At issue: Bottom lines, better lives?
Rethinking MDB finance to the private sector

As multilateral development banks receive large injections of public money, their controversial approach to supporting the private sector in developing countries should be under the spotlight. A fundamental rethink is needed, to stop prioritising the needs of foreign investors, and instead focus on delivering maximum benefits for the poor.

Private sector finance is now a major part of the overall portfolio of many multilateral development banks (MDBs). MDBs are intergovernmental agencies, such as the World Bank's International Finance Corporation (IFC). Their capital is provided by public funds and their lending activities are backed by governments. They wield considerable influence in developing countries, not just through their lending, but through the policy prescriptions they promote, the technical advice they provide and the sway they have over other key actors, such as donor agencies from rich countries. Nowhere is this influence more palpable than in their attitude towards the private sector, yet their controversial activities in this area, though growing rapidly, are rarely examined.

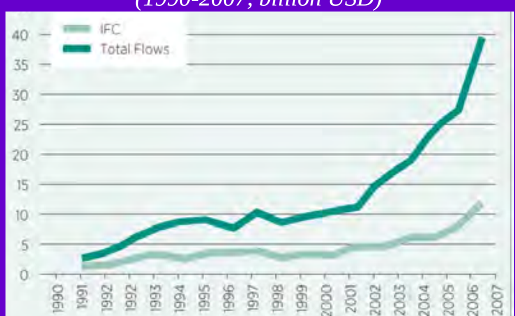
Since 1990, financing to the private sector by MDBs has increased ten-fold, from less than $4 billion to more than $40 billion per year.

The private sector is a critical contributor to development in almost all countries of the world. Private businesses, including small enterprises, can create decent jobs, supply essential goods and services, contribute to sustainable management of natural resources, and provide tax revenues. They can, however, have damaging effects too. So which businesses are promoted by powerful actors, and how they behave, matters enormously. What kind of business models do MDBs favour?

Attracting foreign investment

Unfortunately MDBs' approach to the private sector and development has not always focussed on promoting sustainable development or reducing poverty. They have tended to adopt an 'investment climate approach' to the 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 focused 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." Christian Aid argues that this leads to a standardised approach to policy making, not one tailored to a country's needs, and "continues to liberalise investment regimes despite developing country opposition."

Multilateral finance to the private sector
(1990-2007, billion USD)



Source: IFC Annual Report 2008, p. 29

The MDBs' approach has also tended to focus on reducing direct public involvement in the economy, even though 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 one MDB, the Asian Development Bank, argues that moving public assets to the private sector frees up government resources for other purposes, even though privatisation schemes can substantially increase public expenditure, as private operators shift social costs to governments and demand risk guarantees in exchange for their private capital.

MDBs have also adopted a banking model which has focussed activities in areas which are already favoured by investors, rather than the sectors in which investment would reap the highest returns for sustainable development. In determining which projects are selected, both the country assistance strategies drafted by MDBs in consultation with governments and their environmental and social lending policies are commonly much less influential than commercial potential. Of course it is important for businesses to be commercially successful in order to survive, but this should be treated as a minimum pre-condition, with MDB investment decisions made on the basis of the scale of the environmental and social returns.

Influencing policy

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 seven-fold increase in the last seven years. In the IFC, advisory services staff now make up the majority of its presence in the field in developing countries. Similarly, the European Bank for Reconstruction and Development engages in dialogue with publicly-owned companies to support privatisation, 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 on 'land grabbing' – the acquisition of land, often by private investors or wealthy nations, in developing countries in order to produce crops for export – links its rise to advice from the IFC and its Foreign Investment Advisory Services (FIAS).

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 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 said to be "making it more difficult to do business" because it introduced a social security contribution.

Project selection

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. This was a key finding of the World Bank's Independent Evaluation Group (IEG) *Annual Review of Development Effectiveness 2008*. It 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 the small-scale projects in remote regions that may have the greatest impact on poverty reduction. Monitoring and evaluation methodologies have also been insufficiently focussed on poverty reduction, and transparency and disclosure of information has been weak.

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 installment. The IFC stated that it had hoped to raise standards within an industry notorious for illegal deforestation and human rights abuses, but withdrew investment once it recognised that the project would fail to do so.

However 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. The IFC's withdrawal came soon after a Greenpeace investigation revealed that Bertin's suppliers were still destroying protected parts of the Amazon. 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, which was released before the project was approved.

Arms-length finance

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. There are two main ways in which MDBs work with financial intermediaries. First, they may make investments in private equity funds and multi-donor funds that buy shares in businesses in developing countries. Second, they may offer credit lines or equity investments to commercial banks which then lend the funds on to private companies, including small and medium-sized enterprises.

The IFC's portfolio of financial sector investments has grown seven-fold in the last five years, from $1.7 billion in 2004 to $12.3 billion in 2008, with the number of projects doubling. Similarly, the Asian Development Bank had a committed portfolio of 40 private equity funds with a total approved value of $676.4 million by the end of 2007, 50 per cent of which have been approved since 2003.

Whereas direct financing involves a single financing contract associated 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 this prevent a single shareholder or debt-financier from prescribing the exact use of funds, it also becomes challenging for MDBs to track investment flows and evaluate the development impact of the investment. Despite this, MDBs tend to take a 'hands-off' approach to financial intermediaries.

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 MDBs' investment portfolios is extremely poorly monitored, relying 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. There is no shortage of good ideas. First, it is clear that 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, a much clearer focus on their real 'bottom line' – the reduction of poverty – would help enormously. 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. It also means investing in areas which private finance might find too risky, or not have the skills to support.

The logical conclusion would be for MDB private sector activities to only focus on areas where development benefits are high, and where private finance is weak. They should clearly identify and publicly disclose the specific development benefits before financing is committed. MDBs should also 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. It is clear that radical reform is needed first.

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