

WORKING PAPER SERIES

Infrastructure Finance in the Developing World

Challenges and Opportunities for Multilateral
Development Banks in 21st Century Infrastructure Finance

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The *Infrastructure Finance in the Developing World Working Paper Series* is a joint research effort by GGGI and the G-24 that explores the challenges and opportunities for scaling up infrastructure finance in emerging markets and developing countries. Each paper addresses a unique piece of the infrastructure finance puzzle and provides critical analysis that will give impetus to international discourse and play a catalytic role in the creation and success of new development finance institutions. The papers have been authored by top experts in their respective fields, and the process has been carefully guided by the leadership of both organizations. This work has important implications in the post-2015 environment, given the essential role infrastructure must play in achieving sustainable development. To this end, GGGI and the G-24 look forward to further development and operationalization of the contents of these papers.

Challenges and Opportunities for Multilateral Development Banks in 21st Century Infrastructure Finance

Chris Humphrey¹

1. Introduction

Among sources of financial support for infrastructure provision in developing countries, multilateral development banks (MDBs) have historically been among the most prominent. For various reasons, the importance of MDBs in infrastructure has declined in relative terms compared to previous lending patterns as well as to other sources of finance. The basic model of an MDB—a cooperative bank operating among a group of countries to support development with financing and knowledge—remains valid and relevant to help fill huge existing infrastructure gaps worldwide. However, the scale of this role will largely depend on the ability of MDBs—including existing ones such as the World Bank and major regional MDBs (RMDBs) as well as new ones such as the recently announced Brazil, Russia, India, China, and South Africa (BRICS) New Development Bank (NDB) and Asian Infrastructure Investment Bank (AIIB)—to adapt their operational policies and governance arrangements to a fast-evolving global economic and political context.

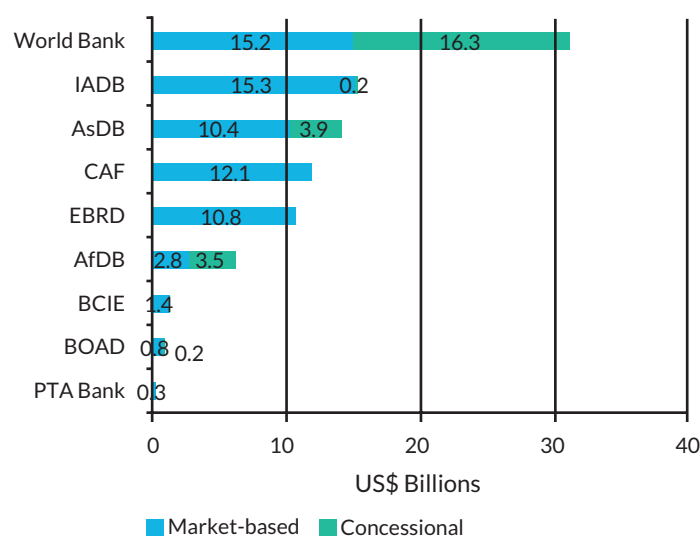
The rationale for MDBs' involvement in infrastructure is essentially three fold.² First, it is widely accepted that infrastructure is a key factor in development, economic growth, and poverty reduction. This impact is channeled via increased productivity, improved access to markets, reduced transaction costs, increased employment opportunities, and enhanced asset utilization, among others.³ As the key mandate of MDBs is to promote development, it is thus logical that they should dedicate a significant share of their activities to infrastructure investment. Second, private financing has been and continues to be clearly inadequate to address the huge infrastructure needs of many developing economies,⁴ and MDBs can help overcome market failures and achieve greater investment than possible without

their intervention. Third, the quality and planning of infrastructure is critical. According to a recent study, utilizing best practices in infrastructure design and implementation can lead to efficiency gains of 30–40% of project costs.⁵ MDBs have an unparalleled ability to transmit best practices via technical assistance and project preparation to realize these gains in developing country infrastructure projects.

MDBs have proven to be an extremely useful model for an international organization, as evidenced by the growing number created since 1944. Purely as financial intermediaries—putting aside the question of developmental impact—MDBs have been extraordinarily successful at raising resources for development. With a relatively small contribution of shareholder capital, MDBs have been able to raise a tremendous amount of financing primarily from private sources and channeled that money—along with development knowledge and expertise—to developing countries. For example, the World Bank's non-concessional International Bank for Reconstruction and Development (IBRD) lending window has cumulatively lent US\$586 billion between 1945 and 2013, based on total paid-in contributions from shareholders of only US\$13.4 billion. Due to this success, MDBs remain a popular model for international development organization, with over 20 in existence and at least two more—the BRICS NDB and AIIB—currently in creation (Figure 1).

Despite their broadly successful track record of channeling finance to developing countries at attractive financial terms and accompanied by developmental knowledge and technical assistance, many existing MDBs face operational limitations that prevent them from maximizing the potential of their unique organizational model. Underlying many of these limitations is the key

Figure 1. 2013 Lending Commitments by Selected MDBs



Source: Annual reports 2013, except BCIE 2012.

Notes: IADB = Inter-American DB; AsDB = Asian Development Bank; CAF = Andean Development Corporation; EBRD = European Bank for Reconstruction and Development; AfDB = African Development Bank; BCIE = Central American Bank for Economic Integration; BOAD = West African DB; PTA Bank = Eastern and Southern African Trade and Development Bank. This includes sovereign and non-sovereign financing for all MDBs except for the World Bank, which comprises project financing from the International Development Association (IDA) and International Bank for Reconstruction and Development (IBRD) windows only (excluding IFC and MIGA).

issue of governance: MDBs are often battlegrounds between different groups of shareholding countries— frequently (though not always) split between borrower countries on the one side and non-borrowers on the other. In the larger MDBs, such as the World Bank and major RMDBs, non-borrowing countries have held sway, and as a result, MDB policies have generally followed their priorities, which do not necessarily coincide with the optimal policies for development outcomes. Despite major shifts in the global economy over recent decades, the balance of power between the major industrialized nations and emerging and developing countries in the governance of the major MDBs has remained materially unchanged.

This paper highlights some of the critical operational, financial, and governance obstacles facing MDBs to provoke new thinking on ways to maximize the potential of the MDB model for development in general and infrastructure in particular. The rationale for MDB involvement in infrastructure remains as compelling today as it did when the MDB model was conceived following World War II. A financial cooperative among like-minded nations can overcome market failures and accelerate development, particularly if coupled with high-quality knowledge to improve project design and implementation. Existing MDBs have tremendous potential for catalyzing infrastructure investment if they are able to address some of the key obstacles inhibiting them, and ample room exists for new institutions utilizing the MDB model, such as the recently announced BRICS NDB and AIIB, among others.

The remainder of the paper is structured as follows. Section 2 reviews the activities of MDBs in relation to infrastructure provision over time as well as between different MDBs and sectors. Sections 3 and 4 analyze, respectively, financial and business procedure/policy obstacles that limit the ability of many MDBs to engage more actively in infrastructure provision. Section 5 concludes the paper.

2. Scope of MDB Support to Infrastructure⁶

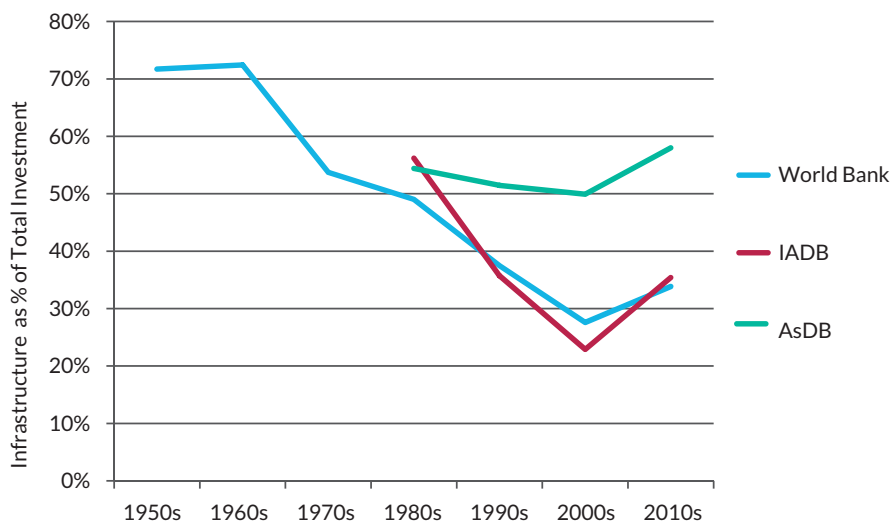
Infrastructure financing has long been a key aspect of MDB activity, although the priority placed upon infrastructure has considerably varied over recent decades. When the World Bank was first created, it primarily aimed to support infrastructure, first European reconstruction following World War II and soon thereafter transportation, energy, and water projects in other countries.⁷ This was also the primary focus of the major RMDBs when they were created in the 1960s.⁸ However, by the 1980s, many MDBs had increasingly turned their focus toward social-oriented lending as well as programmatic or policy operations, and less on physical infrastructure, due to the growing belief among development economists that project lending by itself was not successfully promoting development.⁹ In addition, non-governmental organizations had begun to strongly pressurize especially the World Bank (via their national legislatures, particularly in the U.S.) to rationalize major infrastructure projects on social and environmental grounds.¹⁰ In more recent years, other operational factors discussed later in this paper have also limited MDB infrastructure operations.

2.1. Overall MDB Infrastructure Investment Trends

MDB lending for infrastructure has declined quite considerably in relative terms in the past decades (Figure 2). Over 70% of the operations of the World Bank's two main lending windows was directed to infrastructure projects in the 1950s and 1960s (and even more in earlier years), but that declined to a low of just 19% in 1999 before rebounding to its current level of 30–40%. Similarly,

the Inter-American Development Bank (IADB) dedicated over 70% of project lending to physical infrastructure in 1981 and an average of 56% in the decade of the 1980s, declining to just 10% in 2003 before rebounding to 30–40% currently. The Asian Development Bank (AsDB) shows a similar pattern to the IADB, although with consistently more infrastructure lending (over 50% on average in 1981–2013).

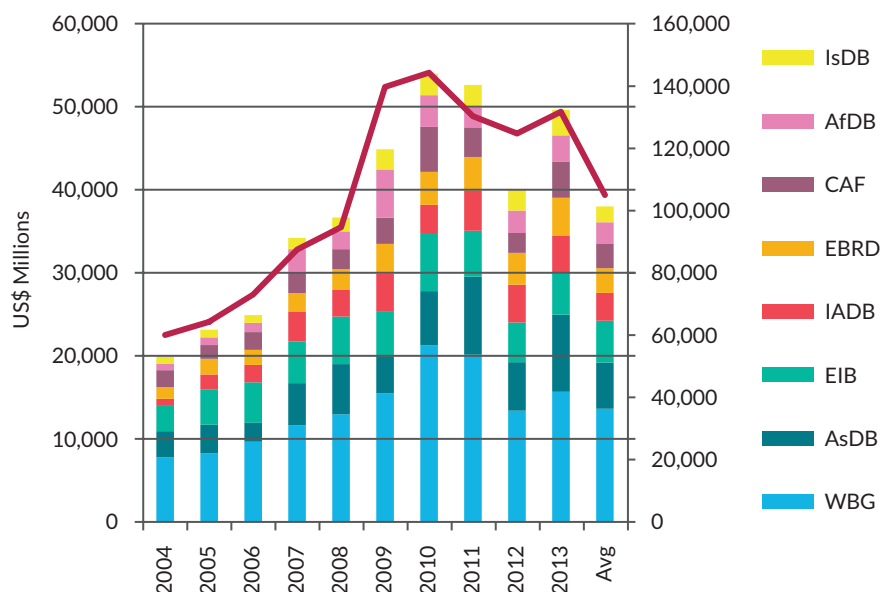
Figure 2. Infrastructure as % of Total Investment Commitments, Decade Average



Source: Annual reports, various years.

