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Research Report

Financing for development series: Development finance by regional development banks - combining regional ownership with multilateral governance

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Financing for Development Series: Development Finance by Regional Development Banks – Combining Regional Ownership with Multilateral Governance

The development finance system is becoming increasingly complex. New actors and instruments are being created with enormous speed and ingenuity. Yet the multilateral development banks still account for a large share of the public resources used for development finance. Of these, the World Bank and the three regional development banks (RDBs) – the Asian Development Bank (AsDB), the Inter-American Development Bank (IDB) and the African Development Bank (AfDB) – play the most important roles.

Multilateral development banks are major providers of finance, knowledge and convening services to developing countries. The RDBs have the additional advantage of a high degree of regional ownership. In an ever more complex global governance system, they can play an important role in regional governance, supporting the provision of regional public goods.

However, the RDBs cannot take this role for granted. In today's diverse development finance system, there is no shortage of competent financing and consulting institutions. The RDBs must make a difference in this system if they are to convince their members of their necessity and usefulness. One way to achieve this is through concentration on fewer areas of activity.

In the current financial crisis the RDBs should play a strong countercyclical role by extending larger volumes of investment and policy loans, particularly to middle-income countries.

1. Objectives and business models of development banks

All multilateral development banks pursue similar objectives and share the same business model. They finance investments in projects or programmes to support developing countries in their efforts to fight poverty and to grow sustainably. Within each bank group, ordinary capital resources are used for non-concessional lending, Official Development Assistance (ODA) resources for grants (and subsidised loans) to less developed country members. Multilateral development banks work as cooperatives, lending capital at a single rate to their members (regardless of individual country risk). With the AAA-rating they derive from the creditworthiness of their industrialised country members, they can offer favourable rates to their developing country members.

While the provision of capital and financial services is the principal task of a bank, multilateral development banks can add value in a number of ways. Within their **financing function**, they provide long-term capital for investments and policy adjustments, they step in as lenders when external shocks lead to a deterioration of access to private capital markets, and they offer loan products which the private banking sector does not offer in thin and shallow local capital markets. Within their **knowledge function**, they produce and disseminate sectoral, policy and project knowledge and help partners to implement programmes in specific country circum stances (customisation of knowledge). As part of their **convening function**, multilateral development banks help to produce regional and global public goods.

The main difference between the World Bank and the RDBs lies in their geographical outreach and their governance structures. The RDBs lend only to their regional members. Unlike the World Bank's members, regional member states have a majority share in the RDBs (though this does not hold for the concessional windows).

Taken together, the three RDBs equal the World Bank in terms of the volume of lending to sovereign states. While the World Bank's private-sector lending – through the IFC – is much higher than private-sector lending by the RDBs, this activity is growing dynamically in all RDBs. The World Bank's concessional window – the IDA – is by far the largest multilateral fund for the granting of finance. Yet the concessional arms of the AfDB and the AsDB are also growing.

2. Regional development banks in the development finance system

The World Bank and the RDBs are the prime candidates for financing complex development investments in each region since they provide the necessary financial leverage, knowledge and convening power. The competition among the multilaterals is healthy: countries have – in an ideal case – the choice between two potent providers of financing solutions that compete on the best ideas. At the same time, competition should force the multilateral financial institutions to be as client-oriented as possible.

However, there are various smaller development finance agencies that give countries a wide choice. From a systemic point of view, it can be argued that there are too many competitors and that the system is too complex to work efficiently. A clearer division of labour between donors and financing institutions would be in the interests of most clients. The RDBs are facing serious challenges because competition is becoming tougher, and this from three different angles: most of their middle-income members can access private capital markets quite easily, specialised aid agencies are increasingly active in sectors of importance for the RDBs, and subregional development banks are growing.

3. Erosion of the client base: middle income countries and multilateral development banks

Since 2002 (and coinciding with the decisions taken at the Monterrey Summit), financing conditions for developing countries have steadily improved. Global interest rates reached low levels, investors recovered their appetite for higher yields in dynamic developing countries, and consequently their financing costs, measured by emerging market spreads, fell. At the same time, macroeconomic conditions in most developing countries improved, and an increasing number were able to enter international capital markets at reasonable rates.

While these developments are welcome for the countries concerned, it poses challenges for multilateral development banks. Middle-income countries are their most important borrowers and so an important source of income for the financing of the banks' non-financial functions. Lending activities to sovereign states have been stagnant in recent years. Some middle-income countries have even repaid their debts prematurely. This reflects the fact that financing conditions for large emerging markets can be even better at the private capital market interest rate than at the uniform rate of the multilateral bank cooperatives.

