Center for Global Development

Growing Business or Development Priority?

Multilateral Development Banks' Direct Support to Private Firms

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CGD Brief

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Direct support to private firms in developing countries constitutes a large and growing share of multilateral development banks' financial activities. This trend contrasts with the advice MDBs gave developing countries until a decade ago to privatize or liquidate the development banks supporting private firms, or to transform them into nonbanking development agencies. Opinion has changed since then, especially after development banks successfully intervened in the recent financial crisis. In this brief, Guillermo Perry assesses whether arguments in favor of such MDB direct support are valid and whether MDBs are living up to priorities coherent with such arguments. He finds that they do so only partially. His recommendations include deepening MDB support to small and medium enterprises, reducing the procyclicality of MDB lending, increasing the share of MDB loans and guarantees to private firms that are made in domestic currencies, and paying more attention to firms in infrastructure and social sectors and to those introducing new products, exports, or technologies.

Public Money for Private Firms: A Growing Business

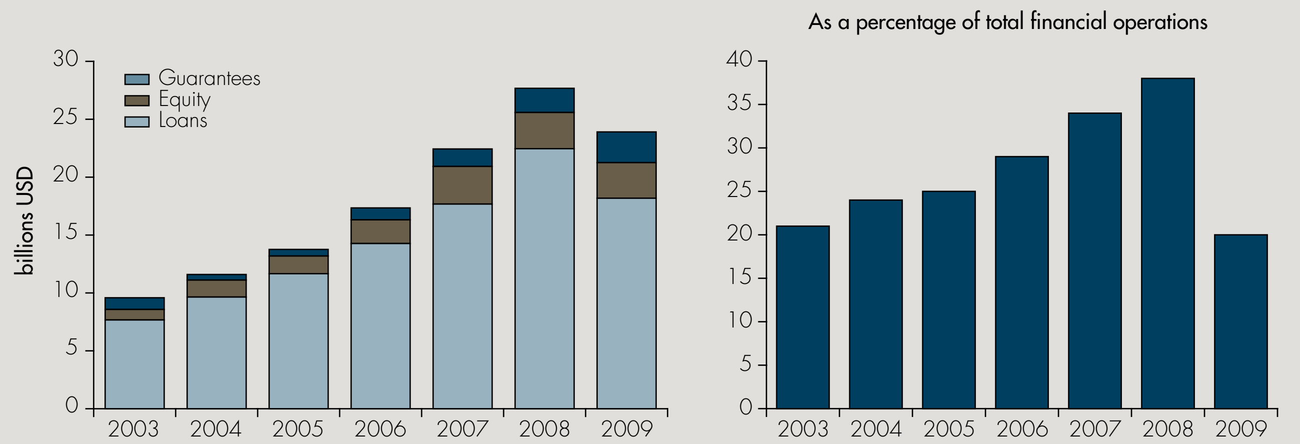
Lending to, investing in, and guaranteeing private firms constitute a large and growing share of multilateral development banks' financial activities. They made up around 35 percent of total financial operations of multilateral development banks (MDBs) in developing countries in 2008, up from below 20 percent before 2002.[1] They dropped in 2009 while support to governments increased sharply because of the global crisis, but their shares are increasing again and are expected to continue to do so (see figure 1).

This trend is in sharp contrast to the advice MDBs gave to developing countries until a decade ago against using public national development banks to lend directly to private firms. They argued that the public banks that were lending to private firms in developing countries were almost always failing in their supposed development role since their portfolios were, in the best of cases, very similar to those of private banks. Not only was public money subsidizing large firms and well-to-do households and inhibiting private financial markets from developing, public banks portfolios often became large fiscal liabilities because of poor governance and outright corruption. Most MDBs therefore recommended privatizing, liquidating, or transforming these institutions into nonbanking development agencies.

This brief is based on a CGD report by Guillermo Perry, former chief economist of the Latin America and Caribbean region of the World Bank and now a non-resident fellow at the Center for Global Development. CGD is grateful for contributions from the Norwegian Ministry of Foreign Affairs in support of this work.

