Bottom lines, better lives?

Rethinking multilateral financing to the private sector in developing countries

March 2010
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**Acronyms used**

ADB  Asian Development Bank  
AfDB  African Development Bank  
DBIs  Doing Business Indicators  
CAO  Compliance Advisor Ombudsman (IFC)  
EBRD  European Bank for Reconstruction and Development  
EIB  European Investment Bank  
IADB  Inter-American Development Bank  
IEG  Independent Evaluation Group (of the World Bank)  
IFC  International Finance Corporation (World Bank Group)  
MDBs  Multilateral Development Banks  
SMEs  Small and medium enterprises
Since 1990, financing to the private sector by multilateral development banks’ (MDBs) – has increased ten-fold, from less than $4 billion to more than $40 billion per year. Private sector finance is now a major part of the overall portfolio of many multilaterals. As organisations that work for poverty eradication, environmental sustainability and human rights, we believe this area of MDB operations can have significant impacts in developing countries, yet is little known and under-examined.

At a time when MDBs are seeking additional public funds to bolster their capital base and expand their activities, including their private sector work, this paper critically examines their overall approach. It focuses on the extent to which the mandates and missions, norms and procedures within the private sector operations of MDBs allow them to put poverty reduction, human rights, and environmental sustainability at the core of what they do.

Focussing on six of the main MDBs, it finds a number of areas of concern, and sets out an agenda for change. This agenda is based on two widely shared principles. First, MDBs should support country-owned development plans and strategies. Second, they should focus their activities in areas where they can most directly contribute to pro-poor, sustainable outcomes.

The private sector can be a vitally important engine for sustainable development, but private companies can also have detrimental impacts on poverty, human rights and the environment. This paper finds that MDBs’ approach to the private sector and development has been controversial and not always sufficiently focussed on promoting sustainable development or reducing poverty. For example they have:

- Tended to adopt an ‘investment climate approach’ to the private sector, which has often meant prioritising attracting foreign investment rather than focussing on those private sector activities that will do most to contribute to sustainable development and build a vibrant national private sector.
- Adopted a banking model which has focussed MDB activities in areas which are already favoured by investors, rather than the sectors in which investment would reap the highest returns for sustainable development.
- Used policy advice, technical assistance and the production and dissemination of research to promote the above.

Further, the MDBs’ project selection, monitoring and evaluation procedures have tended to prioritise commercial rather than social and environmental returns. Internal evaluations have regularly found that MDBs have failed to demonstrate sufficient ‘additionality’ for their financing – meaning that they run the risk of merely replicating the activities of private financial institutions, rather than driving investment towards businesses or sectors that have the greatest benefit for sustainable development. The above and other problems mean that project selection is effectively biased against poorer countries and smaller companies. Monitoring and evaluation methodologies have also been insufficiently focussed on poverty reduction, and transparency and disclosure of information has been weak.

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The rapid growth of ‘arms-length’ financial sector investments through financial intermediaries such as private banks or private equity firms is a particular cause for concern. The failure of MDBs to clearly define the development objectives of their investments is particularly worrying in this case, where operational decisions are delegated to the financial intermediary. MDBs’ procedures have not been sufficiently adapted to intermediary financing, and this part of the MDB investment portfolios is extremely poorly monitored, based almost exclusively on self-reporting. Furthermore, there is evidence that the environmental and social performance of MDBs’ financial sector investments is consistently low.

**Time for change**

It is clear that the basis for multilateral support to the private sector needs to be fundamentally rethought. This paper proposes four key reforms.

**First,** MDBs should support democratically owned national plans and strategies, and focus their contribution on activities that maximise their impacts on poverty reduction and environmentally sustainable development. Overall they should adopt an approach that focuses on supporting a strong and diverse national private sector, tailored to specific country circumstances, rather than promoting a uniform approach which prioritises attracting foreign capital.

**Second,** MDBs should have a clear sustainable development and poverty reduction mandate, and pursue an approach to private sector development that delivers maximum benefit to the poor. This requires MDBs to be more explicit about the outcomes they are hoping to achieve through their private sector activities, for example by signing up to human rights, environmental and other international agreements. They will also need to re-examine their articles of agreement, or other legal founding documents, and rethink their approach to technical assistance (TA), including whether it is appropriate for MDBs to be developing such large TA programmes.

**Third,** MDB private sector activities should only focus on areas where development benefits are high, and where private finance is weak. This means reorienting their operations to ensure that investment decisions are made on the basis of the scale of the environmental and social returns, and adopting a strong policy and institutional bias in favour of investments in sectors and areas where sustainable development will be greatest. They should clearly identify and publicly disclose the specific development benefits before financing is committed.

**Fourth,** MDBs should rethink their approach to financial intermediaries, to support strong, locally owned institutions that are focussed on responsibly providing financial services to the poor, and supporting sustainable development. There should be clearly defined requirements that financial intermediaries must meet in order to be eligible for multilateral financing. These include having clear mandates with a focus on sustainable development and finance for the poor, as well as strong social and environmental safeguards, and acting as responsible taxpayers.

In the aftermath of the financial crisis, there have been calls to increase multilateral financing to the private sector, and the multilateral development banks are eager to expand their activities. However, this paper argues that radical reform of MDB mandates, objectives, processes and governance is needed first.
1. **Introduction**

1a  **The rapid growth of multilateral private sector finance**

Since 1990, as Figure 1 shows, financing to the private sector by multilaterals – intergovernmental institutions involved in lending and grant-making to developing countries – has increased ten-fold, from less than $4 billion to more than $40 billion per year.

This growth has increased dramatically in recent years in all multilateral development banks (MDBs, see Table 2), as Figure 2 shows, and is particularly marked at the World Bank’s private sector arm, the International Finance Corporation (IFC), whose total lending and investment more than doubled between 2003 and 2008.

Private sector finance – direct or indirect loans to or equity investments in private businesses – has also
become a major part of the overall portfolio of many multilaterals. For example, in 2008, private sector investment accounted for 30 percent of the World Bank Group’s overall financing.2

This growth in private sector finance reflects a broader trend: multilateral development banks and donor agencies have increasingly promoted private sector growth as the cornerstone of national development strategies in developing countries. Since the mid-1980s, MDBs have sought to reduce the role of the state in economic planning, and gradually expand private participation and ownership, including through assisting governments with privatization and deregulation reforms.

The financial crisis has led to a sudden and dramatic drop in flows of international finance to the private sector in developing countries, and exacerbated existing capital flight. According to the World Bank, private investment flows to developing countries dropped by more than 40 percent in 2008 as access to international financial markets dried up and portfolio equity inflows fell drastically.3 At the same time, credit markets in developing countries have suffered.

In the aftermath of the financial crisis, there have been calls to increase multilateral financing to the private sector, and the multilateral development banks are seeking to expand their activities, including the private sector activities, through additional public funding to increase their capital base. In April 2009, the G20 agreed to substantially increase the resource base of the MDBs (see Box 1). However, this paper finds that without a radical overhaul of the MDBs’ overall approach, such an expansion could risk doing more harm than good.

**Table 1:** Regions of operation of the MDBs

<table>
<thead>
<tr>
<th>Region</th>
<th>Mainly Private Sector Operations</th>
<th>Mainly Public Sector Operations</th>
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<tbody>
<tr>
<td></td>
<td>IFC</td>
<td>EBRD</td>
</tr>
<tr>
<td>Central / Eastern Europe</td>
<td></td>
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<tr>
<td>Central Asia / Caucasus</td>
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<tr>
<td>Russia</td>
<td></td>
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<tr>
<td>South / East Asia / Pacific</td>
<td></td>
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<tr>
<td>Africa</td>
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<tr>
<td>Latin America / Caribbean</td>
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</tbody>
</table>

**What are the MDBs?**

Multilateral Development Banks (MDBs) are government-backed financial institutions mandated to provide long-term capital, policy advice, and technical assistance to governments and private entities in developing countries.

