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International Development Committee

The Future of CDC: Government Response to the Committee's Fifth Report of Session 2010–11

Fifth Special Report of Session 2010–12

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Fifth Special Report

On 3 March 2011 the International Development Committee published its Fifth Report of Session 2010-11, *The Future of CDC*, HC 607. On 4 May 2011 we received the Government's Response to the Report. It is reproduced as an Appendix to this Special Report.

In the Government Response, the Committee's conclusions and recommendations are in bold text. The Government's response is in plain text.

Appendix: Government Response

CDC Group Plc (CDC), formerly the Commonwealth Development Corporation, is the United Kingdom's Development Finance Institution. It is wholly owned by Her Majesty's Government (HMG) and is but one of a number of agencies that HMG works through to help combat poverty. CDC is currently self-financing, having received no Government funding since 1995.

Since being restructured in 2004, CDC has grown rapidly, more than doubling the market value of its assets to £2.8 billion by the end 2010. CDC invests largely in Africa and South Asia in sectors as diverse as financial, agricultural, retail, infrastructure and manufacturing. HMG does not get involved in individual CDC investment decisions but sets the overall policy and investment framework for CDC's operations. CDC makes over 70% of its new investments in poor countries, a far higher proportion than for the World Bank's International Finance Corporation (IFC) and the Development Finance Institutions of other donor nations.

A determination to increase CDC's overall development impact still further led the Secretary of State for International Development to announce on 12 October 2010 a review of CDC. This included a public consultation on what the future of CDC should be, which ran from 5 November 2010 to 31 January 2011 and covered a range of issues including CDC's business model, geographical and sectoral focus, use of financial instruments and approach to responsible investing. The inputs from that consultation are informing HMG's thinking around the future orientation of CDC, the outcome of which will be reflected in a new CDC business plan to be announced in May 2011.

In parallel with HMG's review and consultation, the International Development Committee decided to carry out its own inquiry into CDC's development impact and how this could be maximized in the future.

The Committee's recommendations and HMG's response to them is given below.

CDC's ability to leverage additional finance

[Paragraph 22]Although it is not always easy to prove, the key benefit of the 'fund of funds' model is its ability to leverage additional finance. This finance is invaluable considering the comparatively small amount of capital at CDC's disposal. By using this capital to demonstrate that investments in developing countries and frontier markets can be successful, CDC can pull in extra investment and have a significantly more substantial impact than if it uses its capital in isolation. diaspora communities often have an interest in poverty alleviation in their countries of origin but have difficulties in finding out how to make investments. CDC should seek to attract funds from such diaspora communities and, in addition, develop partnerships with UK businesses, provided they have a pro-poor focus in developing countries and are not tied to UK national interests.

HMG agrees that the ability to leverage additional finance is an important aspect of CDC and one that should be retained. CDC estimates that for each £1 that it invests, other development finance institutions typically invest £1 to match the CDC investment, while commercial investors provide a further £2.70 of capital.

diaspora communities can contribute to poverty alleviation either by making investments themselves or by managing a fund that raises capital, often from fellow diaspora and then invests that capital. CDC has backed a number of African funds that have diaspora community involvement, including funds managed by individuals from the diaspora. For CDC to raise third party capital (institutional or retail) from diaspora communities and manage a fund for them would be a new business activity for CDC and would entail increased regulatory compliance requirements, greater reputational risk for CDC as well as expenditure on marketing. The possibility of such a change may be considered as part of the on-going policy discussions between HMG and CDC, taking into account that other agencies, such as the World Bank, already have initiatives to mobilise diaspora community investment. HMG agrees that CDC could over time seek to develop closer working relationships with other parties, such as UK businesses, provided they have a pro-poor focus in developing countries and are not tied to UK national interests.

Is CDC's funding additional to private capital?

[Paragraph 25] It is imperative that all of CDC's funding backs investments that the private sector would not otherwise support. CDC should make assessments before investing, including an appraisal of whether their contribution would be additional. Additionality should be demonstrable for all investment decisions. CDC should be careful only to invest in funds that are committed to this principle.