1. I include here the International Finance Corporation, the European Bank for Reconstruction and Development, the African Development Bank, the Asian Development Bank, and the Inter-American Development Bank. Totals are through four different "windows": the Inter-American Investment Corporation, the Multilateral Investment Fund, the Corporate and Opportunities for the Majorities departments of the IADB, and the Corporación Andia de Fomento. I exclude the European Investment Bank and other MDBs that lend mostly in developed countries. The figures include financial operations for public enterprises and subnational governments without sovereign guarantees since they have financial characteristics similar to those of private firms.

Figure 1. MDBs' Financial Operations with Private Firms in Developing Countries



Note: Includes equity investments, guarantees, and loans of IFC, EBRD, ADB, AfDB, CAF, and the IADB group.
Source: MDB Annual and Financial Reports.

Now, there are two potential arguments in favor of MDB direct support to developing country private firms, which tend to be financially constrained and subject to major financial risks. First, such support may help firms overcome their financial constraints and better manage their risks, leading to increased investment, growth, and poverty reduction.

Second, support for many firms in sectors such as health, education, and public infrastructure or for activities related to environmental protection and innovation, including the development of new products and exports, could produce additional advantages through positive spillovers to other firms and activities.

Since the recent financial crisis, thinking about national development banks has changed somewhat, especially after their successful countercyclical interventions. However, given the increasing importance of these operations in multilateral banks' activities, now is the right time to ask whether the arguments in favor of MDB direct support to private firms are living up to their claims. Further, are these institutions supporting firms efficiently and with the appropriate financial and nonfinancial products? Are they doing it at the right time? Is the development impact of MDB direct support to private firms similar to or greater (in the margin) than that of MDB support to governmental efforts to enhance the investment climate and improve institutions and policies for domestic financial sector development?

Box 1. Seven MDB Priorities

1. Lending to and investing in firms in countries with less developed financial markets
2. Helping micro, small, and medium enterprises access external funds
3. Supporting the development of domestic financial intermediaries
4. Supporting firms engaged in public infrastructure, education, health, environmental protection, and innovative activities
5. Offering mostly long-term loans and risk capital (or guarantees that help access such markets)
6. Lending in domestic currencies to firms in nontradable sectors and offering contingent and structured debt instruments and risk management products
7. Lending and investing countercyclically

A Tentative MDB Scorecard

Most MDBs have explicitly adhered to seven priorities derived from the two arguments presented above (see box 1). I offer below a tentative assessment of how well they are performing in these areas.

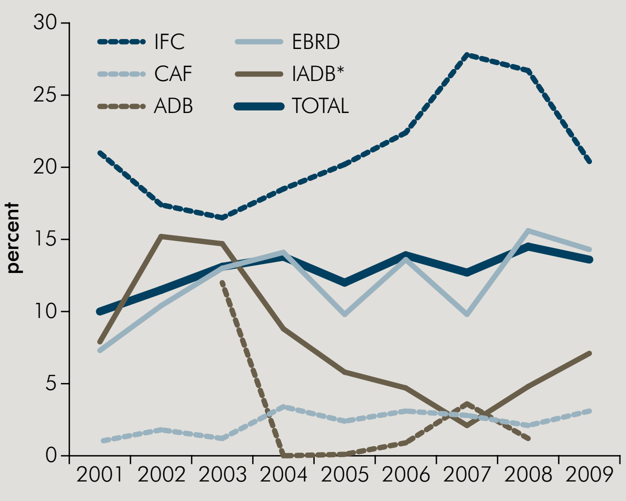
Lending to and investing in firms in countries with less developed financial markets

MDBs have identified supporting firms in countries with less developed financial markets as a priority because such firms are presumably more financially constrained, but most MDB lending to private firms still goes to middle-income countries (MICs) with more developed financial markets. Nonetheless, support to firms in low-income countries (LICs) represent's a higher share (and increasing until 2008) of their respective countries GDP; that is, the relative "intensity" of support to firms in LICs has been higher than in MICs. Among MDBs, the African Development Bank (AfDB), has the largest share of its operations in support of private firms in LICs, which is to be expected because a larger fraction of its constituency is composed by low-income countries.