In this paper, we focus on six of the main MDBs which have significant private sector activities in developing countries (see Tables 1 and 2). Of these six, two – the International Finance Corporation (IFC, the private
Table 2: Multilateral Development Banks with Private Sector Operations

<table>
<thead>
<tr>
<th>MDB</th>
<th>HQ</th>
<th>Founded</th>
<th>Staff</th>
<th>Portfolio (by region)</th>
<th>Portfolio (by sector)</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFC</td>
<td>Washington DC</td>
<td>1956</td>
<td>3,325</td>
<td>Europe/Central Asia, 28%</td>
<td>Financial Markets, 38%</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Latin America / Caribbean, 25%</td>
<td>Manufacturing, 18%</td>
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<td></td>
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<td></td>
<td></td>
<td>East Asia/Pacific, 14%</td>
<td>Infrastructure, 18%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>South Asia, 11%</td>
<td>Extractives, 11%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Middle East and North Africa, 11%</td>
<td>Agribusiness, 7%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Sub-Saharan Africa, 10%</td>
<td>Global ICT, 4%</td>
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<td></td>
<td>Global, 1%</td>
<td>PE and Funds, 4%</td>
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<td>Health / Education, 2%</td>
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<td>Subnational Finance, 1%</td>
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<tr>
<td>EBRD</td>
<td>London</td>
<td>1991</td>
<td>1,407</td>
<td>Russia, 36%</td>
<td>Financial Markets, 39%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Eastern Europe / Caucasus, 26%</td>
<td>Agribusiness, Manufacturing, property, and telecom, 26%</td>
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<td></td>
<td></td>
<td>Southeastern Europe, 21%</td>
<td>Infrastructure, 18%</td>
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<td></td>
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<td></td>
<td>Central Asia, 11%</td>
<td>Energy and extractives, 17%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Central Europe / Baltics, 6%</td>
<td></td>
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<tr>
<td>ADB</td>
<td>Tunis</td>
<td>1963</td>
<td>1,445</td>
<td>Low-income Africa, 41%</td>
<td>Financial sector, 50%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Middle-income Africa, 38%</td>
<td>Industry, 31%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Regional/Multinational, 21%</td>
<td>Infrastructure, 14%</td>
</tr>
<tr>
<td>IADB</td>
<td>Washington DC</td>
<td>1959</td>
<td>2,000</td>
<td>Country-level data on IADB’s private sector financing is not publicly available</td>
<td>Energy, 62%</td>
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<td>Finance, 16%</td>
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<td>Telecom, 10%</td>
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<td>Transport, 10%</td>
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<td>Health, 2%</td>
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<td>EIB</td>
<td>Luxembourg</td>
<td>1957</td>
<td>1,599</td>
<td>Turkey, 44%</td>
<td>Energy, 28%</td>
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<td></td>
<td></td>
<td>Sub-Saharan Africa (excl. South Africa), 8%</td>
<td>Communications, 28%</td>
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<td>Morocco, 5%</td>
<td>Credit Lines, 26%</td>
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<td>Syria, 5%</td>
<td>Water, 10%</td>
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<td></td>
<td>Egypt, 4%</td>
<td>Industry, 7%</td>
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<td></td>
<td></td>
<td>South Africa, 3%</td>
<td>Education/Health, 1%</td>
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<td></td>
<td>Brazil, 3%</td>
<td></td>
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<td></td>
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<td>Croatia, 3%</td>
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<td></td>
<td></td>
<td>India, 2%</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>Other, 23%</td>
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<td></td>
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<td>Note: For projects outside of EU. Includes both public and private sector operations</td>
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</tbody>
</table>
sector arm of the World Bank Group4) and the European Investment Bank (EIB) – are mandated to operate in more or less all developing countries. The remaining four - the African Development Bank (AfDB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), and the Inter-American Development Bank (IDB) - have mandates limited to one or more regions5 (see Table 1).

A summary of these MDBs, including their location, staff size and division of portfolio by sector and region is given shown below in Table 2. There are other regional MDBs, such as the Islamic Development Bank and the Andean Development Bank, which this paper does not cover.

The private sector operations of these MDBs fall into two broad categories. First, they borrow money on international financial markets, typically by issuing bonds, and use this to make commercial loans to or equity investments in private companies which operate in the developing world, either directly or through financial intermediaries. Given the commercial orientation of multilateral financing to the private sector, it is often forgotten that a significant part of the reason that MDBs are able to borrow cheaply from international financial markets is that they are publicly-backed by member-states, which provide their capital. Second, they provide policy advice and technical assistance to both private companies and to governments and government bodies in developing countries.

1c Purpose of this paper

This paper focuses on the extent to which the mandates and missions, overall approach, norms and procedures within the private sector operations of MDBs allow these institutions to put reduction of poverty, the protection of human rights, and environmental sustainability in developing countries at the core of what they do. It aims to contribute to the ongoing debate about the role and impacts of the private sector operations of MDBs in developing countries.

It is divided into four sections. After this first background chapter, the second section examines the mandates, missions and assumptions behind the private sector financing operations of the MDBs. The third section looks at how projects and activities are selected, implemented, monitored and evaluated. Finally the paper examines the major shift towards the use of financial intermediaries by MDBs that has occurred in recent years. There are many other important issues that this paper does not cover in detail, though they may be referred to in passing, which they are already the subject of in-depth critique by civil society organisations and others. This paper focuses therefore on the critical topics outlined above, of which two in particular stand out.

First, the governance structures of many MDBs are heavily skewed in favour of western countries. For example at the World Bank’s IFC, the EU countries and the USA control over 50% of voting shares.6 Developed countries even maintain large shareholdings in regional MDBs – the US has almost a third of the shares of the IADB, for example.7 Developing countries have no shareholding at the EIB, despite its large-scale operations in the developing world. A pre-condition for any reform to improve the effectiveness of MDBs is fundamental change to governance structures to make them more democratic, transparent and accountable to the people who are most impacted.8 It can be argued that many of the problems highlighted in this paper are the result of the undoubted influence that powerful countries wield at these institutions, and the lack of true accountability to affected communities, though this paper does not examine these issues in depth.

Second, MDB procedures or ‘safeguards’ to ensure that environmental, social and human rights issues are identified and acted upon have been the subject of frequent debate. These standards ought to be rooted in international protocols and treaties, especially in the sphere of human rights, which are legally binding on signatory states. Civil society groups and others have pushed to strengthen and improve safeguards so that internationally agreed standards and rights are upheld and strengthened.9 The importance, in particular, of the IFC’s ‘performance standards’ (safeguards) cannot be overstated, as they form the basis of the ‘Equator Principles’ by which over 70 major international banks have agreed to abide. These include commercial banks such as the Bank of America, Barclays, BNP Paribas, Citigroup and HSBC, as well as several national banks, such as the Industrial Bank of China. This paper does not explore this issue in any detail, but it is worth noting briefly that these standards contain many problematic elements. For example, the principle of ‘free, prior, and informed consent’ (FPIC) which is critical to protecting the rights of indigenous peoples and local communities in development,10 and has been adopted by 144 countries in the UN Declaration on the Rights of Indigenous Peoples,11 is not recognised in the IFC’s performance standards framework.12
Mandates and missions

Poverty reduction and sustainable development are not normally included in the articles of agreement or other legal documents that set out the role and mandate of MDBs. However, all MDBs have adopted mission statements that in general terms commit them to promote sustainable development and reduce poverty in developing countries (see Box 2). The question of which private sector activities can best contribute to this mandate is explored in section 2b below. In some cases, such as the EIB, these objectives are part of a broader mandate, that may include potentially conflicting priorities - the promotion of European companies in the case of the EIB, for example.14

However, these missions are open to wide interpretation and are rarely spelled out in any detail, which can lead to a lack of focus on achieving sustainable pro-poor outcomes, or even negative outcomes (see Box 3). It is beyond the scope of this paper to set out precisely what outcomes MDBs should focus on, but two principles should underpin the development of far clearer sustainable development missions for the MDBs’ private sector operations. First, they should support, not undermine democratically owned national plans and strategies. Second, they should focus their contribution to national efforts on activities that maximise their impacts on poverty reduction, supporting the poorest and most marginalised and environmentally sustainable development, and should uphold internationally agreed norms and standards. We will briefly examine each principle in turn.

In order for MDBs’ private sector activities to effectively contribute to sustainable development outcomes, they will need to support country-owned development plans and strategies. Ensuring a vibrant, socially aware private sector that contributes to sustainable development is no easy task, and the best strategies will vary from country to country. There is no ‘one size fits all’ approach, and for MDBs to be effective

Box 2

Mission Statements of the MDBs: a summary

The IFC’s purpose is to create opportunity for people to escape poverty and improve their lives by:

- Promoting open and competitive markets in developing countries
- Supporting companies and other private sector partners where there is a gap
- Helping to generate productive jobs and deliver essential services to the underserved.