However, it does not mean that middle-income countries do not need multilateral development banks any more. First, development banks should act as countercyclical lenders at times of financial crisis. The recent credit crunch and the global recession have already worsened access for emerging economies to private capital markets and will adversely affect growth, employment and poverty reduction in developing countries. Development banks can mitigate these external shocks. Second, as China and other emerging economies have pointed out internally and in public, they are still very interested in the banks' knowledge services. Investments go hand in hand with advice on policy and governance solutions and with support in project implementation and evaluation. This is the main reason why countries that build up huge reserves keep borrowing from multilateral development banks. It follows, however, that development banks must demonstrate clearly to their customers that they add value in terms of knowledge and convening services.

4. Competition from specialised aid agencies

In recent years, more multilateral aid vehicles have been established than in all previous decades. Most of these agencies concentrate on global public goods (environmental issues) and on special issues in social sectors, an example being innovative agencies that improve access to medicines. While certain advantages of a division of labour may be realised and additional resources may be raised, the other side of the coin is the growing complexity of the development finance system.

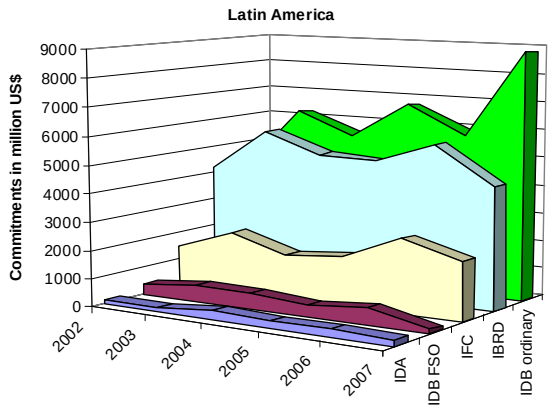
There are two main implications for multilateral development banks: first, they need to compete in their services with an increasing number of specialised agencies. This calls for greater concentration in their portfolios, since it is hard to see how they could offer first-class knowledge in all areas of importance to developing countries. They should concentrate on the issues typically neglected by the new aid vehicles, such as infrastructure and regional public goods. Second, multilateral development banks can increasingly use their convening power to coordinate development efforts of diverse players in the market, thus leveraging their own resources. This "new" function of development banks augurs particularly well for the RDBs, since they can rely on a high degree of regional ownership.

5. The "new regionalism" in development finance

However, regional ownership does not guarantee the RDBs a dominant role in the development finance systems of their regions since other players are rooted in the region. In each region, the RDBs face different challenges:

In Latin America, the IDB is well accepted by its regional members as "their" bank. However, subregional development banks are enlarging their market shares. The most successful of these is the Andean Bank (CAF). In the five member countries of the Andean Pact, the CAF is already the most important public lender. Subregional development banks are controlled entirely (or mostly) by developing countries themselves, which leads to even more pronounced regional ownership. Compared to the RDBs, the subregional banks concen-

Figure 1: Multilateral Development Banks – Latin America

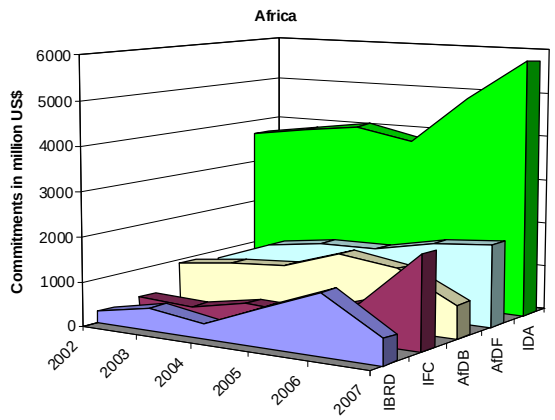


Source: IFC / World Bank / IDB

trate on the financing function and set less store by knowledge services. The successful cases, such as the CAF, have managed to offer efficient financial services and to compete with the RDBs in the profitable lending business.

In Africa, financing needs are huge, and regional members have had limited financial resources of their own in the past. The concessional resources of multilateral development banks and of bilateral donors therefore play a dominant role in Africa's development finance system. The AfDB is only a minor player in the continent, as most donors focus their resources on Africa. It has a hard time showing its members that it can "make a difference". In terms of knowledge creation, the AfDB is at a disadvantage compared to the World Bank and large bilateral donors owing to resource constraints. At the same time, subregional development banks are growing in Africa too, presenting themselves as new players with strong regional ownership.

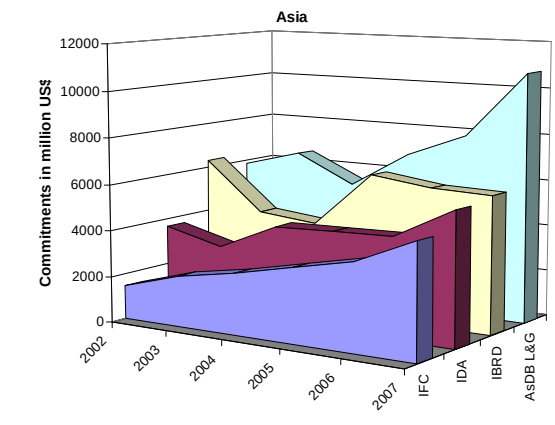
Figure 2: Multilateral Development Banks – Africa



Source: IFC / World Bank / AfDB

Asia's dynamic economies have enjoyed fairly good conditions in private capital markets (although this is changing in the current financial crisis). In addition, there are ongoing initiatives (supported by the AsDB) to create regional bond markets to enable capital markets of smaller economies to be deepened. While the countries of the region still have serious poverty problems, ample capital is available thanks to high savings rates and generally favourable macroeconomic conditions. The AsDB therefore needs to transform its services by placing less emphasis on transferring capital to clients and focusing more on leveraging private capital, on knowledge services and on support for regional project development and implementation.