Note: World Bank includes IBRD and IDA only. Includes only investment in new or rehabilitated physical infrastructure; does not include sectoral reorganization, policy reform, or privatization operations. "2010s" refers to 2010–2013.

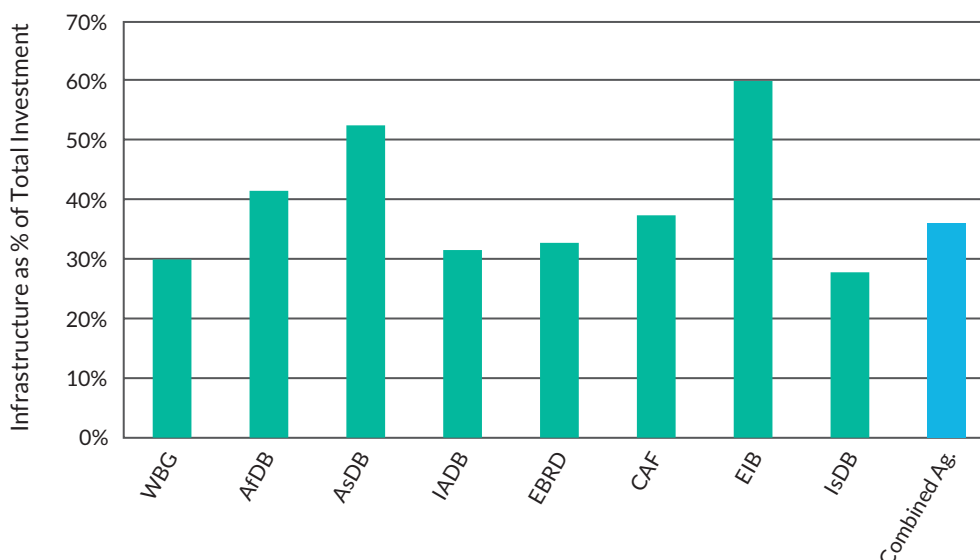
Figure 3. Infrastructure Investment Commitments by MDBs, 2004–2013



Source: Annual reports.

Note: Left scale: infrastructure loan, guarantee and equity commitments. Right scale: total MDB loan, guarantee and equity commitments. IsDB = Islamic Development Bank; CAF = Andean Development Corporation; EBRD = European Bank for Reconstruction and Development; WBG = World Bank Group (IBRD, IDA, IFC, and MIGA). EIB investment includes only projects outside of the European Union. Both sovereign and non-sovereign guaranteed projects as well as non-concessional, concessional, and grant financing included. Includes only investment in new or rehabilitated physical infrastructure; does not include sectoral reorganization, policy reform, or privatization operations.

Figure 4. Infrastructure as a % of Total Investment Commitments, 2004–2013 Avg.



Source: Annual reports.

Note: WBG includes IBRD, IDA, IFC, and MIGA. Includes only investment in new or rehabilitated physical infrastructure; does not include sectoral reorganization, policy reform, or privatization operations.

Looking at the most recent decade (2004–2013), the eight largest MDBs¹¹ invested on average approximately US\$38 billion per year across the globe through different financial instruments (concessional and non-concessional loans, grants, equity investments, and guarantees). Of this, the World Bank Group (WBG) invested approximately one-third (US\$13.6 billion), the AsDB and IADB each invested a bit over US\$5 billion, and the other six MDBs invested US\$2–3 billion each (Figure 3). Although the WBG has by far the highest total amount of infrastructure lending, it is actually one of the lowest as a share of total investment, averaging 30% in the past decade, compared to 60% for the European Investment Bank (EIB), 52% for the AsDB, and 42% for the African Development Bank (AfDB) (Figure 4). The pattern in Figure 3 may give the appearance that the MDBs ramped up their infrastructure lending over most of the period, but in fact infrastructure lending simply followed the overall counter-cyclical increase in lending occasioned by the global financial crisis.

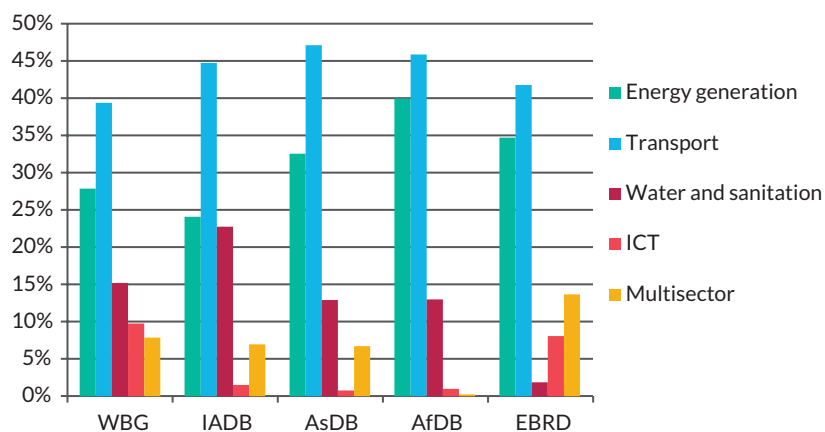
2.2. Sectoral Trends

The sectoral breakdown of infrastructure investment by each MDB varies considerably, but some broader trends are apparent. Transportation and electricity generation are by far the two most strongly supported sectors in the past decade, constituting over 70% of infrastructure lending for all eight MDBs and over 75% for the WBG and four main RMDBs (Figure 5). Transportation is a much higher focus of the WBG and main RMDBs (44%), while energy is a substantially lower priority (32%, and even lower for the WBG and IADB). The Andean Development Corporation (CAF) generally follows a

similar pattern, but the EIB and Islamic Development Bank (IsDB) prioritize energy generation much more highly compared to transport (Figure 6). The lower share of energy generation by the WBG and four larger RMDBs may relate to the fact that the environmental priorities of major non-borrower shareholders have made it much more difficult for these banks to invest in hydroelectric and coal-fired power plants in recent years. The impact of changing priorities in this area can be seen clearly in the pattern of World Bank lending for power generation, which has declined steadily since the 1950s, when it constituted over half of total lending (Figure 7).

Also notable is the priority placed by both the EIB and IsDB on water and sanitation, in contrast to all the other MDBs reviewed here. This seems appropriate in light of the fact that investments in water and sanitation frequently have greater difficulty attracting private investment due to more complex cost-recovery and the fact that in many countries, water and sanitation are considered public as opposed to private goods.¹² Investment in information and communications technology (ICT) is quite low for most MDBs, which makes sense given the high level of private investment in this sector, even in low-income countries. In the 1990–2012 period, ICT received by far the highest share of private investment of all infrastructure sectors, 43% of total.¹³ The exception is the WBG, where ICT constitutes approximately 10% of total investment. This is driven entirely by concessional International Development Association (IDA) projects, many of which are focused on the expansion of internet services in very low-income countries.

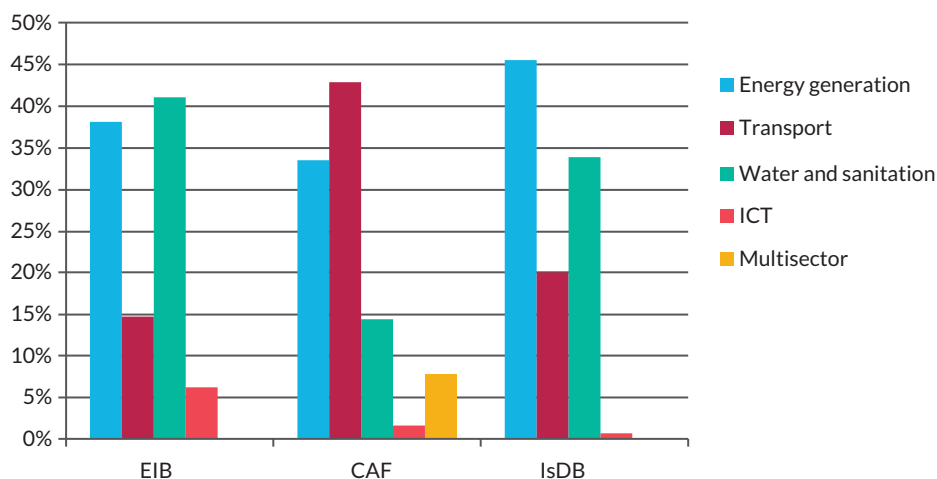
Figure 5. Sector Breakdown of Infrastructure Investment Commitments, 2003–2014 (1)



Source: Annual reports.

Note: WBG includes IBRD, IDA, IFC, and MIGA. Includes only investment in new or rehabilitated physical infrastructure; does not include sectoral reorganization, policy reform, or privatization operations.

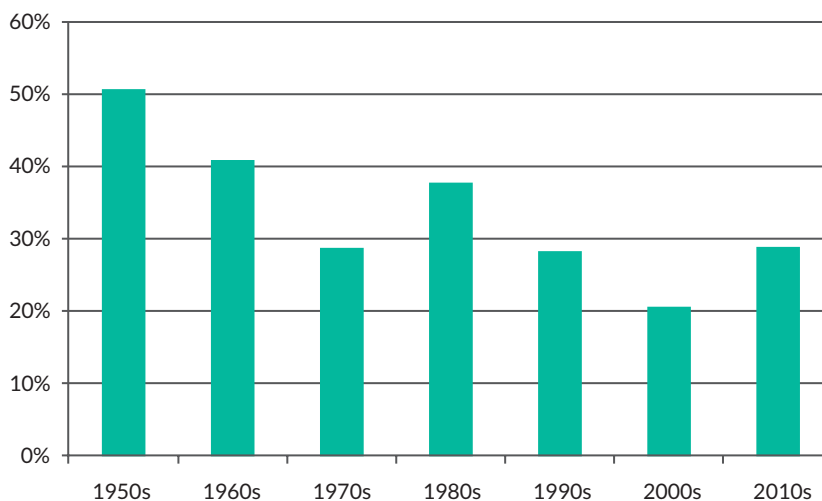
Figure 6. Sector Breakdown of Infrastructure Investment Commitments, 2003–2014 (2)



Source: Annual reports.

Note: Includes only investment in new or rehabilitated physical infrastructure; does not include sectoral reorganization, policy reform, or privatization operations.

Figure 7. Energy as % of Total Infrastructure Investment Commitments, World Bank



Source: Annual reports.

Note: Includes only IBRD and IDA. Includes only investment in new or rehabilitated physical infrastructure; does not include sectoral reorganization, policy reform, or privatization operations. IFC and MIGA were not included to allow for direct comparisons across decades.