The EBRD supports projects in central Europe to central Asia. The EBRD’s statute obliges it to promote, in the full range of its activities, environmentally sound and sustainable development. Investing primarily in private sector clients whose needs cannot be fully met by the market, the Bank aims to foster transition towards open and democratic market economies. It aims to follow the highest standards of corporate governance and sustainable development.

The IADB partners with countries to combat poverty and promote social equity through programmes tailored to local conditions. Working with governments as well as with the private sector and civil society, it seeks to promote sustainable economic growth, increase competitiveness, modernise public institutions, and foster free trade and regional integration.

The ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people.

The overarching objective of the AfDB is to spur sustainable economic development and social progress in its regional member countries, contributing to poverty reduction. It achieves this by mobilizing resources for investment; and providing policy advice and technical assistance.

The EIB participates in implementing the Union’s development aid and cooperation policies. It operates in the candidate and potential candidate countries in South-East Europe, non-member Mediterranean countries. In addition, it operates with separate regional mandates for Asia and Latin America, and for the African, Caribbean and Pacific (ACP) States, South Africa and the OCTs (Overseas Countries and Territories), where it promotes environmental sustainability and energy security, and the development of basic infrastructure and the local private sector to promote economic growth and wider benefits respectively.
partners, they will have to ensure that their activities support, not replace or direct, national efforts. In the absence of such coordinated, country owned efforts, it is unlikely that MDBs’ private sector activities will have a positive impact on sustainable development, particularly in the medium to longer term. In so far as MDB activities can undermine such national efforts – for example by supporting policies or activities that do not align with national policies – they can also have negative impacts on the development process. The importance of country ownership to development has been recognised in many international agreements, including the Paris Declaration on Aid Effectiveness in 2005 and subsequent 2008 Accra Agenda for Action on aid effectiveness to which all the MDBs in this study have signed up.21 As a coalition on Aid Effectiveness in 2005 and subsequent 2008 international agreements, including the Paris Declaration on Aid Effectiveness in 2005 and subsequent 2008 Accra Agenda for Action on aid effectiveness to which all the MDBs in this study have signed up.21 As a coalition on Aid Effectiveness in 2005 and subsequent 2008 Accra Agenda for Action on aid effectiveness to which all the MDBs in this study have signed up. As a coalition on Aid Effectiveness in 2005 and subsequent 2008 Accra Agenda for Action on aid effectiveness to which all the MDBs in this study have signed up.

Therefore multilaterals and other development actors should be seeking to support nationally and regionally owned institutions that can play many of the roles currently played by MDBs, such as directing publicly backed finance for the private sector, providing effective policy and technical advice and engaging in lesson learning across countries. Over time, this is likely to lead to a reduction in the role and scope of international bodies. It will also mean that existing national and regional bodies will have to be improved, for example in their governance, accountability and safeguards.

As MDBs are always likely to be small players compared to overall private sector activity and financing, they should focus their activities in areas where they can most directly contribute to pro-poor sustainable outcomes. This will require MDBs to be more explicit about the outcomes they are hoping to achieve through their private sector activities. It would make sense for these to be based on contributing to the achievement of internationally agreed norms and targets. In theory, the various safeguards and performance standards that some of the MDBs have adopted ought to reflect these norms. However, far from setting out the principles and outcomes that should guide all activities, they tend to adopt an ‘end of pipe’, reactive approach, attempting – though not always succeeding – to prevent bad outcomes.

It worth noting that there is a sound basis in international

Bottom lines, better lives?

Box 3

Ignoring environmental impacts?
The EIB’s finance for the Gilgel Gibe projects

By helping to finance the controversial Gilgel Gibe hydroelectric projects in Ethiopia, the European Investment Bank and African Development Bank have raised questions as to whether they focus sufficiently on the development benefits of projects, or ensure adequate accountability and transparency.

The African Development Bank is lending $250 million to help finance the $1.4 billion Gibe III dam. The EIB, having previously provided €50 million for the Gilgel Gibe II hydroelectric plant, is considering involvement in Gibe III via a murky ‘shadow appraisal’ that evades the usual accountability mechanisms. This below-board approach echoes violations of national procurement laws which have taken place in both projects: the construction contracts were awarded to Italian corporation Salini without tender.

Moreover, the developmental benefits of the projects have been called into question. The World Bank has expressed concerns about the sustainability of the financial burden that they impose on Ethiopia. NGOs CounterBalance and International Rivers have pointed out that the projects are not driven by the need to expand access to energy. The power generated will far exceed domestic demand and is destined for export – though arrangements for that remain unclear.17

The MDBs’ support for the projects also shows disregard for their direct social and environmental impacts. Campaigners warn that fragile ecosystems, which support the livelihoods of half a million people, will be destroyed. According to Mamadou Goita, director of the Institute for Research and the Promotion of Alternatives in Development in Mali, “The Gibe III dam violates the African Development Bank’s own policies on environmental and social assessment, poverty reduction, resettlement, public disclosure, and water management.” In a critique of the environmental and social assessment, the African Resources Working Group (ARWG), a group of international academics with ties to Ethiopia, wrote that “The quantitative [and qualitative] data included in virtually all major sections of the report were clearly selected for their consistency with the predetermined objective of validating the completion of the Gibe 3 hydro-dam.” The MDBs’ engagement therefore sends damaging signals about the type of ‘development’ that they are willing to support.
law for the MDBs to adopt international standards and to hold their client companies accountable for these. The International Court of Justice has stated that: “international organisations are subjects of international law, and as such, are bound by any obligations incumbent upon them under general rules of international law.” For example, the Universal Declaration of Human Rights is considered customary international law, and is therefore binding upon international organisations. In addition, MDBs are able to assume the obligations of international agreements, or become party to them. As MDBs are inter-governmental bodies, a strong case can also be made that they should therefore embrace all international human rights and environmental obligations of their member governments.

Furthermore, there is an evolving consensus on the human rights standards that companies should be held accountable for, reflected in the mandate of the UN Special Representative on human rights and transnational corporations and other business enterprises. He has explicitly stated that companies should respect all rights upon which they have an impact, a point that should be reflected in the standards that MDBs apply to companies.

2b Approach to the private sector

Before we examine the approach that the MDBs take, it is worth emphasising four things. First, the private sector is a critical contributor to development in almost all countries of the world. Private businesses can create decent jobs, supply essential goods and services, contribute to sustainable management of natural resources, and provide tax revenues. Small and medium enterprises can make up a significant share of private sector activities in many developing countries, and can provide the majority of jobs.

Second, however, not all businesses or sectors have an equal development impact, and some can have negative consequences. For example, the extraction of natural resources, particularly oil, can in certain circumstances contribute to the ‘resource curse’ by harming the economy through, for example contributing to Dutch disease, and undermining political systems through encouraging rent-seeking behaviour and corruption. Private sector activities can also have severe environmental and human rights consequences for local communities (see Box 4).

Third, it is clear that the growth of different sectors of the economy will have different development impacts. For example, in many developing countries, the agricultural sector is the major provider of livelihoods, and sustainable growth can have knock-on impacts on the rest of the economy. For example, in Zambia, studies suggest that each additional dollar of farm income creates an extra $1.50 of income outside agriculture.

Finally, the performance of individual companies varies widely in terms of their attention to the social and environmental consequences of their activities, and their provision of decent work for their employees.

Therefore, though there is widespread agreement that one key to successful development is the nurturing of successful national private sectors, how this should be done will always be the subject of debate, and effective approaches will vary. For example, there is no ‘correct’ level of direct involvement of the government in the economy. Different countries, at all levels of development, have widely differing approaches to the scale and type of public enterprises, provision of subsidies or protection for domestic industries. In general terms, however, the public sector tends to play a far larger role in the provision of basic services, with no country for example, achieving universal basic education without heavy involvement of the state. Cooperatives also make significant contributions in many countries.

MDBs have tended to adopt an ‘investment climate approach’ to the private sector, which has often meant prioritising attracting foreign investment rather than focussing on those private sector activities that will do most to contribute to sustainable development and build a vibrant national private sector. A recent paper by Christian Aid explains that the investment climate approach “analyses policy from the perspective of investors and prescribes a package that aims to create the right business environment for investment.”

