Dear Meg,

I am writing on behalf of the Department in response to the Committee's report of 25 April 2017 entitled "Department for International Development: Investing through CDC." In that report, the Committee has recommended that the Department should write to the Committee setting out a detailed rationale for the current governance arrangements between the Department and CDC.

This letter provides that rationale and explains in particular why it is that:

1) the Department does not seek to influence or veto individual investment decisions taken by CDC, and
2) there is no representative of the Department on CDC’s Board.

Governance Framework: Overview

DFID is the sole shareholder of CDC. The UK Financial Reporting Council (FRC) defines corporate governance as "the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place."

As part of their Value For Money Study, the NAO undertook a review of the three tiered governance framework within which CDC operates. The conclusion reached by the NAO was that the current arrangements are "thorough" [para 1.17; p14]

Overarching Principles

The Department has deliberately structured the governance arrangements for CDC to be at "arm’s length". This decision has been chosen by the Department to create a
structure that is tailored to the needs of a public limited company wholly owned by the British Government and mirrors best practice in the private sector. The arm’s length governance structure addresses several important principles:

i. **Alignment.** The investment policy, investment code and strategic objectives are set by the Shareholder, with a fully accountable Board, ensuring that CDC’s mission of making patient capital investments with high development impact and positive financial returns is fully aligned with the Department’s objectives.

ii. **Accountability.** The arm’s length relationship enables the Department to hold CDC solely and fully responsible and accountable for delivery of the strategy and the decisions taken to achieve strategy objectives.

iii. **Expertise.** The Department uses its development expertise to set the investment policy and code, while ensuring that a carefully selected professional Board has the necessary expertise (in private equity, impact investing, risk management, and development impact) to oversee CDC’s execution of the strategy.

iv. **Continuity and stability.** Five year strategy cycles ensure CDC is not subjected to unnecessary short-term policy changes and provide the continuity and stability that are important to enter into the long-term commercial agreements needed in patient development finance.

v. **Independence and commercial reputation.** The arm’s length relationship allows CDC to maintain a reputation in the financial markets for being a commercial investor and a reliable partner, with operational decision making independent of government or political pressure.

vi. **Financial regulation and confidentiality.** As an investment company, CDC is subject to FCA rules. These impose obligations such as commercial confidentiality and data protection rules. Accordingly, the governance structure allows CDC to maintain appropriate commercial confidentiality, especially of market-sensitive information.

As a consequence of the above principles, DFID does not involve itself in CDC’s individual investment decision making process and does not exercise a veto on CDC investments. Nor does it sit on the Board. More detail on the governance structures are set out in the following sections.

**Shareholder Policy and Strategic Setting**

DFID sets CDC’s overarching Investment Policy, within which CDC is given delegated authority to make individual investment decisions. The Investment Policy is agreed by the Secretary of State and is a published document. It sets out the shareholder’s objectives for CDC and how the shareholder expects CDC to deliver those, including through specifying CDC’s mission and specific objectives and ways of working - including types of investment instruments, details on priority sectors and countries of operation, specific limits on the portfolio in some geographies, excluded activities, reporting obligations and specific performance targets linked to financial returns and development impact. It also importantly incorporates a very detailed Code of Responsible Investing, which sets out specific environmental, social and governance standards including those related to business integrity – which CDC and its investee companies must meet.
Decisions on individual investments are then made by CDC Investment Committees. CDC currently has four separate investment committees: one for each of the four products that CDC offers (Direct Equity, Direct Debt, Intermediated and Impact Fund investments). The committees are chaired by CDC’s Chief Investment Officer and subject to investment proposals to detailed challenge and review, following agreed operational guidelines. CDC’s Investment Committees provide a clear framework and audit trail for deal decision making, through three successive stages (screening, preliminary approval and final approval).

DFID holds CDC accountable to deliver a portfolio of investment decisions that in aggregate deliver the investment policy and strategy and holds CDC accountable that every individual investment decision must adhere to the investment policy and the code. CDC reports annually its compliance with the investment policy and the code in addition to regular reporting through the year, including provision of monthly management accounts and annual audited statements and formal quarterly and annual shareholder meetings, attended by the CDC’s Chair, CEO, Chief Financial Officer and Chief Operating Officer and DFID’s Director General for Economic Development.