HMG agrees that it is important that CDC funding supports investments in the poorer developing countries that the private sector would not otherwise make on its own. HMG is discussing with CDC a revision of its method whereby, before making an investment, CDC checks that that investment is additional and is not crowding out capital from other sources. For the larger countries, such as Nigeria, India and Pakistan, CDC will in future draw up strategies that set out how CDC proposes to invest so as to maximise development impact and avoid sectors and industries that already have sufficient access to capital markets. Over time, CDC will extend this approach to other countries and regions. Further details will be provided in the CDC Business Plan to be announced in late May 2011.

Implementation of CDC's Investment Code

[Paragraph 47] We acknowledge the difficulty some companies have in complying with CDC's Investment Code during initial stages and support the notion of encouraging improvement in Environmental, Social and Governance standards. However, CDC's Investment Code must set a clear baseline standard of compliance for investments. We are concerned by the claims that some of the funds in which CDC has invested have not met these standards. We recommend that CDC ensure that thorough due diligence and monitoring is conducted on all CDC-backed investments.

HMG agrees with the recommendation. HMG is in discussion with CDC about revising the Investment Code and will consider with CDC whether there is a need to distinguish more clearly between mandatory and discretionary aspects of compliance. The enforceability aspect of the Code will also be reviewed and HMG and CDC will consider how to improve the Code with regard to the remedies and sanctions CDC has available to it in the event of non-compliance and Fund managers' remedial engagement with investee companies on Environment Social and Governance matters. CDC will also consider how it could provide even more practical support to fund managers in their remedial engagement with investee companies around Code compliance issues.

Measuring development impact

[Paragraph 52] We welcome the increased independent evaluation of CDC's development impact. CDC should establish more comprehensive indicators relating to development impact, poverty reduction and employment generation (including whether the jobs are permanent, the wages paid, whether any jobs were lost due to restructuring before an investment was made etc.) CDC should monitor these indicators and report on them.

HMG agrees that there is a need to develop further the framework for measuring, assessing and reporting CDC's development results, and through which CDC will be held accountable. HMG and CDC will identify a small number of top-level, key development impact indicators and targets. HMG and CDC will also agree a set of achievement targets that CDC will aim to meet over the period of its new Business Plan. These key indicators will stand at the top of a broader and deeper set of indicators that will comprise CDC's full evaluation framework.

The key indicators, and the targets set for them, will be subject to periodic review based on the findings of evaluations. Due account will have to be taken of the practical difficulties for CDC's monitoring and evaluation imposed where it operates through intermediaries, such as fund managers, when gathering data on the impact of investments.

Transparency

[Paragraph 54] Transparency is essential to enabling the public to hold CDC, a Government-owned company, to account. We acknowledge that commercial

sensitivities exist but recommend that much more rigorous requirements are placed upon CDC to ensure that its investment decisions, development impact and the tax payments of their fund managers are as transparent as possible. In its response to this report, DFID should indicate how it plans to do this.

HMG agrees that CDC should be as transparent as possible about its activities. CDC will set out an ambitious and unambiguous new approach to transparency in a new Disclosure Policy that ensures mutual trust between business partners and interested parties. In formulating this policy, CDC will take account of relevant initiatives such the UK's Aid Transparency Guarantee and the International Aid Transparency Initiative (IATI).

Use of tax havens

[Paragraph 60] The domicile of companies and funds in tax havens is a complex area which demands further investigation and we stress the importance of HM Treasury addressing this issue. Once established, CDC should follow standards of best practice. By doing so, CDC could raise standards across all DFIs. The tax payments made by CDC's fund managers and investee companies should be transparent. They should be published annually on a country-by-country basis.

HMG agrees that CDC should follow best practice with regard to use of offshore financial centres and that it will need to be as transparent as possible with regard to its activities from a tax perspective.