In practice, however, this means that MDBs, particularly the World Bank have focussed on attracting foreign direct investment (FDI), even though the “basic assumption – that FDI is good for development and, therefore that more of it is better – is dubious because studies have shown that FDI can undercut or stifle development.” They have prioritised the needs of foreign investors even though “there is evidence that the investment climate is less significant in attracting FDI than other factors, such as market size, GDP, growth rate, available resources and existing infrastructure.” In practice, Christian Aid argues, this leads to a standardised approach to policy making, not one tailored to country needs, and “continues to liberalise investment regimes despite developing country opposition.”

The MDBs’ approach has also tended to focus on reducing direct public involvement in the economy, even though, as noted above, there is no universally accepted ‘correct’ level of public involvement, and many developed countries maintain large public enterprises, particularly in the service sector. For example, the ADB argues that moving public assets to the private sector frees up government resources for other purposes even
Flaunting safeguards, following markets:
The IFC’s loan to Bertin

The IFC’s problematic involvement with Bertin, a cattle corporation operating in the Amazon, shows the perils of not focussing on sectors that are likely to have strong social and environmental returns.

The IFC approved a $90 million loan to Bertin in 2007, but terminated its support prematurely two years later, withholding the final $30 million instalment. The IFC stated that it had hoped to raise standards within an industry notorious for illegal deforestation and human rights abuses, but eventually withdrew investment once it recognised that the project would fail to do so.

However, critics argued that the IFC should never have embarked on the project. The IFC’s capacity to promote positive environmental practices was not clearly proven: less than two-thirds of Bank projects in Brazil over the ten years to 2008 achieved a satisfactory level of compliance with its environmental policies. Supporting an industry that the IFC accepts is a key driver of deforestation in the Amazon was therefore highly risky.

The IFC also ignored its own environmental requirements for high-carbon projects, despite Bertin’s massive greenhouse gas emissions, according to a report by US NGO, the Sierra Club, released before the project was approved. Further concerns were raised about the environmental and social impact assessment produced by Bertin, which the Sierra Club argued was incomplete and inadequate. This was particularly grave given that the IFC was aware of “potential issues associated with Bertin’s suppliers … including deforestation, slave labour, land title fraud and rural violence.”

Civil society groups cautioned that, regardless of the IFC’s involvement, the industry was incapable of the transformation the IFC envisaged. Trevor Stevenson, director of the environmental network Amazon Alliance, said that cattle-ranching is “not an appropriate activity for the Amazon region, where it is not a sustainable practice.” The IFC, however, has been unwilling to modify its “conviction that market based solutions have a role to play in helping conserve the Brazilian Amazon.”

In order to fulfil their missions and ensure a focus on achieving sustainable outcomes that improve the livelihoods of the poor, MDBs’ niche should be to support enterprises or sectors with the highest development impacts. For example, there should be no reason to use publicly-backed financing to invest in fossil-fuel based energy sources that perpetuate the problem of climate change and lock countries into the use of these resources for decades. A more sensible focus would be on using relatively scarce resources to help change energy sectors towards clean technologies.

Policy advice and technical assistance (TA)

The influence of MDBs over government policy and attitudes to the private sector in developing countries is strong and growing. MDBs are increasingly providing policy advice to governments on how to regulate the private sector. In particular, the IFC has expanded its “advisory services” dramatically, with an active portfolio approaching $1 billion and employing 1,262 staff – a sevenfold increase in the last seven years.
The IFC’s evaluation unit suggests that it should aspire to take a leadership role in coordinating the approach toward private sector development among donors. The main purpose of this activity is to promote investment climate reforms that support private sector development. In the IFC, advisory services staff now make up the majority of its presence in the field in developing countries. Similarly, the EBRD engages in dialogue with publicly-owned companies to support privatization, restructuring of state-owned firms and improvement of municipal services. The policy advice given by MDBs can be highly controversial. For example, a recent report from US NGO Oakland Institute links increases in ‘land grabbing’ – the acquisition of land, often by private investors or wealthy nations, in developing countries in order to produce crops for export – to advice from the IFC and its Foreign Investment Advisory Services (FIAS).

In many cases, policy and corporate advice is provided cost-free to recipients through the use of donor funds. A number of studies have found that providing technical assistance (TA) as a ‘free good’ severely weakens the ownership by recipients of the advice received. A comprehensive study on technical assistance (TA) by the OECD Development Assistance Committee for its 2005 Development Cooperation Report found that TA programmes have come under repeated criticism for being too costly, inappropriate to recipients’ needs, or fostering dependency. As Sakiko Fukuda-Parr, a professor of International Affairs at The New School and author of numerous reports on TA has commented, “technical assistance has been notorious in failing to build capacity because as an instrument it is precisely taking ownership away from developing countries. At the core of the problem is that the power relationship embedded in TA contradicts ownership.” Consideration should therefore be given to whether it is appropriate for MDBs to be developing such large TA programmes – a better alternative would be to support national or regional providers, or to allow recipients to select the assistance they require rather than providing MDB assistance free of charge.

The production and dissemination of research and data meant to inform government policy often comes with ideological strings attached. In particular, the IFC’s Doing Business indicators (DBIs) act as a rating system which is hugely influential, affecting both donors’ and investors’ attitudes towards developing countries, and thereby influencing government policy. However, Doing Business has attracted frequent criticism for advocating a country ranking system that rewards less regulation, regardless of whether it results in more efficient or simply inadequate labour laws. In response, in 2009 the IFC decided to eliminate its ‘employing workers indicator’ and review its ‘paying taxes indicator.’

However, in practice this resulted in little change in the 2009 report, with countries such as Georgia praised and given a better ranking for abolishing their social taxes, Belarus gaining a good score for making it easier to fire people, and conversely, as the International Trade Union Confederation pointed out, Cambodia was said to be “making it more difficult to do business” because it introduced a social security contribution.

Such uniform evaluation methodologies ignore whether each indicator is applicable to particular countries, and the extent to which countries at different stages of their development may want to pursue different public policies. For example, the DBIs are also based on an assumption that foreign direct investment always promotes poverty reduction, irrespective of sector or broader institutional conditions. The United Nations Conference on Trade and Development (UNCTAD) and others have shown that there are in fact a number of factors which determine whether the macroeconomic effects of FDI are positive or negative.

The increasing role MDBs play in providing advice and shaping policy in developing countries opens the door to potential conflicts of interest. This is because they are giving policy advice on matters that may influence the financial performance of companies they are invested in. There is often a close link between the return on investment and the nature and implementation of government policy. In turn, policy changes may affect the commercial profitability of firms with which MDBs have commercial relationships, or increase the potential for new investment opportunities.

For example, the AfDB is a supporter of the African Legal Support Facility, which provides policy advice to governments on how to negotiate better deals with companies in the extractive industries, while also providing direct financing to such companies. Similarly, some donors promote MDB trust funds in areas that they have a commercial interest, such as Norwegian and Dutch support for shipping-related funds, and Spain’s contribution to renewable energy reforms in Pakistan. It is highly problematic for a multilateral institution to position itself as an objective source of policy advice on matters where it has a direct financial stake in the outcome, particularly in low-income countries that may not have the resources to procure advice from other sources, or in countries where weak democratic processes do not provide adequate checks and balances relative to external donors. The introduction of internal guidelines...
Project selection, monitoring and evaluation

or ‘Chinese walls’ to prevent such conflicts of interest are unlikely to be a sufficient counter-weight to the incentives in favour of opportunistic advisory work that positively impacts investments.

3a Selecting projects

In general terms, MDBs argue that private sector operations can be successful in promoting their respective missions if investments satisfy four general principles. They should:

• Have a positive financial performance which is commonly measured in a satisfactory risk-adjusted rate of return;
• Have a positive economic performance, which means generating new employment opportunities and other positive spill-over effects for local businesses;
• Supplement and mobilise private capital, not compete with it;
• ‘Add value’ by diffusing high management standards and new technologies, improving corporate governance, and promoting corporate responsibility.

In practice the first of these principles – the need to produce a satisfactory rate of return – often dominates. This exaggerates the basic assumption of the above principles: that successful businesses in general are likely to have positive development impacts, rather than focussing on those businesses and sectors with the highest development returns.