2.3. Summing Up

Clearly, the volume of MDB investment in infrastructure pales in the face of the overall needs, as noted for example by Bhattacharya, Romani, and Stern (2012), which indicates a gap of US\$1 trillion per year between current spending and the needs for emerging and developing countries by 2030.¹⁴ Of course, MDBs have more impact than simply the volume of loans, as many observers have highlighted. Chelsky and Morel (2013) note that MDBs can play important catalytic roles to attract private investment in at least three other ways: (1) helping establish the necessary policy framework, (2) contributing through technical assistance and other support to the design and implementation of the project, and (3) providing comfort to private investors through a demonstration effect. This report does not discount these highly relevant roles of MDBs. The focus here, however, is on the volume of financing involved, and here MDBs are falling short of their potential. This is due to two over-arching reasons, explored in the two subsequent sections: (1) limitations on the available supply of financial resources, and (2) business practices that make MDBs less attractive partners for infrastructure finance from the perspective of developing countries.

3. Financial Challenges Facing MDBs

The first important limitation facing MDBs is the financial resources they can employ. This is restricted for two main reasons. The first is the willingness and ability of shareholders to contribute capital to MDBs, which relates to fiscal and political restrictions in some countries, combined with governance issues. Second, MDBs have traditionally managed their finances in a highly conservative fashion such that shareholder capital is not translated into as high a level of development operations as might arguably be possible. MDBs are built to take financial risks in the interests of development, undertaking operations that do not attract private funding but have positive social benefits. However, currently, many

MDBs are in fact taking fewer risks than private banks, a perverse outcome that calls into question their financial management.

3.1. Capital Base: Weakened Impact of Callable Capital, Difficulties Raising Paid-in Capital

As in any financial institution, MDB operations are underpinned by shareholder equity. This, in turn, is made up of (1) the paid-in capital contributed by shareholders, and (2) reserves and surpluses accumulated during the course of operations.¹⁵ MDBs also have a unique type of “callable” capital that is not actually paid-in by shareholders, but rather guaranteed in the event that an MDB should face a crisis.¹⁶ All the major MDBs operating today define in their articles of agreement a specific ratio between their total capital—paid-in plus callable—and the size of their outstanding portfolio of operations. The World Bank first defined the capital to portfolio ratio in 1944 as 1:1, and almost all other MDBs have followed suit. Exceptions are EIB, which allows a much higher ratio of 2.5:1 (largely because it lends mainly to industrialized European countries, which are perceived as less risky); CAF with a ratio of 4:1 but considering only paid-in capital;¹⁷ and International Finance Corporation (IFC), which has no fixed ratio (Table 1).

Due to these statutory provisions, the potential scope for operations of almost all MDBs is limited in the first instance by the amount of total shareholder capital. As can be seen in Table 1 below, the statutory provisions are not binding for the MDBs considered here, with the AfDB portfolio at only 16% of its statutory ceiling, the AsDB at less than a third and the IADB and EIB at approximately half. Only the European Bank for Reconstruction and Development (EBRD) comes relatively close to its limit, but it could still expand its portfolio by one-third and remain comfortably within the ceiling.

Table 1. Selected Financial Data, 2013 (US\$ Billions Unless Specified)

	IBRD	IADB	AsDB	CAF	AfDB	EBRD	EIB	IFC
Total Subscribed Capital	223.2	128.8	160.8	5.5	102.9	40.9	335.5	2.4
Of which, % Paid-in	6.0%	3.8%	3.7%	71.7%	4.4%	20.9%	8.9%	100%
Subscribed Capital + Reserves	252.5	146.5	172.1	9.4	107.2	52.8	385.5	22.2
Statutory Portfolio Limit	100% total capital + reserves	100% total capital + reserves	100% total capital + reserves	400% paid-in capital + reserves	100% total capital + reserves	100% total capital + reserves	250% total capital + reserves	None
Portfolio (2013)	141.7	70.7	53.1	18.0	16.9	35.0	590.0	34.7

Source: 2013 financial statements.

Notes: “Portfolio” refers to outstanding loans, guarantees, and investments for developmental purposes. EBRD, EIB, and IFC are included for perspective, and are not directly comparable to the other MDBs due to the nature of their operations. EIB operates mainly in industrialized European countries, with only a small share of operations outside the EU. IFC invests exclusively in the private sector, with no public-sector clients. EBRD lends mainly (approximately 80%) to private-sector clients.

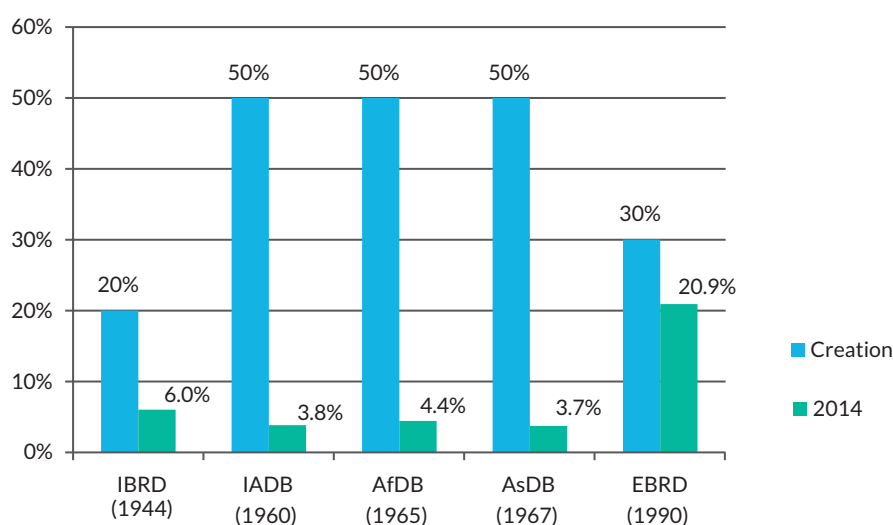
However, since the 1990s, MDB treasuries have increasingly focused on shareholder equity (paid-in capital plus reserves) as a more appropriate way to gauge capital adequacy, in line with the practices of private financial institutions. Combined with the difficulty in raising more paid-in capital from shareholders, this explains why the lending capacity of most MDBs is more restricted than what their statutes permit. Shareholders—particularly wealthy non-borrowing countries—are much more inclined to offer callable capital, for the simple reason that it does not imply any direct budgetary outlay, but rather a commitment to pay at some hypothetical point in the future, should the MDB require it. Callable capital has never been called on at any point in the history of any MDB, making it a rather abstract concept. The share of callable capital in total capital has risen sharply over the decades for each of the major MDBs with non-borrower shareholders (Figure 8). For example, while the headline figures for most recent capital increase following the global financial crisis were in the tens of billions, only a very small share—or in the case of the EBRD, none at all—was in actual paid-in capital (Table 2).

In many cases, borrower shareholders have unsuccessfully sought higher paid-in capital increases.¹⁸ This is a function

of the difficulties faced in obtaining budgetary authority for paid-in capital from domestic legislatures, as well as MDB governance. If emerging nations such as Brazil, China, India, or others were able to contribute higher capital shares that are not matched by traditional major shareholders, this would result in changes to voting power, as voting and shareholding are directly linked. Voting rules on at the World Bank (IBRD), IADB, AsDB, and EBRD are such that the major industrialized country shareholders—notably the U.S.—control any changes to the capital structure and membership, and these countries are unsurprisingly loath to relinquish that power. Thus, politico-fiscal restrictions and a desire to maintain power in MDB governance on the part of traditional non-borrower shareholders mean that capital increases are rare and mainly limited to callable capital.

The declining relevance of callable capital has been further accentuated following the global financial crisis and the revision of how rating agencies assess MDBs. Most major MDBs are rated AAA,¹⁹ which permits them to fund themselves at very attractive terms in international capital markets, hence limiting the cost of their loans to borrowing countries. In previous years, ratings agencies considered the callable capital of non-borrowing countries as the

Figure 8. Evolution of Paid-in Capital as % of Total Capital, Selected MDBs



Source: Annual reports.

Note: Parenthesis denotes the year of MDB founding.

Table 2. Recent Capital Increases at Selected MDBs

	IBRD	IADB	AfDB	AsDB	EBRD
Date Agreed	25 April, 2010	23 March, 2010	23 April, 2009	29 April, 2010	14 May, 2010
Total Capital Increase	US\$86 billion	US\$70 billion	US\$66.5 billion	US\$110 billion	US\$15 billion
Paid-in Portion	US\$5.1 billion	US\$1.7 billion	US\$3.8 billion	US\$4.4 billion	0
% Paid-in	5.9%	2.4%	5.7%	4.0%	0

Source: Weiss 2012.

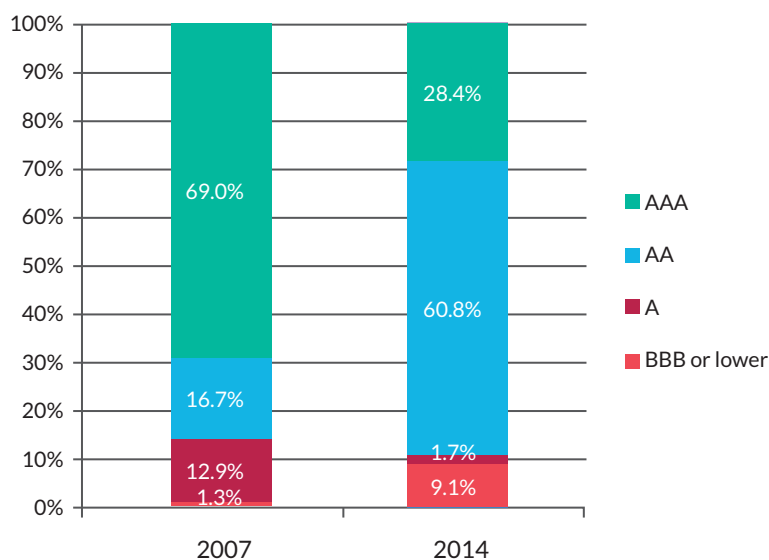
key factor in awarding a high bond rating to an MDB.²⁰ This situation has changed dramatically, for two reasons. First, the agencies themselves have overhauled their methodologies to place much greater weight on paid-in capital, and grant relatively limited “uplift” to MDBs on the basis of highly rated callable capital.²¹ Second, the ratings of industrialized countries have dropped considerably in recent years, meaning the ability of their callable capital to provide rating uplift is much reduced (Figure 9).

In an effort to raise paid-in capital without general capital increases, most MDBs have systematically allocated annual net income to financial reserves, which also serves to expand an MDB’s equity capital.²² However, this has two negative impacts on an MDB from the borrower countries’ perspective. First, net income is generated in part from the interest charged on loans to borrower countries,²³ meaning net income comes partly at the cost of higher development loan prices. This could at the margin reduce the attractiveness of loans for projects with potentially high social returns. Second, this “back door” capital increase does not come with any concomitant increase in the voting share of the borrowing country shareholders who are making this contribution (via interest payments on their loans). It is thus no surprise that this technique

is favored by MDBs with a large representation of non-borrowing shareholders, whereas the AfDB, CAF, and especially IsDB instead emphasize paid-in capital as the basis for growing their operations (Table 3).²⁴

In light of the constraints outlined above, MDBs have begun seeking more innovative strategies to strengthen their equity capital base. One bold move currently underway at the AsDB is to fold its concessional lending window (ADF) into its non-concessional window.²⁵ This will involve transferring the entirety of the concessional loan portfolio (approximately US\$31 billion) to the reserves²⁶ of its ordinary capital window, thus providing a massive injection of equity without any need for either a capital increase or net income transfers. This one-time operation—planned to be completed by early 2017—raises numerous financial and developmental questions, but if successful, it has the potential to significantly increase the AsDB’s lending capacity in the coming years.²⁷ A similar operation may be feasible (though on a smaller scale) for the IADB, but is not currently realistic for IBRD/IDA nor for the AfDB, for various reasons relating to legal provisions as well as the size of the concessional window relative to the non-concessional window at these MDBs.