Remuneration

[Paragraph 62] Remuneration should be linked to performance but we are concerned that current pay rates within CDC are above what is necessary to recruit and retain the appropriate staff. The remuneration framework needs to be redesigned to provide more incentives to CDC's staff to increase CDC's development impact, instead of focusing too heavily on financial returns. CDC should, as the Secretary of State proposed, examine the possibility of recruiting experienced staff that might be willing to work in a development organisation at lower pay rates.

HMG agrees that CDC's remuneration levels need to be commensurate with a publicly owned body whose ultimate purpose is poverty alleviation. The CDC Board will develop a new remuneration framework in line with these principles and taking into account new FSA guidance and emerging EU legislation.

Actis

[Paragraph 64] We were astonished to discover that following the sale of Actis for just £373,000 the taxpayer had not received any return despite being entitled to 80% of the company's profits. We recommend that DFID's shareholding in Actis should be sold, but care must be taken to achieve the maximum value. The capital received from the sale could be reinvested into CDC.

HMG agrees with the recommendation and is exploring a possible sale of its interest in Actis. HMG is very seized of the importance of achieving maximum value for money for the taxpayer from any prospective sale.

New investment model for CDC

[Paragraph 66] We recommend that the 'fund of funds' model continue to be the predominant part of CDC's operations. We believe that the continued use of this model should be contingent on improvements in transparency, accountability and targeting. CDC is renowned for its expertise in being a 'fund of funds' and should remain pre-eminent in this area. The UK's DFI should remain distinct from and complementary to the range of other bilateral and multilateral DFIs.

HMG agrees that CDC should retain its distinctiveness while offering a range of services in support of private sector investment in the poorer developing countries that is complementary to that provided by other DFIs. While intermediated fund of funds equity investment will continue to be a significant part of CDC's business model going forwards, it will no longer be the only instrument used by CDC, which will develop over time the capacity to deploy a wider mix of instruments, including debt and co-investment, to enable it to support investment's in a wider range of markets.

[Paragraph 69] All of CDC's investments must aim to be profitable in the long term. Nonetheless, CDC can allow for lower returns on parts of its portfolio. Therefore, we propose that CDC be divided into two parts. Alongside the existing 'fund of funds' model, which henceforth will be called CDC Funds, we recommend that CDC reinvest a significant proportion of the profits resulting from equity investments into a separate body which will be referred to from now on as CDC Frontier.

CDC Funds should:

- **use the 'fund of funds' model and co-investment as its primary investment methods**
- **focus on ensuring that its investments are additional**
- **make a higher proportion of investments in SMEs.**

CDC Frontier should:

- **have an explicit mandate to reduce poverty**
- **accept lower rates of return on its portfolio**
- **fund sectors most in need of support**
- **use a mix of financial instruments, including grants and loans.**

HMG has noted recommendations 10 and 11. The Secretary of State for International Development is open to the idea of CDC having different pools of capital with differentiated risk-return profiles, but does not wish to split the business into separate entities for this purpose. HMG has invited CDC to reflect further on this idea and to put forward proposals for consideration in due course.

[Paragraph 71] By making targeted investments CDC Frontier would improve its development impact. Although CDC should allow for lower rates of return from CDC Frontier it should not sacrifice the quality of investment. By default the types of investment that CDC Frontier will be mandated to make will have a higher inherent risk, but the separation of CDC Funds and CDC Frontier will enable this risk to be managed effectively.

HMG has noted the recommendation and has invited CDC to reflect further on the matter. See the response to the previous recommendation (above).

[Paragraph 72] The 'fund of funds' part of the business in CDC Funds should be ring fenced so as not to damage CDC's reputation with private investors and to ensure it does not lose money. The anticipated profits from the 'fund of funds' part of the business could fund or subsidise CDC Frontier.

HMG has noted the recommendation and has invited CDC to reflect further on the matter. See our response to the previous recommendation (above).

Investment methods

[Paragraph 76] We recommend that, in order to increase CDC's development impact, CDC should start to use co-investment alongside the 'fund of funds' model. The 'fund of funds' approach and co-investment should remain the primary investment methods for CDC Funds. Co-investment would enable CDC to target its investments without incurring the high costs that direct investment would involve.