Project selection criteria and procedures in MDBs do not sufficiently prioritise development outcomes. This problem is reinforced by key mechanisms including: the proposal-driven approach, low benchmarks for ‘additionality’, and a lack of explicit focus on setting development objectives.

First, the natural consequence of selecting projects on the basis of submitted investment proposals from private companies is that project selection is strongly influenced by the capital demands of growing markets, and less so by a sector or project’s potential to generate significant and direct positive impacts for the poor.

The proposal driven approach can potentially have serious consequences:

• At the micro-level, it may discriminate against smaller companies that do not have the resources, capacity, time or knowledge to submit an investment proposal for multilateral financing. Many of these may be indigenous enterprises strongly embedded in local, rural economies.

• At the macro-level, it is prone to be pro-cyclical and susceptible to inflating investment bubbles, as investment volumes follow and reinforce market trends, rather than counteract them or correct market failures. Over the long-term, pro-cyclical lending increases volatility and systemic risk.

Second, while a commitment to only financing economic activities that the private sector is unwilling or unable to finance is embedded in the mandates of all MDBs, much multilateral financing to the private sector barely passes this test. For example, MDBs provide advisory services to middle-income countries, even though these are markets flush with private consultancy firms. The ADB’s evaluation unit has noted in relation to investments in private equity funds that “there is a lack of evidence demonstrating significant value addition as ADB has continued to target traditional products such as late-stage regional SME funds and funds operating in relatively developed countries such as India and the PRC [People’s Republic of China] where the size of the private equity market has grown exponentially.”

A 2008 study by the Independent Evaluation Group (IEG) of the World Bank examined the question of ‘additionality’ – how much value the IFC adds to private financing. It found that the IFC’s understanding of additionality was based more on assumptions than evaluated results. It found that only a third of projects exhibited either ‘operational additionality’ – through improving a project’s design or functioning – or ‘institutional additionality’ – improving standards of corporate governance and environmental and social sustainability.

Third, the broader development objectives of a project are rarely clearly identified in any detail or publicly disclosed before financing is committed. This is particularly important for financial sector investment where the added value of multilateral financing may be difficult to identify. Evidence from self-evaluation forms routinely produced by project teams suggest that there is often a lack of clarity as to which broader development objectives they are meant to achieve. In 2004, a study produced the IADB’s own evaluation unit concluded that “there is a pressing need [for] better communication and management of expectations, and a spelling out of what the implicit “comfort” that comes
with Bank involvement can and cannot do. It is safe to assume that if the project team responsible for preparing and implementing the project does not know what the broader development objectives are, the client does not either. While some MDBs (notably the IFC and the EBRD) have made some improvements to internal analytical tools for these purposes, evaluation studies make clear that the setting of clear development objectives (beyond financial performance) and monitoring progress during the implementation stage is often lacking.

Investment operations in MDBs are commonly organised in sector departments in charge of identifying and preparing projects within a particular industry. Each project is managed by an investment officer (or task manager) in charge of a project team, which often has only limited expertise in assessing the broader development impacts of projects. The practice of co-locating legal, environmental, and social specialists within banking teams can contribute to a ensuring a broader perspective in project selection. However, there are generally few incentives that compel investment staff to decide against a particular investment that is financially viable but nevertheless not worthy of support because it does not generate high levels of broader developmental benefits.

Furthermore, existing project selection and evaluation criteria do not seem to account for the fact that profitable private sector projects can sometimes have an adverse effect on democratisation, environmental sustainability and social inequality. It is true that a private sector venture that loses money is unlikely to create sustainable jobs and make long-term investments that benefit local communities. However, profitability is no guarantee of achieving a positive development impact. For example, a profitable multinational venture benefiting from the ‘comfort’ of MDB support (in the form of political risk mitigation and additional private capital) may attain a competitive advantage in the market relative to domestic producers, thereby stifling rather than stimulating competition.

Finally, MDBs structure their financing in ways that is likely to induce private participation, by for example mitigating political risks and only financing a small share of total project costs. Inevitably this often leads to an approach that ‘follows’ the market, rather than focussing on areas where development outcomes are highest. This is not to suggest that MDBs should not seek to induce additional private investment and raise the standards of that investment, but if this is made the primary goal, as it often is, this can lead to MDBs focussing in areas where private investment is likely to be high anyway, rather than encouraging investment in areas with lower investment, but where development returns will be higher.

**The above problems and other incentives within MDBs mean that project selection is effectively biased against poorer countries and against smaller companies.** This was a key finding of the World Bank’s Independent Evaluation Group (IEG) Annual Review of Development Effectiveness 2008, which found that “internal staff and management incentives favour large projects, such as infrastructure or power.” According to the IFC, projects in smaller low-income countries tend to require less capital (with the exception of extractive industries), have higher administrative costs, be operated by less experienced private companies, and be associated with more risks during project construction and operation. For MDBs that are sensitive to keeping administrative costs low and the financial performance of projects high, these characteristics are not attractive. Similar to commercial banks, MDBs like repeat customers for efficiency reasons, which creates a bias against small-scale projects in remote regions.

For example, in a review of its financing between 1990 and 2003, the EIB found that while the indicative programme for risk capital in the Africa, Caribbean, and Pacific regions guaranteed a minimum service for each country, the “final geographical breakdown of its projects was clearly biased towards ‘bankable’ countries in the Caribbean and Southern Africa.” According to the IFC, projects in middle-income countries reached the best ratings, whereas only half of those located in the low-income countries of the Middle East, North Africa, and Sub-Saharan Africa met or exceeded specified benchmarks and standards, although with “some slight improvement.”

MDBs tend to favour large projects with high total capital costs and low risk, as they are more likely to be operated by well-established private companies with strong financial track records, have a higher resource mobilization potential, and be more likely to generate a large number of jobs in the short-term. Perversely, they also help MDBs demonstrate ‘additionality,’ as the size of the investment means that is unlikely local capital markets will be able to finance it. While large projects can generate significant development benefits, small projects are often more appropriate and effective, for example, in meeting basic needs in rural areas. Moreover, the IFC’s own evaluation unit found that the superior performance of large projects is in part because they receive greater scrutiny during operational review.

Rectifying these problems will require a significant change in MDBs, including re-examining their attitudes to and assessment of project risks. For example, investment in smallholder agriculture is crucial for poverty reduction, yet may sometimes be high risk; it is unlikely to be serviced by financing models that depend overly on commercial assessments.
A better approach would be to focus on supporting national and local economic activity, through supporting small and medium enterprises, including cooperatives, and only selectively supporting larger enterprises, including public enterprises where appropriate. Support to larger enterprises should be focussed where development benefits will be very high, taxes are paid without attempts to evade or avoid them, and high environmental and social standards are adhered to. It would also mean focussing where need was greatest. Typically, private sector investment may be expected to be lower in, for example, countries with smaller domestic markets, low per capita income, or high levels of state fragility.

**3b Monitoring and evaluation**

**MDB methodologies for reporting and tracking project performance rarely use indicators that directly correlate with poverty reduction, such as access to basic services among the poor.** This is, of course, a complex and difficult issue. General figures on employment creation or local business activity, often used by MDBs, are important and useful, but imperfect in identifying whether the poor benefitted from these positive externalities. As a result, it becomes difficult to assess the poverty-reducing impact of particular projects, or a portfolio of projects. In fact, if project benefits flow disproportionately to people who in relative terms are well off, or if projects adversely impact some groups, positive employment and economic figures may in fact disguise an overall negative impact on the poor. In particular, it is always important to disaggregate impacts by gender, as women and girls who usually make up a majority of the poor, are often ignored or excluded in traditional evaluation frameworks and are regularly the most negatively impacted.

While project monitoring and evaluation have improved in terms of developing standard indicators and tracking these systematically in some MDBs, such as the IFC, serious problems remain with practices and methodologies (see Box 5). Specifically, the extensive reliance on desk-based reviews of reports generated by professionals who have a personal stake in the content of those reports necessarily undermines the integrity of the evaluation process. It is indicative that the most frequent criticism of this self-reporting system made in the MDBs’ own evaluations is that they are incomplete, meaning that relevant sections have not been duly filled out.