Figure 9. Sovereign Rating of World Bank Non-borrower Capital, 2007 and 2014



Source: World Bank Annual Report 2007 and 2013; Standard and Poor’s Sovereign Ratings 2007 and 2014.

Table 3. Shareholder Equity and Reserves, 2013

	IBRD	IADB	AsDB	EBRD	AfDB	CAF	IsDB	EIB	IFC
Shareholder Equity (US\$ billions)	39.5	23.6	17.1	20.5	9.0	7.8	11.2	79.8	22.2
Of which, % Reserves	74.0%	75.2%	66.1%	58.0%	50.0%	50.0%	33.9%	62.5%	89.2%

Source: 2013 financial statements.

Notes: Shareholder equity as reported on balance sheet of annual financial statements (paid-in capital plus reserves) in all cases.

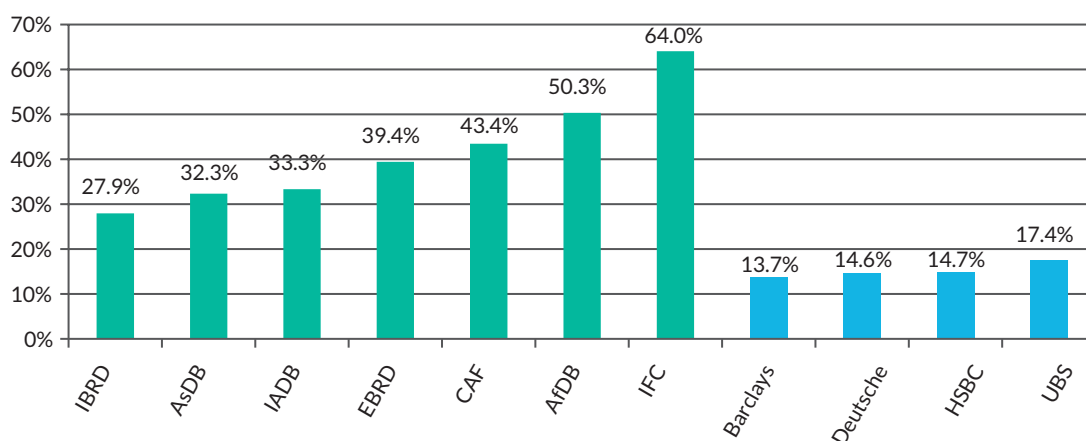
3.2. Utilizing Equity Capital: MDBs are Highly Conservative

Based on a given amount of available equity capital, the question is then to select a financially prudent level of operations.²⁸ In this, MDBs are extremely conservative. Private banks, in recent years, have generally maintained equity/loan (E/L) ratios of 12–17%, compared to the E/L ratios (double or more) maintained at the major MDBs (Figure 10). This indicates that in purely financial terms, MDBs could double the size of their loan portfolios based on the same level of equity, and still remain within acceptable financial prudence according to international standards. Furthermore, this does not consider the very considerable levels of callable capital available to MDBs, which is specifically designed to provide further security to MDB bondholders and which is not available to private banks.

What explains this extremely conservative MDB financial management? Why not expand lending to meet the evident pressing development needs? One might imagine that the reason is that MDB loan portfolios are inherently more risky, but in fact this is not the case. Because of the preferred creditor status enjoyed by most MDBs and their close links with borrower governments, loan portfolios are considerably healthier than private financial institutions, on average (Figure 11). The only MDBs with non-performing loan ratios comparable to private banks are the EBRD (which loans mainly to private sector borrowers, unlike most MDBs) and the AfDB (which operates in a region with long-standing debt problems). Even these two cases are not riskier than most private banks, and other MDBs have far stronger portfolio track records.

The higher E/L ratios employed by MDBs appear to be related to the desire of non-borrower shareholders to

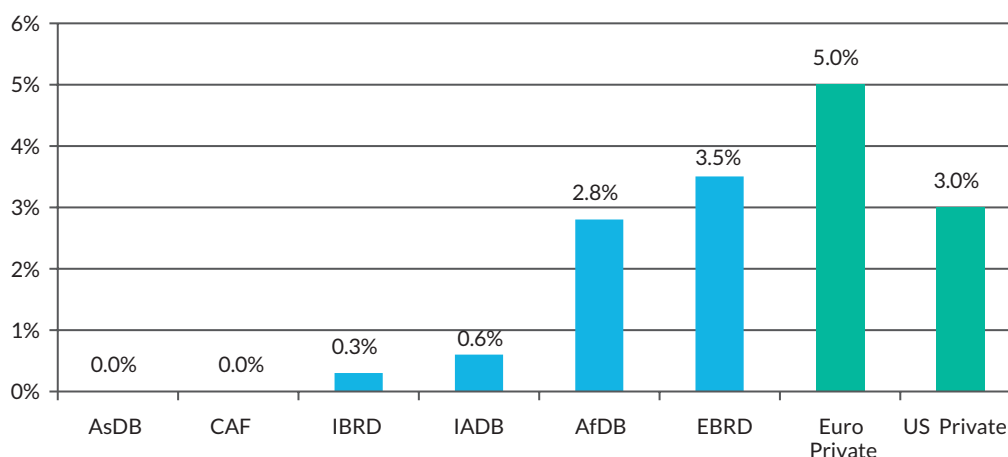
Figure 10. Equity/Loans, Selected MDBs, and Private Banks



Source: 2013 Balance sheets of annual reports.

Note: “Loan” for MDBs refers to development investment portfolio, which includes guarantees and equity investments. Of the MDBs here, only IFC and EBRD have significant guarantee and equity portfolios. “Loans” for private banks includes only loans to customers and other banks.

Figure 11. Non-Performing Loans as a % of Total Loan Portfolio, 2013



Source: 2013 annual reports for MDBs; BIS 2013 for private banks.

Note: Private bank data represents averages for Euro area and U.S. In all cases, NPL refers to loans more than 90 days past due or in non-accrual status.

avoid a call on their callable capital.²⁹ Moody's notes this in an analysis of the World Bank: "The Bank judges its capital adequacy as the ability of its equity to generate future net income to support normal loan growth and respond to a potential crisis without having to resort to a call on capital."³⁰ A top official in the World Bank's Corporate Finance division, which sets financial strategy, stated in an interview that the E/L ratio was well beyond what bond markets called for, and went on to explain why "shareholders traditionally have not wanted us to call capital. A call on capital is something they want to avoid, because it's not something in their budget, it would come out of nowhere. So the history of the Bank has always been to manage itself to avoid a call on capital."³¹ A top treasury official at the IADB concurred: "Ultimate we are trying to protect—in our case it's not bankruptcy, its callable capital. The main non-borrowing shareholders, especially the U.S., do not want to get called on."³²

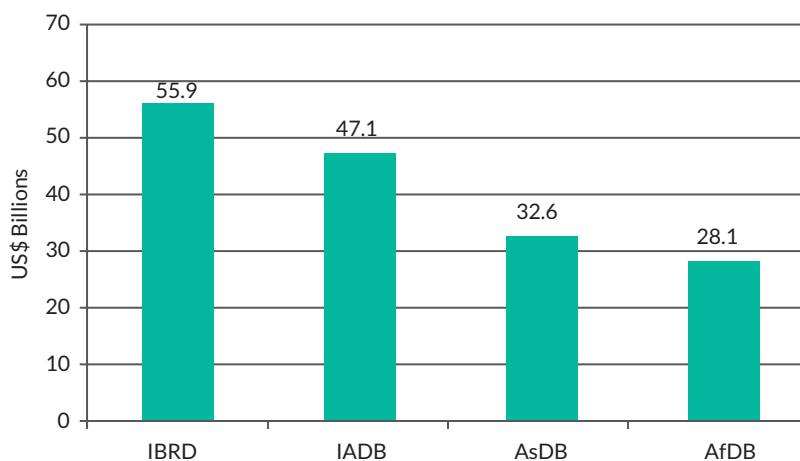
Hence, callable capital has a perverse effect on the way MDBs manage their finances. Originally intended to provide MDBs with a higher level of security, it has ended up becoming a reason for MDBs to act *more* conservatively than their private counterparts. Interestingly, this seems to impact even MDBs that do not have a significant share of callable capital, such as CAF (E/L above 40%). Ratings agencies have become accustomed to expecting high E/L ratios over the decades, following the example set initially by the World Bank since the 1950s—it is what is now considered "normal" for an MDB, regardless of how this compares with private banks.³³ A former MDB analyst at one of the top rating agencies agreed in an interview that the ratio was higher than necessary. "Viewed strictly as a financial institution they could come down quite considerably. Certainly, 20% would not be a problem and something below that would be doable as well" (Ratings agency interview, Aug. 20, 2012).

Such a change in policy would free up very considerable resources to expand development lending. If the World Bank and four major RMDBs (AsDB, IADB, AfDB, and EBRD) were to maintain an E/L ratio of 20%, that would mean their outstanding loan portfolios would be collectively US\$208 billion higher than their current portfolio, based on existing equity levels (Figure 12). It is of course not realistic nor desirable for all MDBs to immediately expend all lending headroom based on a given E/L ratio—due to the long-term nature of their lending, that would force them to limit lending until loans were repaid and headroom opened up again, and would also limit the scope of emergency counter-cyclical lending. Nonetheless, it is clear that the major MDBs have very considerable stockpiles of equity capital that could be put to more effective use. In recognition of this reality, the World Bank (IBRD) recently lowered its own target E/L ratio to 20%, even though the actual level is still much higher. This may provide opportunities for other MDBs to make a similar change without repercussions from the ratings agencies.

3.3. Techniques for MDBs to Leverage External Resources

One important role MDBs can play that effectively utilizes their multilateral character, ability to manage risk, and deep country/project knowledge is as a lever to bring in other external financing to projects, particularly for major infrastructure facilities. This is not only highly appropriate to the nature and mission of MDBs, but also can go a long way to overcoming their own financial limitations. Numerous techniques are available for MDBs to engage in leveraging, including targeted investments, guarantees, loan syndication, and co-financing arrangements. However, existing MDBs have had only limited success with these instruments thus far, for various reasons. Other ideas include creating "spin-off" facilities dedicated

Figure 12. Potential Increase in Loan Portfolio Utilizing an E/L of 20%



Source: Annual report financial statements, 2013.

Note: EBRD was not included as its portfolio is not directly comparable to others due to much higher private sector exposure (80%) and also a higher share of equity investments (25% in 2013) in the total portfolio.

to infrastructure, notably the World Bank’s Global Infrastructure Facility (GIF) and the Africa 50 Fund supported by the AfDB. These innovations are still at the incipient stage, and it remains unclear if they will succeed in fulfilling the expectations of their creators.