HMG agrees that CDC should expand its co-investment activity alongside the fund of funds instrument. CDC already has a programme of co-investing alongside fund managers and in time this could be extended to work with other partners. CDC's new country and regional strategies will explore the scope for co-investment.

[Paragraph 77] Making direct equity investments would be a radical change to CDC's current operations and should only be undertaken if CDC can identify investments responsibly. The potential development benefits should be balanced carefully against the cost of conducting thorough assessments of investments which would involve CDC having locally based staff. Moreover, direct investment could not take place immediately but would have to wait until CDC had the appropriate staff or partners in place. DFID offices should be targeted to work with CDC Frontier.

HMG agrees that CDC should only undertake self-originated direct investment activity after further careful assessment and consideration, including having the necessary capacity in place.

Investment tools

[Paragraph 80] We welcome the opportunity for CDC to be allowed the flexibility to use a wider range of investment instruments when the correct opportunities arise. However we remain cautious about how many new investment tools CDC should take on. We note that CDC is regarded as an expert in private equity and although we are keen for CDC to best serve the needs of the poorest people it must protect its reputation. There is a danger that CDC could lose its expert status if it tries to take on too many new roles too quickly.

HMG agrees that CDC should not try to take on too many new roles too quickly. There will need to be a period of transition from the current business model to the new business model. The building of a more diversified investment portfolio will clearly take time and will, amongst other things, need to reflect the time necessary for CDC to build its investment team to handle a wider range of instruments than previously and for CDC to identify suitable investment opportunities for these new instruments.

[Paragraph 81] We therefore recommend that CDC diversify the investment tools it uses slowly and only when it has access to sufficient expertise. Other financial instruments are available through other DFIs; CDC should not aim to do everything and should concentrate on what it is best at and what is needed. It should work alongside the other DFIs to provide the range of tools needed by developing countries.

HMG agrees that CDC should not aim to cover the whole waterfront and that it should not significantly expand its range of investment activity until it has in place the necessary capacity to do so. HMG also agrees that CDC should continue to seek to work alongside and in partnership with other DFIs wherever possible so as to provide the widest range of tools needed by developing countries.

Sectoral mandate

[Paragraph 82] CDC should target its investments at key sectors, such as agriculture, infrastructure and SMEs, in order to improve its development impact. If the Government accept our recommendation to split CDC into two parts, we recommend that CDC Frontier prioritise these key sectors, which are underfunded. We envisage that CDC Frontier should aim to have approximately 25% of its investments in agriculture, and another 25% in infrastructure. Large-scale infrastructure is particularly lacking and will require a mix of financing. Investment in agriculture and infrastructure would directly alleviate poverty, have multiple benefits and contribute to wider development goals such as food security which is increasingly important with the growing threat of climate change. We acknowledge that CDC Frontier should decide in which sectors the other 50% of investments should be made, since it will require the flexibility to remain innovative and the most appropriate sectors for investment will vary from country to country.

HMG has noted the recommendation but prefers not to set CDC any specific target sectors, recognising that in different countries different sectors will offer the most potential for development impact and the importance of CDC retaining flexibility to respond to those opportunities. However, CDC will set out how it will approach sectors in its country and regional strategies, including how it will avoid investing in companies and/or sectors with ready access to commercial finance. HMG also expects that CDC investment decisions will be underpinned by robust analysis of the access to capital at investment level and, particularly for larger countries, some analysis of how good access to capital is at the country level, including its access to FDI flows.

[Paragraph 83] CDC would benefit from closer collaboration with DFID in ascertaining in which sectors and in which countries they should invest to have the most demonstrable development impact. DFID could help identify suitable investment opportunities for CDC Frontier. In addition, CDC should consider making investments consistent with developing countries' national development strategies.

HMG has noted the recommendation. In DFID footprint countries, CDC and DFID offices will be encouraged to build a good relationship with each other. This relationship, which will be based primarily on information sharing and mutual lesson-learning, will help build complementarities among HMG programmes and CDC's investments and reinforce impact.