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**Box 5**

**Outsourcing development?**

**The ADB’s private equity funds**

The Asian Development Bank’s (ADB) finance for private equity funds exemplifies the pitfalls of investments through financial intermediaries in the absence of adequate monitoring of social and environmental impacts.

Private equity funds are a key component of the ADB’s private sector development strategy, with ADB funds investing in approximately 400 companies, according to a recent report. Despite the scale of these investments, there appears to be very little, if any, monitoring of the impacts of these companies’ activities. An internal audit found that while the ADB is tasked with providing oversight of investment proposals to ensure they comply with its social and environmental safeguards, the Bank “does not provide any material input once the investment is committed. There is no risk-rating system in place for social and environmental impacts ... or independent monitoring of compliance with requirements once PEF investments are approved.”

In addition, the auditors found that “there is a lack of data on development, environmental, and social impacts at the investee level.” Fund managers do not appear to be reporting on the environmental and social impacts of investee companies.

The lack of effective monitoring is particularly worrying given the risky sectors in which some investees are active. For example, the ADB committed $20 million to the private Asia Clean Energy Fund in 2008, which was intended to help leverage a total investment of $200 million. Planned investments by the fund include bio-diesel in Indonesia, incinerator plants in Korea, and palm oil projects in south east Asia. Palm oil developments have been linked to human rights violations, such as forced land seizures, and indigenous peoples have been particularly badly affected. Acute environmental concerns also surround the carbon emissions of such projects and their impacts on wildlife. The International Finance Corporation suspended investments in palm oil in 2009 because of investee breaches of World Bank social and environmental safeguards.

Authority to determine whether investments will infringe the rights of indigenous peoples, cause involuntary resettlement or environmental damage, and to make plans for affected peoples, has often been delegated to private equity fund managers – though there is nothing to indicate that they have the expertise necessary to do so. Unsurprisingly then, internal evaluations show that developmental returns from the ADB’s private equity investments are low.
To ensure that projects conform to operational priorities and enable constructive evaluation exercises, most MDBs have developed internal analytical tools that require investment officers to set project objectives a priori, and once completed, produce a report on whether they have been achieved. But crucially, much internal results tracking is based on documentation produced by the investment teams that have a personal stake in project success. Civil society organisations have called for the monitoring, evaluation and complaints procedures for projects to become independent of the MDBs, ensuring significant stakeholder input particularly from affected communities.72

**Transparency**

MDBs have a poor record on transparency and disclosure of information, particularly for private finance activities. With financial sector investments, the public availability of information about the eventual beneficiaries of multilateral funds is even poorer, in part because the MDBs themselves do not systematically gather it. MDBs frequently cite that a client’s ‘commercial confidentiality’ prevents them from disclosing key project-related documentation, such as lending contracts and periodic monitoring reports. However, there is a serious potential conflict of interest here. MDBs are attempting to support ‘bankable’ projects and therefore have an interest in not demanding too much transparency of their clients, for fear of complicating or jeopardising their relationships. Transparency is critically important to affected communities but as MDBs’ agreements with private sector clients are secret, movements during operation are not divulged so even in cases where the MDB may have attempted to raise standards, no one outside can know if compliance criteria agreed upon have been met. This conflict can only be resolved through clear, explicit commitments to transparency on the part of MDBs. MDBs should develop reporting templates and disclosure rules that allow maximum transparency. For example, it should be possible to redact genuinely confidential third-party information from financing contracts that is of little use to stakeholders, while still disclosing the majority of information, including broader terms and conditions upon which financing is disbursed. Specific guidelines and support should be agreed for small enterprises, to ensure that transparency requirements do not impose any undue burdens on them.

The Global Transparency Initiative has developed a global transparency charter that clearly sets out the standards that all multilateral should follow in this area, including automatic disclosure of information with a limited regime of exceptions, a right to request information with a clear appeals procedure and informed participation in decision-making by those affected by decisions.79
This study has not focussed on complaints or other formal accountability procedures, though their absence, or incompleteness and difficulty of use continue to be major concerns.80

The growth in multilateral financing to the private sector has included a surge in ‘arms-length’ financial sector investments, which are investments conducted by financial intermediaries, with little involvement of the MDB in project selection or monitoring. There are two main types. First, investments in private equity funds and multi-donor funds that buy shares in businesses in developing countries. Second, credit lines to commercial banks which then lend it on to private companies, including small and medium-sized enterprises. The modalities for this kind of finance are shown in Box 6.

**Growth of ‘arms-length’ financial sector investments through financial intermediaries accounts for a large share of the recent increase in multilateral financing to the private sector.** The IFC’s committed portfolio of financial sector investments has grown sevenfold in the last five years, from $1.7 billion in 2004 to $12.3 billion in 2008, with the number of projects doubling.81 Between 1994 and 2006, its financing in support of SME growth in “frontier countries” alone (characterized as either low-income or high-risk) expanded from $33 million to $497 million.82 Similarly, the ADB had a committed portfolio of 40 private equity funds with a total approved value of $676.4 million by the end of 2007, 50 percent of which have been approved since 2003.83

The rationale for this surge was to service private companies in sectors and regions that do not have direct access to multilateral financing, lower the administrative cost of finance, and support the development of financial markets and institutions in developing countries. More broadly, operational strategies that focus on financial sector investments are based on the notion that developing countries need strong and robust financial markets to protect themselves against external shocks, and to respond efficiently to demands for credit and finance from local businesses. While the goal of building local savings and investment is laudable, it is not immediately clear that MDBs are the best vehicles for this, particularly as there are a number of areas of concern with how MDBs have used financial intermediaries in practice.

**The failure of MDBs to clearly define the development objectives of their investments is worrying given the delegated nature of arms-length finance.** Whereas direct financing involves a single financing contract associated

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**Box 6**  
**Intermediary Finance**

In this financing arrangement, the multilateral development bank,

- Provides capital – either in the form of debt or equity - to a financial intermediary, which invests the funds in multiple sub-projects.
- Does not predetermine the exact use of funds beyond stipulating broad geographic and sectoral parameters.
- Does not itself select, appraise, or monitor the private companies that ultimately receive its funds, as these tasks are delegated to the financial intermediary.
- Requires financial intermediaries to periodically report on the financial performance of sub-projects and notify any serious breaches of environmental and social standards.

with a single project, intermediary finance involves multiple investments over a long time-scale. To achieve the returns demanded by shareholders, fund managers and loan officers often adjust their investment strategies according to changes in the market environment. Therefore, not only does the corporate structure of a private equity fund or a commercial bank prevent a single shareholder or debt-financier from prescribing the exact use of funds, it also becomes challenging for MDBs to predict deal flows and evaluate the development impact of the investment. Despite this, MDBs tend to take a "hands-off" approach to financial intermediaries. In the case of the ADB and EIB, evaluation studies found significant weaknesses in the way investments are justified and measured.

The analytical tools and methodologies used to evaluate the development outcomes of direct financing projects cannot be easily applied to intermediary financing, leaving serious gaps in MDB procedures. While the IFC and the EBRD have given more attention to financial sector investments in recent revisions of environmental and social lending policies, there is a real sense that this financing modality is ill-suited to meeting the standards for information disclosure, development results tracking, and accountability expected of MDBs. Whereas investment officers are obliged to produce and publicly disclose project documents during the appraisal stage that identify what the project is expected to achieve, financial intermediaries do not disclose such information. In some cases, a lack of analytical tools and internal capacity prompts MDBs not to demand information on the development impact of sub-projects at all. The ADB noted that there is no independent review of financial intermediaries after financing has been approved, making it difficult to assess environmental and social performance.

Considering the large amount of multilateral financing provided to financial intermediaries, this part of the MDB investment portfolios is poorly monitored and is based almost exclusively on self-reporting. Financial intermediaries are not typically required to provide information on sub-projects beyond customary data on financial performance and assurances that sub-projects comply with environmental and social standards. In 2003, a major evaluation study by the IFC’s Compliance Advisor Ombudsman (CAO) found that the IFC had lost sight of the development impact of sub-projects during the rapid growth of its financial sector portfolio. In 2008, a study by the Independent Evaluation Group of the World Bank concluded that little had changed: "IFC’s environmental and social management capacity and approach for financial institutions has not kept pace with the increase in funding during the last five years."