Figure 3: Multilateral Development Banks – Asia



Source: IFC / World Bank / AsDB

6. Reform processes in the RDBs

All three RDBs have launched far-reaching reform processes in recent years. While the AfDB and the AsDB have commissioned High Level Panels to advise them on a new long-term vision, the IDB has chosen to implement reforms after internal discussions. Five common themes emerge in the new strategies:

1) All RDBs want to invest strongly in their knowledge services. By hiring new personnel or restructuring existing staff, they plan to offer better knowledge services to their clients.

2) The introduction of new financing instruments is being discussed across the board. This includes sub-sovereign finance without sovereign guarantees, local currency loans or risk management services.

3) The RDBs plan to increase their private-sector activities significantly. This is by far the fastest growing part of their portfolios.

4) Infrastructure finance forms an important part of the portfolio of all RDBs. They all plan to strengthen this focus and to specialise more strongly in some areas of activity beyond infrastructure. The AfDB wants to concentrate on governance issues, private-sector development and higher education as well as on regional integration and fragile states. The AsDB calls environment, regional cooperation, financial-sector development and education its core operational activities.

5) To implement the new strategies, all RDBs have launched internal reforms. They have decentralised decision-making powers and capacities to their client countries, they are trying hard to reduce the 'hassle factor' in their credit operations, they are introducing results-based management, and they are modernising their human-resource management.

The reforms can be commended as going in the right direction. However, it will be important for the RDBs to reinforce some of the reforms, paying particular attention to three challenges:

In a development finance system which rewards excellence and knowledge, the RDBs must **specialise even more consistently** if they want to compete with other providers of development solutions. In this effort, they will face conflicts among their members since every country has its own perception of what exactly its bank should do. The

members must therefore understand that many things are important for development – but that a RDB cannot and need not provide solutions to all problems since there are alternatives in the development finance system.

The trend towards more private-sector activities and more differentiated financing instruments may be an appropriate answer to changing client needs, but it poses major challenges to the **risk management** systems of the RDBs. The banks must make sure that the higher risks involved do not harm their ratings or their financial stability, which would affect their sovereign loans too. Moreover, the RDBs still need to invest in their project evaluation systems to demonstrate the added value of loans to the private sector. Public loans are justified only if they are subsidiary and have an additional development effect (as compared to a baseline scenario of financing with private capital).

Results-based management principles must be applied more forcefully. This is an important precondition for more efficient and effective internal organisation which reduces the 'hassle factor'. Moreover, it would enable the non-regional members of the RDBs' boards to step back from the supervision of each lending operation.

7. Open issues and recommendations

Multilateral development banks are important providers of finance, knowledge and convening services to developing countries. The RDBs have the additional advantage of a high degree of regional ownership, which distinguishes them from the World Bank. In an ever more complex global governance system, the RDBs can perform an important role in regional governance.

They cannot, however, take this role for granted. In today's diverse development finance system, there is no shortage of competent financing and consulting institutions. The RDBs must make a difference in this system if they are to convince their members of their necessity and usefulness. One way to achieve this is through concentration on some areas of activity. The RDBs should strengthen their comparative advantage in infrastructure finance, with particular emphasis on sustainable solutions in view of climate change and the challenges of urbanisation. This includes the provision of innovative financing mechanisms and competent advice on governance matters (poverty-sensitive tariff policies, regulatory frameworks). They should also be more forceful in assuming their role as part of the regional governance system and increase their efforts to foster regional integration and to finance regional public goods. There are huge challenges to be overcome, but most other development finance institutions are in a less advantageous position to perform this important task.

For industrialised countries, the RDBs remain an important actor in the development finance system. From their perspective, the RDBs are a comparatively low-cost instrument for influencing development policies in specific regional contexts. They should, however, seek to withdraw from the day-to-day business and concentrate on high-level political dialogues and the general supervision of strategy implementation and the banks' financial situation.

The advanced regional member countries, in turn, have a great opportunity to increase their influence in the RDBs as most have enough capital to invest in the banks – be it as shareholders or as financiers of the concessional windows. If the RDBs are to become really strong players in their regional governance systems, then the more advanced regional members need to show that they are willing to support the banks beyond their own short-term national interests.

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