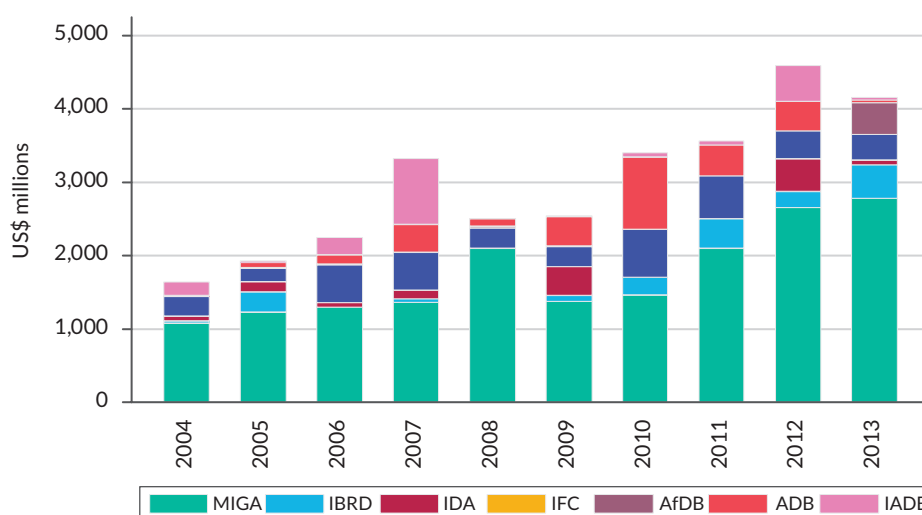
Targeting instruments and maturities to the portion of the investment most in need of multilateral support is an increasingly interesting strategy being pursued by MDBs as a way to ration the use of their own scarce financial capacity and leverage greater private resources. As indicated by Gatti (forthcoming) in this same paper series, the risks facing private investors vary considerably over the life of a major infrastructure project. Construction in particular is a high-risk phase, especially in the less certain context of a developing country. An MDB can come in with shorter maturity loans, equity or guarantees to shoulder this higher-risk phase, and then sell out its participation to private investors once the facility is running and generating revenue. By targeting its participation, an MDB can maximize the impact of its investment to turn an infrastructure project into an asset attractive to even institutional investors interested in facilities with a steady income stream but unable to take on construction risk. At the same time, the MDB is able to commit resources for a shorter period than its normal long-term loans (five years instead of 18–25), and thus recycle capital more quickly into new projects.

Loan guarantees are not a new concept for MDBs—in fact they were expected to be the main task of the World Bank when it was created in 1944, although direct loans quickly took over as the main instrument used by the World Bank and other MDBs.³⁴ The use of guarantees by MDBs began in earnest in the 1990s, and several types of project guarantees are now offered by all the major MDBs.³⁵ However, project guarantees have fallen well short of expectations, constituting only 4.5% of total

financing operations undertaken by the World Bank Group, IADB, AfDB, and AsDB in 2013 (Figure 13).³⁶ A key problem limiting guarantee usage is the fact that even though guarantees are not funded (unless they are called, which is very rare), they must still be backed by the same amount of MDB equity capital as a regular loan according to the MDB treasury policy, which makes them expensive and unattractive to clients. The pricing issue is particularly problematic as the financial uplift offered by MDB guarantees is limited due to the nature of borrowers receiving the guarantee and the perceptions and incentives of private lenders. Moreover, neither MDB staff nor clients are generally sufficiently aware of how guarantees function, and frequently prefer to proceed with regular loans.³⁷

Loan syndication is also a useful instrument to bring external resources into private sector transactions that an MDB designs and administers, and is growing in importance although still incipient. Syndication generally can take two forms, either as an A/B loan program—wherein the MDB is the lender of record, and the external financier simply provides a set amount of resources as part of the overall loan package via the MDB—or as a parallel loan—wherein the MDB and the external source each conclude separate loan agreements with the borrower, on a project designed and administered by the MDB. Syndication offers numerous benefits: borrowers obtain much larger volumes of resources than otherwise possible, external financiers can rely on MDB knowledge in an area where they would like exposure but cannot adequately assess and hedge risk, and the MDB increases its development impact while using less equity capital. The EBRD and especially the IFC have strong and growing loan syndication programs, while the AsDB is making a concerted push in this direction in recent years (Table 4). Public sector loan syndication is not currently feasible for MDBs, and would be complex for various reasons, but may be worth exploring going forward.

Figure 13. Total Volume of Non-Trade Guarantee Commitments, Selected MDBs (US\$ Millions)



Source: Humphrey and Prizzon 2014.

Table 4. Syndication Activity in Selected MDBs, 2012

	AsDB	EBRD	IFC
Syndications, US\$	US\$200 mln	US\$1.6 bln	US\$2.7 bln
% of non-sovereign loan commitments	2.2%	16.9%	31.8%

Source: Annual reports 2012.

Co-financing is similar to syndication, but for a portfolio of loans rather than by individual project. Unlike syndication, co-financing arrangements can involve sovereign as well as non-sovereign loans. An MDB agrees to develop a portfolio of loans in a given sector or geographic region, and the third party commits funds to be paired with MDB resources for loans. The AfDB has been active in developing co-financing arrangements, including the US\$400 million Economic Development Cooperation Fund with the Korean Ex-Im Bank for public sector operations, the US\$1 billion Enhanced Private Sector Assistance Initiative with Japan's JICA for private sector operations, and a US\$2 billion Africa Growing Together Fund supported by the People's Bank of China announced in May 2014.³⁸ The IFC launched a co-financing program in September 2013, the Managed Co-Lending Portfolio Program (MCLPP), with a US\$3 billion pledge from the People's Bank of China.³⁹

Risk-sharing facilities are another option for an MDB to utilize external funds to stretch the developmental capacity of equity capital. This can be accomplished in various ways. One option is to seek external guarantors for a portion of the MDB's exposure on a project-by-project basis. The EIB utilizes risk sharing extensively, with 58.4% of its outstanding portfolio in 2013 backed by some type of third-party guarantee (Table 5). This is somewhat easier for

the EIB as many of its clients are in Europe and hence less risky, but is a technique that could be scaled up at other MDBs, particularly for private sector lending portfolios. A new and more innovative option is for a bilateral donor to guarantee a portion of an MDB's loan portfolio, thus freeing up risk capital that can be deployed on other loan operations. For example, the Swedish government is currently considering a proposal to provide a guarantee to back a portion of the AsDB's outstanding loan portfolio.⁴⁰ With an AAA-rated country guaranteeing a group of loans, the AsDB could reduce the amount of its own equity capital set aside to cover those loans, freeing up resources to be used for further lending. The proposal is a creative way to provide more support to an MDB, without requiring paid-in capital contributions.

Due to difficulties in generating sufficient resources for the huge infrastructure investment needs, MDBs have also begun creating *spin-off vehicles* to attract investors and free themselves from some operational and financial restrictions facing MDBs. Most notable are the AfDB's Africa 50 Fund and the World Bank's GIF, both formally launched in 2014. Africa 50 is legally and financially separate from the AfDB. The AfDB initially contributed US\$100 million in equity and is planning a total investment of a US\$500 million, with total goal of US\$3 billion raised from all shareholders. This equity capital will then serve as a basis for bond issues to raise project resources. Other target investors include regional sovereign wealth funds, central banks, commercial banks and insurance companies, as well as non-regional investors.⁴¹ The facility will focus on not only investing but also providing resources (on a commercial basis) to develop projects that can then seek investment from both Africa 50 as well as other sources.⁴² The GIF, in contrast, is being created as a multidonor trust fund within the legal structure of the World Bank

Table 5. EIB Risk Sharing on Loan Portfolio, 2012

Borrower \ Guarantor	States	Public Institutions	Banks	Corporates	Not Guaranteed ^[1]	Total 2013	Total 2012
States	0	0	0	0	43 971	43 971	42 461
Public Institutions	26 611	14 520	517	3 184	61 356	106 188	99 731
Banks	25 150	36 787	36 395	30 543	20 570	149 445	140 669
Corporates	21 262	10 150	27 971	42 873	70 973	173 229	165 457
Total 2013^{[1][2][3][4][5]}	73 023	61 457	64 883	76 600	196 870	472 833	
Total 2012^{[1][2][3][4][5]}	66 809	60 176	65 195	69 866	186 272		448 318

[1] These amounts includes loans for which no formal guarantee independent from the borrower and the loan itself was required, the borrower's level of solvency itself representing adequate security. In the event of certain occurrences, appropriate contractual clauses ensure the Bank's right to access independent security.

[2] The loans in risk-sharing operations amount to EUR6 817 million as of 31 December 2013 (2012: EUR 6 665 million).

[3] This amount includes loans granted under Facilities.

[4] This amount does not include loan substitutes (2013: EUR 13 179 million; 2012: EUR 12 718 million).

[5] These amounts exclude loans to current European Union Member Status but granted before their accession to the European Union and guaranteed by the European Union budget or the Member Status.

Source: EIB Financial Report 2013, p. 61.

(in partnership with the AsDB, EBRD, EIB, and IsDB), and was given an initial seed contribution of US\$15 million from World Bank net income in September 2014.⁴³ Its goal is to develop complex infrastructure projects as a viable asset class for institutional investors.

While both these vehicles are creative efforts to leverage more resources than the MDBs themselves can provide, their future success is far from clear. On the one hand, despite optimistic rhetoric, no outside investors have yet publicly committed to contributing to either fund. On the other, the limitations inhibiting greater MDB investment in infrastructure discussed in this paper may simply be replicated in the new vehicles, such as bureaucracy and operational restrictions. For example, a World Bank Board of Directors statement noted that “there was potential for reputational risks to the World Bank Group, and in this regard called for strong Board oversight and for the GIF to draw upon the Bank’s standards, safeguards, and procurement processes.”⁴⁴ Despite these limitations, the facilities could play a valuable role in helping develop projects, regardless of their own ability to invest.

Project preparation facilities are another area where external financing could play an important role in increasing MDB effectiveness in infrastructure promotion. The importance of project preparation is highlighted by many observers considering how to scale up infrastructure finance, notably Kortekaas (forthcoming) in a companion paper in this series. Formerly, MDBs themselves were able to dedicate considerable resources for helping borrowers to design and develop infrastructure projects, which the MDB would then lend to implement. However, these resources have declined in recent decades, in tandem with the decline of infrastructure lending by MDBs generally as well as the gradual budgetary tightening experienced at all MDBs. Some trust fund resources have been made available, but not enough to address the high cost of adequate project preparation (commonly estimated at up to 5–10% of total project cost) on a significant scale, and many are fee-based, which debars many projects in lower-income countries most in need. MDBs can dedicate net income generated by non-concessional lending to project preparation facilities, but their ability to do so depends on the willingness of shareholders to permit such an allocation. Appetite for net income transfers to project preparation facilities has declined at the World Bank and major regional MDBs in recent years, despite the high positive impact these facilities have on both the quality of projects as well as an MDB’s own loan portfolio.

4. MDB Business Practices: Quality Control Versus Bureaucratic Hassles

MDBs are also constrained by business practices that in some cases offset MDB’s attractive financial terms and considerable knowledge value added. When borrowers seek financing from an MDB, they face an array of processes and requirements, including multiple, lengthy levels of internal review, rigorous safeguards

on environmental and social issues, and stringent rules on how resources can be spent by the borrower. These qualitatively differ for the most part from what a borrower must face when obtaining private financing,⁴⁵ and in many cases are required over and above the national laws where the project is undertaken. MDB business practices impose considerable costs and added time, to the point where some borrowers find it preferable to find other financing sources, even if this means paying higher financial (or other) costs. Infrastructure projects are especially impacted by these business practices, which in part explain the declining demand on the part of borrowers for MDB infrastructure financing.