Monitoring has been found to be particularly lacking at the ADB, whose investments in private equity funds have surged in recent years. A recent internal evaluation found that "there seems to be no regular internal ADB assessment, reporting, or focussed management of reputational, environmental, or other nonfinancial risks [for investments in Private Equity Funds]." The EIB noted that unsuccessful projects in its Global Loans Programme were often associated with "weak monitoring of financial intermediaries, particularly after allocation, as well as arrangements for using interest subsidies that are too complex and whose application was not properly monitored."

The activities of various financial sector capitalisation programmes – undertaken by MDBs in response to the financial crisis – are very unclear. Both the IFC and the EBRD will administer large funds on behalf of donor governments. Beyond statements saying that programmes will facilitate equity purchases in banks, many of them foreign-owned, there is little information on which criteria will be used to determine the destination and size of bail-out funds, and on what terms and conditions.

There is evidence that the environmental and social performance of financial sector investments by MDBs is consistently low. According to the World Bank’s Independent Evaluation Group (IEG), the overall environmental and social performance of IFC’s financial sector investments has in recent years declined. Low performance was most apparent among financial sector investments in Sub-Saharan Africa. This was attributed to weak environmental and social commitment and management capacity by financial intermediaries, and poor reporting of the environmental and social effects of subprojects. However, poor capacity cannot always be attributed to resource scarcity. Given that half of the IFC equity investments in “frontier countries” are with larger financial intermediaries which have assets over US$1 billion, a 2008 IEG evaluation argued that there is little reason for them not to have developed adequate internal environmental management systems, including a designated staff person to conduct rudimentary environmental and social due diligence and monitor sub-project performance.

Evidence from MDBs also suggests that the financial performance of financial sector investments has been mixed at best. The EBRD observes that while the financial performance of investments in financial institutions has tended to lag behind that of its direct-lending portfolio, it has in recent years caught up. Relative to equity...
investments, 51 percent of companies and financial institutions in which IFC bought a stake between 1990 and 2002 ended up having a negative financial return, the primary criteria for selecting projects. As for the ADB, an evaluation study of private equity funds found the financial performance of funds financed by the ADB to have “been low and highly skewed.”

One way of resolving the above problems would be for MDBs to only invest in financial intermediaries that are, by their very nature, likely to have high development impacts. Again, this approach would recognise that not all financial intermediaries are the same. Some are more likely to support small and medium enterprises, work in areas where development impacts are higher, or have high social and environmental standards or community links as part of their business model. Subsidiaries of foreign banks sometimes prefer to work with foreign companies or with the larger and better established local ones, while local banks may be more open to increasing their exposure to smaller indigenous businesses. In some instances, this approach has already been adopted, where MDBs have invested in micro-credit institutions, rural credit institutions and so on. For example the EIB can set specific guidelines for intermediaries which may exclude certain sectors, require intermediaries to provide long term loans only, restrict the maximum size of sub-loans so as to ensure access for smaller firms, or require intermediaries to apply certain environmental and social standards. However, this approach is not yet the mainstream of MDB activities in this area.
It is clear that the basis for MDB lending to the private sector needs to be fundamentally rethought. Two principles should be the foundation for change. First, MDBs should support, not undermine democratically owned national plans and strategies. Second, they should focus their contribution to national efforts on activities that maximise their impacts on poverty reduction and environmentally sustainable development, and should uphold internationally agreed norms and standards. To do this they should support the development of nationally and regionally owned institutions that can adopt many of the roles currently played by MDBs. This will mean helping existing national and regional bodies to improve themselves, for example in their governance, accountability and safeguards. Over time, this is likely to lead to a reduction in the role and scope of international bodies.

In the short term, the following changes would help to ensure that the private sector operations of MDBs have a better impact on reducing poverty, protecting human rights and sustaining a healthy environment in developing countries.

Ensure MDBs have a clear sustainable development and poverty reduction mandate, and pursue an approach to private sector development that delivers maximum benefit to the poor. This will require MDBs to be more explicit about the outcomes they are hoping to achieve through their private sector activities. It would make sense for these to be based on contributing to the achievement of internationally agreed norms and targets. To do this they should:

- Re-examine their articles of agreement, or other legal founding documents, to ensure that they orient the institution towards supporting sustainable development and poverty reduction in the countries in which they operate. This will cause particular problems for the EIB, which has two contrasting objectives – supporting external countries and promoting European business interests. In the short term, the simplest way to prevent these objectives conflicting would be to hive-off EIB operations in developing countries, and transfer them to a different institution, with a clear development mandate.

- Publicly recognise that they are subject to international law and standards, and accountable to citizens of the countries in which they operate for upholding these. A clear first step would be to sign up to all international human rights, environmental and other relevant agreements.

- Rethink their approach to technical assistance (TA), including whether it is appropriate for MDBs to be developing such large TA programmes – a better alternative would be to support national or regional providers, or to allow recipients to select the assistance they require rather than providing MDB assistance free of charge.

- Adopt an approach that focuses on supporting a strong and diverse national private sector, tailored to specific country circumstances, rather than promoting a uniform approach which prioritises attracting foreign capital.

Ensure that MDB private sector activities only focus on areas where development benefits are high, and where private finance is weak. To do this they should:

- Reorient their operations to ensure that investment decisions are made on the basis of the scale of the environmental and social returns. Achieving a positive financial return should become treated only as a minimum pre-condition for investment. This will require a significant change in MDBs, including re-examining their attitudes to and assessment of project risks, abandoning the strategy of ‘following the market,’ and not relying on a project-driven model. It will also mean urgently reviewing policies, incentives, structures and procedures to ensure that any bias against investments in smaller, poorer countries, and in small and medium sized companies are removed.

- Adopt a strong policy and institutional bias in favour of investments in sectors and areas where sustainable development will be greatest. They should also seek to promote private sector development in areas where development benefits are high but which financial markets regard as too long term, risky or profitable enough. This would mean, for example, not financing fossil fuel energy and focussing instead on clean, renewable energy.

- Clearly identify and publicly disclose the specific development benefits before financing is committed. Methodologies for reporting and tracking project performance rarely use indicators that directly correlate with poverty reduction, such as access to basic services among the poor. In particular, it is always important to disaggregate impacts by gender.

- Sign up to the Global Transparency Initiative’s global transparency charter.
Rethink their approach to financial intermediaries, to support strong, locally owned institutions that are focussed on responsibly providing financial services to the poor, and supporting sustainable development.

- It is likely to be more effective to work through financial intermediaries to provide financial services to the poor, and to those SMEs whose activities are likely to help reduce poverty. Supporting the development of locally owned institutions which have poverty reduction and sustainable development as part of their mandate and core objectives will also strengthen national financial sectors so that they ensure that financial services are available to the poor, and to companies with strong development benefits to their activities.

- However, unless financial intermediaries are carefully chosen, and meet clearly defined requirements, there can be little guarantee that their activities will benefit the poor or promote sustainable development. Therefore, MDBs should have a clear set of criteria that financial intermediaries must meet in order to receive funding. These should include:
  
  - Having sustainable development, or providing services to benefit the poor as their core goals. For example, certain cooperatively owned financial institutions with clear ethical principles exist or could be supported in many countries.
  
  - Having clear environmental and social safeguards, based on international norms for all their lending.
  
