be exclusive to activities that have Canadian benefits. There will be other worthy opportunities with local companies in developing countries, as well as foreign multinationals.

As for geographic focus, a negative list should identify wealthier economies where the DFI would typically not operate. All others—including middle-income countries where the majority of the world's poor still live—should be open to worthy proposals. Flexibility on selection criteria and financing terms, however, might be considered in situations where development impact or Canadian benefits are particularly strong.

Organizational features

To properly deliver the wide range of products and services and administer its investment strategy, the DFI should be an arms-length agency of the federal government. This will allow it to customize hiring practices and compensation to attract and retain top talent in private sector finance and development policy, and to enter into contractual arrangements with a range of private, public and non-profit actors. By retaining its status as an instrument of public policy, the DFI would be positioned to coordinate and develop joint initiatives with development officials, the Trade Commissioner Service, and trade portfolio partners like EDC and the Canadian Commercial Corporation.

The DFI's portfolio needs to be large and diversified enough to accommodate sizeable transactions and long-term positions. As a self-sustaining entity, it should finance these investments with retained earnings and debt-issuance backed by the full faith and credit of the Canadian government. An initial capital injection would be required to cover overhead and ensure sufficient reserves to absorb occasional losses, barring the need for regular authorizations.

Starting a new institution from scratch would be a long and expensive process. An attractive alternative is to establish it as a subsidiary of EDC, which already has a solid base of financial sector expertise, client relationships and experience in developing countries. It also has capabilities in the area of market research, due diligence and social and environmental impact assessment. The DFI would share these resources, but maintain a differentiated mandate, risk management framework, brand and capital base. This would allow it to perform all the functions of an effective DFI, while preserving the integrity of EDC's existing business lines.

Conclusion

Canada is undertaking an ambitious plan to streamline and modernize the way it pursues its international priorities. A homegrown DFI would fill a long-standing gap in the government's tool-kit that has undermined the effectiveness of its development aid and the expansion of Canadian companies to emerging and frontier markets. Canada should urgently seize this opportunity.

Background

In May 2014, the Canadian Chamber of Commerce released a report outlining Canada's weak trade performance over the past decade. It recommended new measures and initiatives to promote the success of Canadian businesses abroad.[12] Among them was the creation of a national DFI to mobilize Canadian investment in developing countries. Following the release of the report, the Chamber established an informal working group drawn from member companies with extensive experience in developing countries to build consensus on key elements that should guide the institution's design.

[12] Canadian Chamber of Commerce. May, 2014.