Why DFID does not sit on CDC investment committees and have a veto on investment decisions taken by CDC

The Department does not involve itself in CDC’s investment decision making process. This arrangement is designed to ensure:

i. **Lines of accountability are not blurred or confused.** CDC understands that it is solely responsible and accountable through its Board to the shareholder and Secretary of State for all the investment decisions it takes.

ii. **Short run political agendas don’t over-ride commercial rigour.** CDC is set a five year Investment policy which provides clear rules and a degree of stability, within which it must make investment decisions and against which it must report. Having DFID officials on investment committees would undermine the independence of CDC and the credibility of CDC in the eyes of the investor community and financial markets.

iii. **Financial Regulations and Commercial confidentiality.** Members of CDC Investment Committees are subject to regulations set and enforced by the Financial Conduct Authority governing the handling of commercially sensitive investment information. The sharing of such information with DFID officials would run counter to FCA rules.

The CDC Board

The CDC Board consists of the Chair, the CEO, the Chief Financial Officer and six non-executive directors (NEDs) who are selected to bring specific skills and experience to the Board. DFID’s expectations of the Board are set out in a detailed Memorandum of Understanding. DFID’s expectations of the Chair are set out in the Chair’s letter, issued annually by the Department.

The Articles give the Secretary of State the right to appoint the Chair and two of the NEDs. All new DFID appointments to the Board are recruited through an open, transparent, and competitive procedure based on merit. Appointee terms of reference
are agreed by the Department and tailored to fill the specific skills gaps that are required on the Board. The Director General at DFID chairs the recruitment panel. The UKGI provides expert advice. The Board in turn is responsible for appointing CDC’s CEO or other members of CDC’s senior executive management.

As set out in the MoU, the Board is held accountable for delivery against agreed objectives that reflect the Investment Policy, Strategy and Code and in circumstances of consistent and/or extreme under-achievement, the Secretary of State may review the composition of the Board and/or ask the Board to make appropriate changes in the CDC management appointments and structure.

The Department has taken a deliberate policy decision not to appoint its own officials to the CDC Board. But Department officials and the Secretary of State have regular meetings with the Chair and the NEDs on the Board. The Department also hold annual meetings with each of the NED Committee Chairs on business critical issues (including Development Impact, Risk Management, Audit and Compliance and Remuneration).

Why DFID is not on the Board of CDC

This arrangement serves to ensure:

i. Robust lines of accountability from the Board to the Shareholder. The Department as shareholder appoints the Chair and sets CDC’s strategic objectives. It is the Board who is then held to account for executing and delivering this strategy. To have a DFID official on the Board would confuse and blur these lines of accountability

ii. An effective and empowered Board. As sole shareholder, we take the view that having a DFID official on the Board, responsible for providing the Department’s considered view on each and every decision, would undermine and potentially destabilise the Board and reduce its effectiveness.

iii. Independence from political pressure. The independence of CDC’s Board sends an important signal to the market. It enables CDC to reassure potential investee companies and co-investors that CDC goes about its business in a commercial manner – without political interference - and will be a reliable and predictable, long term business partner. In this way, it also helps to increase the impact that CDC can have on wider markets and the perceptions and behaviours of private investors – increasing CDC’s catalytic impact.

Conclusion

In our view, DFID’s relationship with CDC is quite clear and has proven itself to be effective in delivering transformative change over the last five years at CDC. DFID is a very active shareholder and has a close relationship with CDC. But DFID is not involved in CDC investment decisions and is not on the Board.

There is no disconnect between this policy and the ability of DFID, both as shareholder and as the sponsoring government department, to take decisions at the strategic level, drawing where necessary on the support and advice of others across the British Government – including HM Treasury and UK Government Investments. This includes designing and quality assuring a business case for the provision of more investment capital to CDC.
The Department will continue to keep governance arrangements under review to ensure they continue to reflect best practice. The Department has listened and acted on the previous recommendations of the National Audit Office and the Public Accounts Committee to provide guidance to posts and other Whitehall departments on DFID’s relationship with CDC, how they can work with CDC and what they can expect from CDC. This guidance will be elaborated as CDC and DFID move forwards in implementing the next five year strategy.

I trust that this letter clearly sets out the rationale for the current arrangements.

Yours sincerely

Rachel Turner.
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DFID