Unquestionably, many aspects of MDB reviews and safeguards can be very valuable to ensure project quality and adherence to certain basic standards. However, if these business practices become such a burden that borrowers are willing to pay a higher financial cost to avoid them, this suggests that they are no longer leading to their intended impact. MDBs must strike a balance between ensuring the quality and outcomes that shareholders demand while at the same time remaining a relevant and attractive source of project financing to borrowers. The evidence suggests that particularly the larger MDBs controlled by non-borrower shareholders are not finding that balance.

This section outlines the main aspects of MDB business practices that impact demand, based on MDB documents and policies as well as interviews with MDB staff, shareholders and borrower government officials. The main topics are (1) project approval review process; (2) procurement rules; and (3) environmental and social safeguards. Following this overview, the section assesses the impact of these processes and policies on MDB engagement with borrowers and reviews recent reform efforts.

4.1. Loan Approval Process

According to the World Bank’s own data, IBRD and IDA took on average 28 months to move a project from initial identification to the first disbursement of resources in fiscal year 2013.⁴⁶ This is far longer than few months or even weeks needed to obtain resources from the private sector—without any additional requirements related to policies, safeguards or procurement—and also much slower than many of the new, non-traditional bilateral sources of finance. Other MDBs are somewhat faster on average, but still extremely slow (Figures 14 and 15) relative to other financing sources.

The multiple country missions, document preparation, and various review stages prior to formal approval by the Board of Executive Directors are the major bottlenecks. At the World Bank, most investment loans involve four separate country missions (identification, pre-appraisal, appraisal, and negotiations) as well as four full formal internal reviews (concept, quality enhancement, decision to appraise, and Board approval).⁴⁷ Adjustment lending follows a similar schedule, but with a higher-level decision

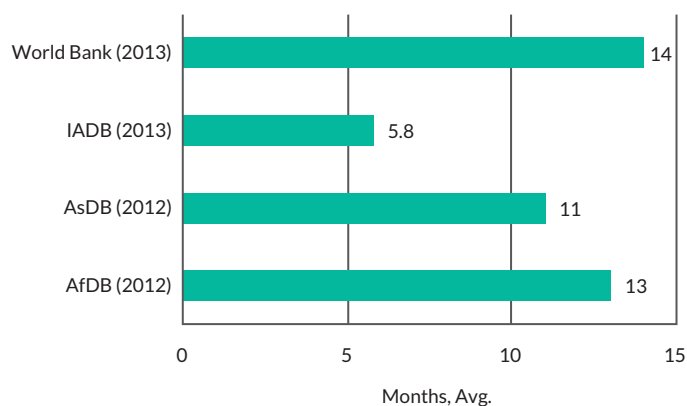
to appraise meeting. Considering the need to organize the project staff team (all of whom are working simultaneously on multiple projects in different countries), coordinate schedules with government officials, circulate documents for review informally and then again formally 2–4 weeks before all review meetings, and find a slot in the crowded Board agenda,⁴⁸ the lengthy approval process should come as no surprise.

The major RMDBs are generally similar. The AfDB has an even more complex process, with fully 20 formal review and approval steps between the initial request for financing and board approval, including (1) initial screening by the country economist; (2) writing and approving the project brief; (3) writing and approving the project identification report (two approvals); (4) writing and approving the

project preparation report; (5) writing and approving the project concept note (seven approvals needed); and (6) writing and approving the project appraisal report (nine approvals including board).⁴⁹ In each case, documents must be written and circulated in advance of meetings, and in the case of concept note and appraisal report, peer review, and comments incorporated. The appraisal report must also be officially translated prior to the board meeting, adding further weeks of delay. Four or sometimes five country missions are required throughout this process.

Both the AsDB and IADB have streamlined their procedures somewhat, requiring shorter documents and shorter circulation times prior to meetings as well as the possibility of having “virtual” internal reviews at some stages and video/telephone conferences with clients

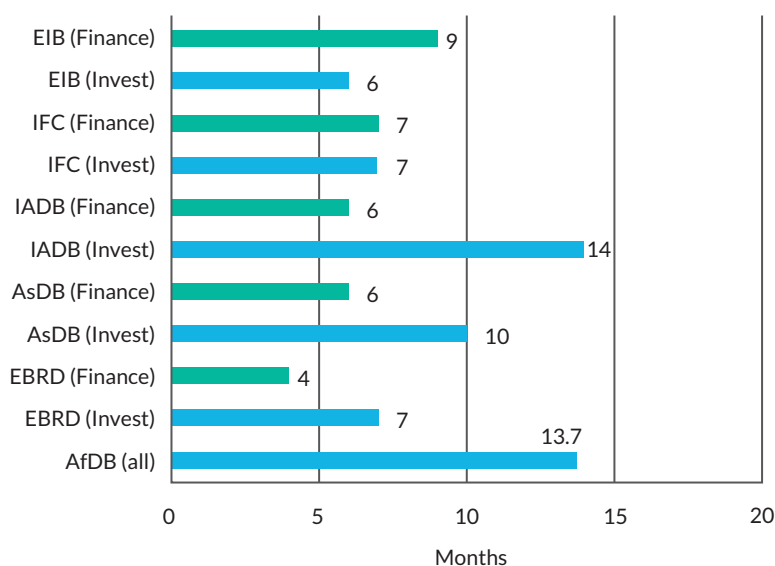
Figure 14. Sovereign Loan Approval Times



Sources: World Bank Corporate Scorecard 2013; IADB 2013a; author interviews with staff for AsDB and AfDB.

Note: Denotes time from initial identification to board approval. Several months more are frequently required to pass effectiveness and procurement hurdles and begin actual disbursement.

Figure 15. Non-Sovereign Loan Approval Times



Source: IADB 2013b.

Note: Denotes time from initial identification to board approval. Several months more are frequently required to pass effectiveness and procurement hurdles and begin actual disbursement. “Finance” relates to investments in financial institutions, while “Invest” relates to all other private sector projects.

instead of country missions. Nonetheless, the process remains very lengthy. MDBs dealing either exclusively (IFC) or mainly (EBRD and EIB) with private sector clients have developed accelerated, risk-based processes.

4.2. Procurement Processes

Following board approval, borrowers face considerable further hurdles related to financial management and especially procurement requirements and approvals at the World Bank and the major RMDBs.⁵⁰ This phase can frequently last up to as much as a year, particularly with complex investment projects such as infrastructure, necessitating major purchases of goods and services. Unless the loan is for a repeater project, government counterparts are usually required to learn a complex set of MDB bidding rules entirely different in many cases from their own national laws, which creates further delays. MDBs generally have few procurement officials responsible for several countries who are frequently traveling and difficult to reach, meaning routine problems take even longer to overcome.

MDBs have improved in recent years in harmonizing procedures. The World Bank and larger RMDBs all now have almost exactly the same procurement policies and utilize the same procurement documents due to harmonization efforts over the past decade.⁵¹ In addition, the World Bank and the four major RMDBs have a reporting system and agreement by which a firm found to have engaged in improper practices at one MDB is barred from bidding on contracts in another MDB. Further efforts have been underway at various MDBs to review and streamline procurement using more risk-based procedures, although the outcome of these efforts remains to be seen.⁵²

4.3. Environmental and Social Safeguards

One aspect of the business practices of the World Bank and major RMDBs that has a particularly strong impact on infrastructure investment is environmental and social safeguard policies. Safeguards comprise procedures and restrictions on different types of lending operations meant to “safeguard” the project from having negative impacts on the environment and social groups. Safeguards were first instituted at the World Bank in the 1990s, and the other major RMDBs followed suit in subsequent years. The World Bank’s safeguards are still considered the most comprehensive and rigorous, but the safeguards of the AsDB, IADB, and AfDB have been gradually tightened over the years such that the differences between them are relatively small, particularly on the hot-button issues of environmental assessment and resettlement.⁵³

As a project undergoes the initial screening process, MDB staff members determine whether it triggers any of the MDB’s applicable safeguards. Should that be the case, a separate series of special requirements must be followed before the loan can be approved and disbursed. The most frequently triggered safeguards in the case of the World

Bank relate to environmental assessment and involuntary resettlement,⁵⁴ and most frequently affect investment projects in the transportation, energy, and urban sectors. The required procedures are extraordinarily detailed and specific,⁵⁵ and in many cases (notably, the World Bank’s IBRD and IDA) extremely difficult for borrowers and even staff to fully understand.⁵⁶ Requirements often include time-consuming, lengthy studies to be undertaken by third-party experts (usually at the government’s cost), lengthy consultations with affected parties (sometimes including unelected non-governmental organizations), extensive mitigations measures, and lengthy mandatory prior public disclosure and comment periods during which time the project cannot move ahead. These requirements supersede whatever national laws may be in place in the borrowing country—a particularly troubling point of principle for many borrowing countries, beyond the practical impacts of safeguards.

Safeguards have evolved considerably at MDBs over the past 20 years, often in an ad-hoc manner. The IFC undertook a major overhaul of safeguards in 2012, and implemented what are now termed “performance standards.”⁵⁷ The thrust of the standards—specifically designed for the private sector, IFC’s client base—is to focus less on required procedures and more on achieving a certain standard level of outcome. Other MDBs are also moving in this direction, notably the World Bank (IBRD/IDA), which is in the midst of a major overhaul of safeguards. According to preliminary drafts of the new policy,⁵⁸ the goal is to move away from a focus on ex-ante process requirements and toward a results-based approach that will incorporate country systems when deemed appropriate by the World Bank.

4.4. Impact on Demand for Lending

Collectively, the lengthy and complex processes described above for MDB project financing is a major deterrent to borrowers, particularly for large-scale infrastructure projects. A recent report by the Overseas Development Institute notes that speed of loan approval is a critical factor among government officials in borrower countries when choosing between sources of development finance.⁵⁹ This matches findings from interviews with over 100 officials in 10 Latin American countries, which consistently found the bureaucratic “hassle factor” of the World Bank and IADB as a key disadvantage of borrowing from these institutions.⁶⁰ The World Bank’s own 2012 client survey found similar results—“reducing the complexity of obtaining World Bank financing” was by far the top response from borrower countries on the best way to provide greater value to clients, well above improving financial terms or knowledge services.⁶¹

The impact of safeguards and procurement rules is particularly strong in major infrastructure projects, such as building roads, urban transit, and energy plants. A World Bank 2001 Cost of Doing Business study found that “the willingness of IBRD borrowers to pursue Bank

lending for certain kinds of infrastructure—electric power, dams, slum upgrading, transportation—is affected by the clients’ desire to avoid the costs, and the ‘hassle,’ of certain safeguard policies. Given other opportunities for financing, IBRD borrowers articulated an explicit hierarchy of preference for official borrowing in these infrastructure sub-sectors: domestic resources, bilateral donors, Regional Banks and lastly, the World Bank.”⁶² Further on, the report noted that “The Bank may be genuinely becoming a lender of last resort, but for perhaps the wrong reasons.”⁶³

Evidence suggests that the situation has not improved in the intervening years. A 2010 study by the World Bank’s Independent Evaluation Group (IEG) on safeguard policies found that environmental, social, and financial safeguards clearly limited lending. “The impact of this chilling effect was reported by a majority of team leaders from Latin America and the Caribbean and over 40 percent from East Asia and Pacific and South Asia.”⁶⁴ Of particular attention is the stringency of involuntary resettlement policy of the major MDBs, which borrowers claim frequently exceeds what would be required in industrialized countries.⁶⁵ Safeguards are further complicated in some MDBs by infighting between project staff and safeguard teams, as well as a strong tendency to over-categorize projects out of risk aversion. As the 2010 IEG report noted regarding the World Bank, “...there is a fairly widespread perception among task team leaders that upward classification is driven by risk aversion rather than an empirical assessment of environmental and social risks.”⁶⁶

Apart from the time and hassle involved in dealing with MDB safeguards, governments face concrete financial costs. The 2001 World Bank Cost of Doing Business study found that “Bank procurement requirements add about 30–35% to borrower’s normal costs, while social and environmental standards add perhaps 40–60% to normal borrower costs and meeting the Bank’s financial reporting requirements would be up to 60–70% more costly.”⁶⁷ The IEG 2010 study reported that environmental safeguard compliance alone cost borrowing countries US\$19 million for category A projects on average and US\$5 million for category B.⁶⁸ MDBs in the past helped finance these process requirements themselves, but in recent years those funding sources have dried up, according to interviews with operational staff at the World Bank, IADB, and AfDB.