Geographical mandate

[Paragraph 84] On the balance of the evidence received, the Committee are content with CDC's new geographic mandate for 2009-2013. It should apply to both CDC Funds and CDC Frontier. We appreciate that investments made in middle-income countries can be valuable, especially given that recent research shows that 75% of the world's poor live in middle-income countries. However, in future CDC should aim for a more evenly distributed portfolio between countries and avoid overconcentration of investment in any middle-income country. CDC should also target the poorest regions or areas of middle-income countries.

HMG has noted the recommendation. Going forwards, CDC will focus on sub-Saharan Africa and South Asia as that is where the majority of the poorest people are. CDC will have scope to invest in most low income countries (LICs) and lower middle income countries (LMICs) in the regions (as defined by the World Bank in 2010). As to LMICs, emphasis will be on supporting investment in DFID footprint countries, although CDC will not be expected to mirror DFID's LMIC footprint exactly and will have some flexibility to invest in non-footprint LMIC countries. However, any CDC investment in non-footprint LMICs will need to be carefully justified by CDC in terms of development impact or wider benefit to low income countries and is not expected to become a significant part of the CDC portfolio.

HMG agrees that CDC should aim to have a more evenly distributed portfolio. Going forward, CDC will adopt lower single country limits to avoid over-concentration of its portfolio in a few countries and to ensure that CDC is more present across the spread of HMG footprint countries.

[Paragraph 85] However, we do not believe that CDC should be restricted to operating only in the countries that DFID does, as DFID is increasingly focused only on the poorest countries. We believe that CDC could make a wider contribution to poverty reduction if its investment policy allows for investment in middle-income countries.

HMG has noted the recommendation. As noted above, while not requiring CDC to mirror DFID's country footprint, HMG will want CDC to have the flexibility to respond to DFID's footprint countries. HMG sees no need for CDC to invest in Upper Middle Income Countries, except where this is primarily for the benefit of poorer countries in the region.

Improving CDC's development focus

[Paragraph 86] The mission statements of both CDC Funds and CDC Frontier should incorporate an explicit reference to their role in poverty alleviation. Investments made by CDC Frontier should include a thorough analysis of their potential for poverty alleviation before CDC commit to making an investment. The commercial viability of investments will remain of central importance, but CDC Frontier's investment decisions should also be based on the potential for alleviating poverty. Once CDC has adopted a more directly pro-poor remit we hope it would provide an example to other DFIs to focus more on poverty alleviation.

HMG agrees with the recommendation that the whole of CDC's operations should be focused on contributing to poverty reduction. CDC's Investment Policy and Business Plan will include explicit language on poverty reduction as well as provision of opportunities for income progression for the poor.

DFID oversight of CDC

[Paragraph 87] We recommend that there be a closer relationship and collaboration between DFID, especially the new Private Sector Department, and CDC than there is at present. In particular, DFID should have closer involvement with CDC Frontier. But as DFID and CDC become closer it is important that the division of accountability between CDC and DFID is made clear. The revised business plan for CDC is likely to be more complex than previously and necessitate higher risks, and will therefore require closer oversight by DFID, its sole shareholder. DFID and CDC should review the business plan on an annual basis to ensure that it remains consistent with the shareholder's aims.

HMG agrees with the recommendation. HMG will maintain far closer oversight of CDC including in accordance with the recommendations made by the National Audit Office and the Public Accounts Committee in 2008 and 2009 respectively. HMG and CDC will review the governance framework with the advice of the Shareholder Executive and will revise it as necessary.

The new CDC

[Paragraph 88]. The Board and staff of CDC should both reflect the mix of development and financial expertise required in the new CDC. The transition to the new model should be dictated by the time that it takes to recruit the most appropriate people.

HMG agrees with the recommendation. The appropriate mix of development and financial expertise for the Board will be a matter for discussion with the Chairman, while the views of the incoming Chief Executive will also be sought on both staffing requirements and on the speed of transition to the new business model.