  - Acting as responsible taxpayers by complying in both letter and spirit with the tax laws and regulations of the country.99
References

1 International or regional inter-governmental agencies such as the World Bank or African Development Bank.
4 There is one other part of the World Bank Group that has important private sector impacts, but which is not covered by this paper: the Multilateral Investment Guarantees Agency (MIGA). MIGA provides insurance against political risks for private companies in developing countries.
5 The European Investment Bank (EIB) is an EU institution and predominately provides financing to EU member states. Its governance structure and financing operations are therefore quite different, also reflected in the fact that the EIB employees must be nationals of one of the member states and be fluent in at least two or three of the EU’s official languages. As a result, it is not commonly referred to as an MDB alongside these other institutions. But given the growth of its non-EU investment portfolio, including private sector investment, it has been included in this discussion paper.
8 Important principles for reforming governance structures applicable to all MDBs are set out in the South Centre paper Reform of World Bank Governance Structures (2007).
10 It is also embedded in several international conventions such as the Convention on Biodiversity.
11 It states, “no relocation shall take place without the free, prior and informed consent of the indigenous peoples concerned and after agreement on just and fair compensation and, where possible, with the option of return.” The Declaration on the Rights of Indigenous Peoples was adopted by the General Assembly on Thursday September 13, by a majority of 144 states in favour, 4 votes against (Australia, Canada, New Zealand and the United States) and 11 abstentions (Azerbaijan, Bangladesh, Bhutan, Burundi, Colombia, Georgia, Kenya, Nigeria, Russian Federation, Samoa and Ukraine).
12 The EBRD, though including FPIC in its environmental and social policy, defines it in extremely limited terms – all that is required is community ‘involvement’ – see http://www.bicusa.org/en/Article.10943.aspx.
14 For example the EIB’s mandate in Asia and Latin America, in part includes a mission to include EU presence in the region by for example augmenting investment from European companies.
17 Ibid.
18 ‘International Rivers (2010) ‘Ethiopia dam suffers tunnel collapse days after inauguration.’’
21 http://www.oecd.org/document/22/0,3343,en_2649_3263698_56074966_1_1_1_100, html.
24 Where the export of natural resources leads to an overvalued exchange rate, harming exports in other sectors of the economy, and making imports cheaper.
30 IFC statements cited in: ibid.
34 IFC (2006) Environmental and Social Review Summary: http://www.ifc.org/ifcext/siwebsite1.nsf/2bc34f01f50f6ee85256a55007f9f1c/ e5db8b7f12d0b28b52733000a7545.
36 Email communication with IFC staff.
43 Evaluation studies frequently state that country strategy papers are not influential enough, or not always used to set project-level priorities. Instead, projects are identified according to market demand for IFC financing, and then the project rationale is made to ‘fit’ with the priorities set in the country strategies.


47 Its website contains numerous handbooks that provide guidance on how to communicate the benefits of such reforms and monitor and evaluate progress, as well as advice on how to reform business licensing processes and providing environment, health, and safety advice to businesses.


49 EBRD website, “About the EBRD”, http://www.ebrd.com/about/index.htm

50 http://www.oaklandinstitute.org/pdfs/LandGrab_final_web.pdf


52 Development Cooperation Report 2005, OECD DAC, pII - http://www.oecd.org/doc/unstdstats/Annex/Un3343.i3343.i3343_en_2649_13721_3605283_5_1_1_1_100.html#TOC

53 http://www.brettonwoodsproject.org/art-561813


56 http://www.brettonwoodsproject.org/art-565367


58 For example, the EBRD found that “negative government behaviour” is often associated with unsuccessful projects in infrastructure, illustrating the significance of a stable policy environment for commercially-oriented projects. (Annual Evaluation Overview Report for 2008, European Bank for Reconstruction and Development, June 2008)


60 All IFC administered funds.

61 The combination of the sluggish pace of project processing and high analysis costs is a major barrier to entry for those sponsors (usually local) which do not have the financial strength to make it through to the end, as well as a serious constraint for prospective smaller-scale projects. From this standpoint, transaction costs are directly impacting the pursuit of the mandate received from the Governors in 2001 to scale up activity in the Group C and D countries. (see, Evaluation of the Bank’s Direct Private Sector Lending Program, 1995-2003 (RER-03), Office of Oversight and Evaluation (OVE), Inter-American Development Bank (IDB), Washington DC, December 2004)


65 For example, at the ADB, the lack of transparency in its Private Sector Operations Department about the precise objectives of investments in private equity funds makes it difficult for anyone to exercise oversight to ensure that projects conform to the ADB’s mandate. In 2004, an evaluation study produced by the of the ADB’s private sector operations concluded that “there is a pressing need for instance, for a more rigorous way to assess performance with any certainty until the fund has established a track record.” (Independent Evaluation of IFC’s Development Results 2008 - Knowledge for Private Sector Development, Independent Evaluation Group, World Bank Group, p.31.)

66 http://go.worldbank.org/X4WTA0R1U0

67 For example, in explaining weak performance among non-telecommunications IT projects funded by IFC, its evaluation unit argues that most of them were small operations involving inexperienced sponsors and unclear product competitiveness. (see, Independent Evaluation of IFC’s Development Results 2009 - Knowledge for Private Sector Development, Independent Evaluation Group, World Bank Group)


70 It may therefore not be surprising that during the ADB’s surge in private sector financing between 2000 and 2007, average project size increased 60 percent from $90 million to $150 million. (Annual Report 2007, Asian Development Bank (ADB), Manila, Philippines, 2007.) Similarly, an evaluation of IFC’s portfolio identified “a concentrated move by IFC towards larger projects”, which tend to be operated by established market players and be export-oriented. (Independent Evaluation of IFC’s Development Results 2009 - Knowledge for Private Sector Development, Independent Evaluation Group, World Bank Group)


72 For example, Bretton Woods Project (2009): ‘Are we nearly there? Bridging UK supported funds and a post 2012 climate architecture.’


75 Fried (2009)


78 Fried, 2009

79 www.ifitransparency.org

80 See for example http://www.brettonwoodsproject.org/art-4436


84 Relative to its Global Loans Program directed at SMEs, the EIB noted that while “the major objective of financing SMEs has been achieved: small enterprises are poorly represented in the portfolio financed by the Bank, in particular because commercial banks prefer larger clients, which have a better risk profile.” (Operations Evaluation Overview Report 2006 - EIB financing in the ACP countries under the Lomé IV Convention, Operations Evaluation, European Investment Bank, 2006)

85 As the EBRD notes in an evaluation of a private equity fund investment, “post-evaluation of private equity funds cannot assess performance with any certainty until the fund has established an investment in...
eval/ldfi.pdf)

At the ADB, the lack of transparency in its Private Sector Operations Department about the precise objectives of investments in private equity funds makes it difficult for the Board to exercise any oversight to ensure that projects conform to the ADB’s mandate (Private Equity Fund Operations, ADB Evaluation Study, Operations Evaluations Department, Asian Development Bank, (Reference Number: SST: REG 2008-17), July 2008). The EIB’s Global Loans were assessed to poorly evaluate the potential of investments during the project preparation phase, resulting in many investments where the financial intermediary is unable to disburse sufficient funds because of a lack of demand for them in the market place. (Operations Evaluation Overview Report 2006 - EIB financing in the ACP countries under the Lomé IV Convention, Operations Evaluation, European Investment Bank, 2006)

Already in 2003, a major review of how the IFC applies its environmental and social lending policies (the Safeguard Policies) to financial sector investments noted that “The rapid growth of the proportion of the portfolio in financial intermediaries has outstripped IFC’s capacity to conceptualize an effective Safeguard Policy system for financial intermediaries. (A Review of IFC’s Safeguard Policies, IFCS’s Compliance Advisory Ombudsman (CAO), January 2003, p.7)


A Review of IFC’s Safeguard Policies, IFCS’s Compliance Advisory Ombudsman (CAO), January 2003, p.44.


The same ADB evaluation noted that the “hands-off approach to investment decisions and difficulties in defining investment restrictions in the fund agreements created problems on a number of occasions with style drift, where the fund manager does not pursue the original investment strategy outlined in the Report and Recommendation to the President and the private placement memorandum, and provided the basis for the Board’s approval of the investment.” (Private Equity Fund Operations, ADB Evaluation Study, Operations Evaluations Department, Asian Development Bank, (Reference Number: SST: REG 2008-17), July 2008)


http://www.brettonwoodsproject.org/art-
564833


The EBRD notes that financial sector projects have outperformed projects in other sectors in recent years, as 86 per cent of projects evaluated in the period from 2004 to 2007 achieved a ‘satisfactory or better rating’ for financial performance. (Annual Evaluation Overview Report for 2008, European Bank for Reconstruction and Development, June 2008)

The nominal financial internal rate of return for private equity fund investment through 2007 was 7.5 per cent, compared to the ADB’s average required rate of return of 14.5 per cent. It noted that “unless investors... were with a top performing manager, evidence indicates that better returns would have been achieved investing in bonds.” (Private Equity Fund Operations, ADB Evaluation Study, Operations Evaluations Department, Asian Development Bank, (Reference Number: SST: REG 2008-17), July 2008)

The OECD has set out guidelines for multinational enterprises on taxation, which could easily be adapted for use by MDBs. OECD Guidelines for Multinational Enterprises, 2007 – http://www.oecd.org/daf/ine/ mnel2000doc.pdf/LinkTo/dafe-ime-
wpg(2000)15-final