Although borrower governments at times value the quality assurance and political cover provided by the extensive review process and safeguards,⁶⁹ they are clearly imposed on the MDBs by the major non-borrowing shareholders. The story of how safeguards came about at MDBs—driven by NGOs pressuring domestic legislatures in the U.S. and several European countries—has been extensively documented.⁷⁰ Similarly, staff and executive directors at the World Bank, IADB, and AfDB unanimously stated in interviews that the lengthy approval procedures are the result of rules imposed by non-borrowers. A similar

process is at work with procurement rules, where non-borrowers impose very strict rules to assure domestic constituencies that MDB resources are not being diverted for corruption (as well, perhaps, as the more self-serving interest of ensuring companies from non-borrower countries are able to compete for MDB project contracts). The influence of non-borrower shareholders on these aspects of MDB policy is highlighted by the different operational policies of MDBs that are majorly or entirely controlled by developing countries themselves, such as the IsDB, CAF, and Eastern and Southern African Trade and Development Bank (PTA Bank) (see Box 1).

4.5. Abortive Attempts at Reform

MDB operational staff members have long been aware that procedural requirements are a disincentive for borrowers. In response, since the mid-1990s, a series of initiatives at the World Bank and other major MDBs have attempted to reduce the bureaucratic burden facing client countries. However, this drive has been largely stymied by the resistance of non-borrowers. Success at implementing what are broadly termed “country systems”—that is, using a country’s own laws and procedures instead of MDB environmental, social, and financial safeguards—have been limited at best.

The concept behind country systems is that it makes no sense for MDBs to impose blanket policies on all countries for all issues, as they have tended to do. Even besides the issue of whether an MDB should impose external developmental priorities, in purely efficiency terms, this strategy does not recognize that borrower countries have very different legal frameworks, developmental contexts, and institutional capacity. As a result, middle-income countries that have well developed procurement systems, environmental standards or ability to design their own projects face the same requirements as very poor and institutionally weak countries. This “lowest common denominator” approach increases the bureaucratic burden and financial cost for the countries as well as for the MDBs themselves.

In the face of this reality, and as part of the Paris Declaration principles, 26 multilateral organizations including the World Bank and the major MDBs agreed in 2005 to move toward greater use of country systems in procurement and safeguards.⁷¹ At the World Bank, this led to the country systems pilot program, wherein staff was given the green light to qualify the systems of 10 countries worldwide for use in World Bank projects.⁷² Similar efforts were launched in the following years at the IADB, AsDB, and AfDB.

However, the restrictions imposed on the country systems pilot ensured minimal success. A World Bank procurement staffer in Latin America said, “We picked Brazil, Colombia, and Panama, and none of them meet the minimum requirements. So we couldn’t apply whole country systems. At the end of the day they [the countries]

Box 1. CAF: The Impact of Governance of an MDB by Borrower Countries

The Andean Development Corporation (CAF)* is an MDB created in 1970 by six countries in the Andean region of Latin America. Although it faced considerable difficulties establishing itself in its early years, CAF has grown tremendously since the 1990s. It now lends about as much each year in Latin America as the World Bank and IADB, and has 18 shareholding countries, all of whom are eligible for borrowing.**

This shareholding context has led to very different operational characteristics compared to the World Bank and other MDBs dominated by non-borrowing shareholders:

- The executive board is non-resident, meeting only three or four times per year. The board comprises ministers and central bank governors, rather than mid-level bureaucrats.
- Loans are approved very rapidly, usually under three months, and face only two major review levels.
- CAF is highly decentralized, with local staff able to lead project development without needing to refer to HQ for many decisions.
- Procurement and financial management rules and environmental/social safeguards utilize country systems almost exclusively. CAF has internal procedures to ensure project quality and protect its own reputation, but decisions are evaluated case-by-case, without rigid, ex-ante requirements.

As one may imagine, this model of MDB is very attractive to many borrowers. However, it comes with tradeoffs:

- Lack of industrialized non-borrower shareholders mean CAF has a lower bond rating than the major MDBs (AA- at last report). As a result, it offers financing at higher interest rates and shorter maturities than other MDBs.
- Project quality has been questioned at times, with inadequate preparation and design leading to delays and problems during implementation.
- The lack of detailed safeguards has led to accusations of CAF running roughshod over environmental and social concerns, although it has strengthened these aspects of its operations in recent years.***
- CAF is mainly a “project” as opposed to “knowledge” bank, focused on financing operations rather than providing extensive knowledge valueadded.

Despite these limitations, the impressive growth of CAF—in terms of projects, membership, and bond rating—suggests that its policies, operational style, and governance arrangements hold lessons for other MDBs.

* The CAF is now formally named the Development Bank of Latin America

** The only two shareholding members from outside Latin America are Spain and Portugal, both of which received CAF loans in 2013 for the first time. Unusually for an MDB, CAF also has a group of private banks as minority shareholders.

*** See for example Bank Information Center 2008.

Source: Based on Humphrey and Michaelowa 2013.

considered that the whole thing was not worth it.”⁷³ A 2010 IEG report on safeguards concluded that “... client expectations that Bank safeguard responsibilities would be transferred to the borrower did not occur.”⁷⁴ A similar pilot program at the IADB has made slightly more progress, with Brazil, Chile, Mexico, and Ecuador qualified to use full national systems and eight other countries qualified to use public procurement sub-systems.⁷⁵ At the AsDB, despite beginning its country systems program in 2009, only one country has even requested to use country systems (Indonesia 2013) and none have done it

successfully till date. Efforts to implement country systems have had positive effects—including considerable technical assistance related to financial, environmental, and social laws, regulations, and oversight capacity—but have not reduced the bureaucratic “hassle factor” associated with MDB operations.

More recently, the Program for Results (P4R) lending instrument was designed and approved for pilot testing on January 24, 2012 at the World Bank. P4R aimed to tackle the same problem in a different way, by having the

World Bank reimburse client countries for expenditures already undertaken, if the agreed results have been achieved. However, early evidence suggests that the same tensions that plagued the discussions on country systems are limiting the use of P4R. Numerous restrictions have been placed on the instrument at the behest of the U.S. with the support of several other non-borrowers.⁷⁶ As a result, many types of lending projects are excluded from P4R, and the instrument has been capped at 5% of World Bank lending. Further, countries will still be required to demonstrate that they are complying with safeguards equivalent to that of the World Bank. The gains of the new instrument appear questionable at best, held back once again by the refusal of non-borrowers to ease bureaucratic and safeguard restrictions. As one ministerial official in Colombia put it about P4R following a meeting with World Bank officials, “Its anachronistic, the position of donor shareholders... ‘We are going to do this to be more flexible, but then you have to complete this and complete that.’ So that means nothing. It seems like the donor shareholders are far removed from the reality of implementing a project.”⁷⁷ However, a thorough assessment of P4R is not yet possible, though the last report of the World Bank’s IEG evaluated the instrument.⁷⁸

The World Bank’s ongoing reform to its safeguard policies appears to address the criticism by many borrowers that MDB procedures have gone too far in the direction of ex-ante control.⁷⁹ The draft policy proposes taking a new approach to country systems in relation to safeguard issues. Rather than the legal and institutional framework of an entire country undergoing a lengthy and complex qualification by the World Bank, the systems specifically pertaining to each project would be assessed at the time of the project, and used if deemed acceptable to the Bank’s standards. This has the potential to utilize country systems on a case-by-case basis, and although the process is likely to be laborious at first, it could accelerate after multiple projects in a similar sector. However, as with other attempts to streamline process requirements at the World Bank, the proposed new approach faces considerable resistance from the NGO community⁸⁰ as well as non-borrower governments. A group of U.S. senators has come out against the reforms, stating that “The World Bank has drafted these proposed safeguards to become more nimble and competitive. But we believe these safeguards will hurt the World Bank’s efficiency, undermining its ability to compete with other development banks.”⁸¹ Hence, the reforms may be watered down or restricted in a similar fashion to the previous P4R and country systems, again at the behest of non-borrower shareholders.

From a developmental perspective, it is to a degree desirable that the major MDBs prioritize project quality over trying to match the speed of other sources of development finance. This is a critical part of their value-added process—carefully designing projects for maximum developmental impact. However, many of the larger MDBs have added layer after layer of processes

and requirements to achieve these ends, almost entirely driven by the domestic political considerations of major non-borrower shareholders. Many emerging and developed countries are delayed by the additional time, cost, and hassle, and prefer other financing sources. The key for MDBs is to find the correct balance between quality assurance, knowledge value added, and efficiency. Development is extraordinarily complex and requires taking risks to achieve results. The extensive ex-ante requirements imposed at the major MDBs instead encourages a risk-averse, legalistic, and process-oriented approach by staff that inhibits innovation. Creating new systems and procedures that ensure reasonable operational quality ax-ante while at the same time promoting a level of risk-taking—coupled with strong ex-post assessment to improve future operations—would be a more promising strategy from a developmental perspective.

5. Conclusions

In light of the overwhelming needs for infrastructure finance in emerging and developing economies and the limitations facing alternative flows of financing, there is a clear role of MDBs to continue and in fact step up their activities. The reasons are multiple as follows:

- The development payoff of infrastructure projects in terms of improved living standards and potential to catalyze greater economic activity and poverty reduction is tremendous.
- The nature of MDBs—as cooperative banks created by national governments—gives them numerous important operational advantages (financial and otherwise) that can be applied to effectively support infrastructure provision. This remains true today as it did when the World Bank was established in 1944.
- Due to their broad membership and scope of activities, MDBs have a unique ability to transfer knowledge of best practices in terms of efficiency, effectiveness, and sustainability—critical limitations for many infrastructure projects.
- MDBs face a differentiated risk profile compared to private sector actors, and are thus able to take on risky projects with high potential benefits, not only with their own financing but also to provide comfort to private investors, and thus leverage much greater resources in the interests of infrastructure development.

Simultaneously, existing MDBs face numerous significant constraints to their operations that limit their ability to support greater infrastructure provision. This paper has highlighted critical constraints to MDB financial management, access to capital markets, capital structure and financial instruments that combine to reduce the ability of many MDBs to take advantage of their unique financial model. Similarly, an array of business practices hampers many MDBs from effectively and flexibly delivering developmental services. Many borrower

countries are loath to accept long approval times, heavy bureaucracy, and external policy impositions, even if they value the attractive financial terms and developmental knowledge offered by MDBs.

Underlying many of the constraints described in this paper is the overriding issue of MDB governance. Many existing MDBs face important splits between non-borrower and borrower country shareholders, with the former in many cases holding dominant voting power. Non-borrowers have tended to view MDBs as useful organizations for broader developmental goals, but with a strong inclination to impose rules and policies that protect their own interests even if this may hamper MDB effectiveness. In addition, these governance tensions reduce the legitimacy with which some MDBs operate, with many countries viewing major MDBs (fairly or unfairly) as tools of the major industrialized economies. Other MDBs run by borrower nations, such as the CAF, Central American Bank for Economic Integration, or the PTA Bank in southern Africa, tend to have business practices much more attractive to borrowers, but also greater difficulty accessing financial resources and limitations of knowledge provision and quality control. A clear need exists for reforming existing MDBs and/or building new ones that are able to find the best balance between these two extremes, and maximize the positive impact of this powerful organizational model.

The history of MDBs shows that governance, finances, and operations are all inter-linked, and have the potential to be either mutually reinforcing or to create tensions that can undermine the effectiveness of an MDB. Management and shareholders of existing MDBs as well as those currently being designed should consider disregarding short-term political considerations in the interests of building institutions capable of addressing the fast-evolving requirements of 21st century development.

Endnotes

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² For a fuller discussion, see among others Spratt and Collins 2012.

³ For more on the relationship between infrastructure and development, see Prud'Homme 2005 and OECD 2006.

⁴ For more on infrastructure needs, see Bhattacharya, Romani, and Stern 2012.

⁵ McKinsey Global Institute 2013.

⁶ All data on infrastructure lending by MDBs used in this paper were compiled from the project descriptions in the statements of loan commitments in the annual reports of each MDB. (The only exceptions are the few cases where project descriptions are not available in the annual report, in which case the MDB's own aggregate data on infrastructure lending was used.) Only projects that had

at least some component of physical infrastructure were counted. Projects related to infrastructure sectors but without any actual physical infrastructure component were not counted (thus excluding, for example, sectoral reorganization, policy reform or privatization operations). As a result, the paper's data differs from the aggregate data on infrastructure lending supplied by the MDBs themselves.

⁷ See Kapur et al. 1997 for a comprehensive account of early World Bank lending policies.

⁸ Although some regional MDBs accentuated social lending more than the World Bank, even in their early years. The IADB, for example, explicitly targeted more social areas to offset the lack of World Bank funding in these areas when it first began operations in the 1960s. See Tussie 1995 and Humphrey 2014a.

⁹ For a thorough discussion of this transition, see Mosley et al. 1991.

¹⁰ For more on this issue, see Wade 1997 and Shihata 1991, 1995, and 2000.

¹¹ These eight MDBs account for the vast majority (97% in 2013) of total annual MDB investments to developing countries. Other, smaller MDBs include Central American Bank for Economic Integration (CABEI); Caribbean Development Bank (CDB); West African Development Bank (BOAD); East African Development Bank (EADB); PTA Bank; North American Development Bank (NADB); and Nordic Development Bank (NDB).

¹² See Winpenny 2003.

¹³ Private Participation in Infrastructure Database, World Bank (ppi.worldbank.org).

¹⁴ A draft update of that paper projects a gap of closer to US\$1.5 trillion annually (personal communication with authors).

¹⁵ Some of the MDBs here are allowed by their statutes to redistribute accumulated net income to their shareholder governments, but in practice MDBs invariably allocate net income to their reserves instead.

¹⁶ This is similar to contingent capital utilized by private institutions, with the difference that it is not backed up by any underlying asset (such as debt that would convert to equity).

¹⁷ Because CAF is owned by borrower countries, ratings agencies consider its callable capital to be less reliable, and hence it relies almost exclusively on paid-in capital.

¹⁸ See for example Reuters 2009 and Bloomberg 2009.

¹⁹ The AfDB did not achieve AAA status until 1990. Due to financial difficulties it was downgraded to AA+ in 1995, and did not regain AAA rating until 2003. IsDB is rated AAA and CAF is AA-. Sub-regional MDBs such as BCIE, CDB, BOAD, EADB, and PTA Bank all have lower bond ratings.

²⁰ See Mistry 1995.

²¹ See Standard and Poor's 2012 and Moody's 2013. The agencies now rate MDBs on a stand-alone basis, and give a small degree of uplift based on the quality of "shareholder support," of which highly rated callable capital is a major component.

- ²² See Mohammed 2004 and Humphrey 2014b for more on net income and reserve policies.
- ²³ The other part comes from income derived from MDB investments, which can be considerable.
- ²⁴ See Kapur and Raychaudhuri 2014 for a discussion of innovative options to credit the borrower contributions to reserve equity in the context of the IBRD, following the model of mutual banks in the United Kingdom.
- ²⁵ AsDB 2014a.
- ²⁶ The transfer is being done into reserves rather than paid-in capital to side-step issues about changing voting shares.
- ²⁷ Although in a sign of the uncertainty with which the proposal is being viewed from a financial point of view (are outstanding concessional loans as strong as cash?), the AsDB has said it will increase its equity-to-loans ratio to a minimum 37–40%, thus considerably limiting the overall impact of the equity increase on its operational capacity. One may expect that the AsDB can attempt to lower this going forward as rating agencies and certain shareholders become comfortable with the performance of the new arrangement.
- ²⁸ This chapter focuses on MDB financial restrictions at the aggregate level. However it should also be noted that MDBs face important limitations at the country level, due to country risk and portfolio concentration, which are increasingly important in the view of ratings agencies and bond buyers. Exploratory efforts are underway to consider exposure swap arrangements among MDBs to address this growing problem.
- ²⁹ See Humphrey 2014b for more on this issue.
- ³⁰ Moody's 2008, p. 4.
- ³¹ World Bank Corporate Finance interview, January 20, 2011.
- ³² IADB interview, November 15, 2010.
- ³³ This explains why CAF—with a small share of callable capital and no non-borrowing shareholders—also maintains a high E/L ratio: it would be in danger of downgrade if it lowered the ratio compared to other MDBs.
- ³⁴ For more on this aspect of the World Bank's early operational history, see Mason and Asher 1973 and Kapur et al. 1997, Vol. 1.
- ³⁵ The two main project guarantee instruments offered are partial credit guarantees and partial risk guarantees. Trade finance guarantee facilities are also available, and unlike project guarantees, these have grown very rapidly in recent years.
- ³⁶ This includes the World Bank's Multilateral Investment Guarantee Agency, which is dedicated entirely to guarantees.
- ³⁷ For more on multilateral guarantees, see Humphrey and Prizzon 2014.
- ³⁸ AfDB 2014a.
- ³⁹ IFC 2014.
- ⁴⁰ Based on an interview with the Swedish development agency SIDA, 1 October 2014.
- ⁴¹ Financial Times 2014a.
- ⁴² For more details on Africa50 see ICA 2014 and AfDB 2014b.
- ⁴³ World Bank 2014a.
- ⁴⁴ World Bank 2014b.
- ⁴⁵ Some bilateral financiers also impose similar reviews and safeguards, notably those from traditional OECD donors such as the U.S. and most European countries. Newer non-traditional bilaterals tend to have fewer requirements.
- ⁴⁶ World Bank Corporate Scorecard 2013.
- ⁴⁷ World Bank 2012a.
- ⁴⁸ Many World Bank projects are approved now on a non-objection basis, but even this requires a full month before the project is considered approved.
- ⁴⁹ AfDB 2013a.
- ⁵⁰ See World Bank Corporate Scorecard (2013) and annual development effectiveness reports of the AsDB, IADB, and AfDB.
- ⁵¹ See for example World Bank 2014c and 2014d, IADB 2011, AfDB 2012 and AsDB 2013a.
- ⁵² See for example AfDB 2013b and AsDB 2014c.
- ⁵³ A Global Environmental Facility review of safeguards at major development agencies reports that all the MDBs considered in the review (AfDB, AsDB, IADB, EBRD) fully or substantially met eight criteria related to social and environmental safeguards. The AfDB was assessed as falling short in some areas, notably indigenous peoples and natural habitat protection, pest management, physical cultural resources, and dam safety. See GEF 2013.
- ⁵⁴ According to World Bank 2010a, 72% of World Bank investment loans between 1999 and 2008 triggered environmental assessments and 30% involuntary resettlements. The remaining safeguards were triggered 1–17% of projects.
- ⁵⁵ The operational policies run to the dozens and even in some cases over 100 pages for each safeguard. For example the World Bank's Environmental Assessment safeguard comprises the policy (OP 4.01), three lengthy annexes for specific issues, a separate set of Bank Procedures that also includes two further annexes with more procedures. This is just one of 10 safeguards at the World Bank. Similarly, see the IADB's operational guidelines for its three main safeguard policies: IADB 1999, IADB 2006, and IADB 2007, and the AsDB's operational sourcebooks: AsDB 2013c, AsDB 2012a, and AsDB 2012b.
- ⁵⁶ As noted by a recent study commissioned by the German government on World Bank safeguards. See Von Bernstorff and Dann 2013.
- ⁵⁷ IFC 2012.
- ⁵⁸ World Bank 2014f, and accompanying presentation to a meeting of civil society organizations in Bern, Switzerland on 3 December 2014.
- ⁵⁹ Prizzon and Greenhill 2013.
- ⁶⁰ Interviews done by the author as part of a consultancy for the IADB in 2012–14.
- ⁶¹ World Bank 2012c.
- ⁶² World Bank 2001, p. vii
- ⁶³ *Ibid.*, p. 22.
- ⁶⁴ World Bank 2010a, p. 46.

- ⁶⁵ World Bank 2000, p. 2; World Bank 2010 p. 19; interviews with government officials in 10 Latin American countries (2012–14).
- ⁶⁶ World Bank 2010a, p. 19.
- ⁶⁷ World Bank 2001, p. 9.
- ⁶⁸ World Bank 2010a.
- ⁶⁹ Interviews done by the author as part of a consultancy for the IADB in 2012–14 as well as background work for Humphrey 2014b and 2014c.
- ⁷⁰ See, in particular, Wade 1997 and Shihata 1991, 1995, and 2000.
- ⁷¹ OECD 2012.
- ⁷² World Bank 2010b.
- ⁷³ World Bank interview April 24, 2012.
- ⁷⁴ World Bank 2010a, p. 85.
- ⁷⁵ IADB 2013d.
- ⁷⁶ This was confirmed directly to the author by the U.S. executive director in a 2012 interview.
- ⁷⁷ Interview, Colombia Ministry of Finance, 29 May 2012.
- ⁷⁸ Anecdotally, officials from Ethiopia recently reported some success with the P4R instrument in personal communication with the author.
- ⁷⁹ World Bank 2014f.
- ⁸⁰ At a meeting with civil society groups and World Bank representatives on 3 December 2014 in Bern, Switzerland, all social activist groups present (including Amnesty International, Greenpeace, Alliance Sud, and Gesellschaft für Bedrohte Völker) were vehemently opposed to the reforms, saying they would weaken environmental and social standards.
- ⁸¹ Financial Times 2014b.
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