Helping micro, small, and medium enterprises access external funds

Previous studies have found micro, small, and medium enterprises (MSMEs) to be more financially constrained than large firms. While MDBs have been introducing a variety of programs and instruments to enhance access to finance for MSMEs, most of their private sector portfolios are still highly concentrated in large firms. Direct support to numerous, widely dispersed MSMEs is too difficult and too costly. MDBs have instead directed most of their support through intermediaries. They invest in, lend to, guarantee, or advise local and regional financial and nonfinancial agencies that in turn invest, lend, guarantee, or deliver nonfinancial services to MSMEs.

Figure 2. Share of Private Sector Operations in Favor of MSMEs



*IADB annual value of loans for SMEs excludes indirect financing.

Source: EBRD's Annual Reports, IFC's Annual Portfolio Performance, and CAF and IADB information to the author.

MBD data indicate that somewhat less than 15 percent of total direct support has gone, either directly or through financial intermediaries, to MSMEs, with a slightly increasing trend. The International Finance Corporation (IFC) appears to be the only MDB with a significant share in the MSME segment of private firms. Its share peaked at nearly 25 percent in 2008 (see figure 2).

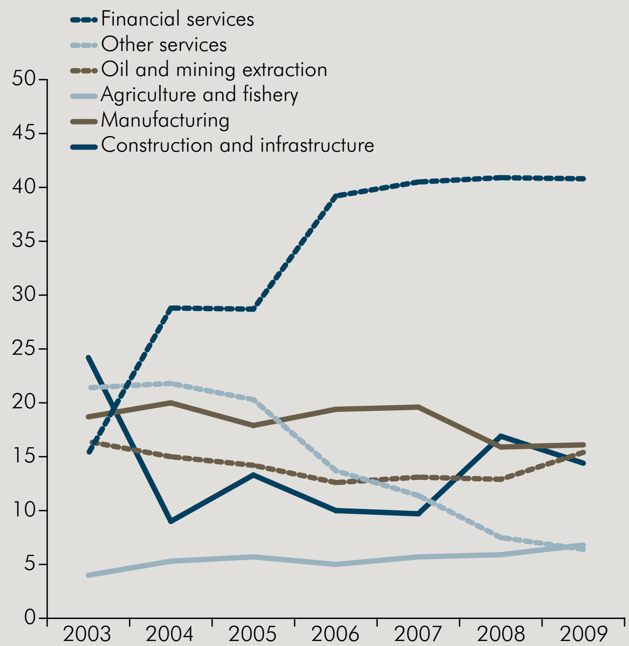
Supporting the development of domestic financial intermediaries

MDB lending to and investments in private firms have been increasingly concentrated on financial intermediaries. The Asian Development Bank (ADB) is an exception; it has concentrated more on firms in the infrastructure sectors (see figure 3). Supporting intermediaries can help build deep and broad domestic financial markets so that firms in developing countries can eventually overcome their financial constraints and gain access to risk management products. Some of these operations appear to have made major contributions to domestic financial development, especially those that have helped introduce new types of financial instruments and agencies. But a more in-depth inquiry is needed to assess with greater certainty how well MDBs are meeting this objective.

Supporting firms engaged in public infrastructure, education, health, environmental protection, and innovative activities

Direct support for firms engaged in public infrastructure, education, health, environmental protection, and innovative activities is thought to have positive development externalities. The share devoted to private operations in public infrastructure, with the exception of the ADB's, has been small, although it increased slightly in 2008 and 2009. Direct support to private firms in social services has been negligible. Support to environmental activities has been increasing, especially through advisory services but also through lending for clean energy projects and carbon finance deals. On the basis of available information, it is difficult to judge how much MDBs have supported innovating firms and the development of new products and exports. In sum, supporting sectors or activities with presumably high spillovers gets mixed marks.

Figure 3. Distribution by Sector of MDB Loans to Private Firms in Developing Countries (Percent)



Source: MDBs Annual and Financial Reports.

Offering mostly long-term loans and risk capital (or guarantees that help access such markets)

Firms in developing countries are especially constrained in access to long-term debt and risk capital. As one might expect, MDB loans to private firms have been mostly those with long maturities,[2] but the share of equities and guarantees has on average been quite small (figure 1). Only the IFC has had a significant level and growth in both equity and guarantee operations. The European Bank for Reconstruction and Development has also significantly increased its equity operations. However, more emphasis in equity investments and guarantees is needed in most MDBs.

Lending in domestic currencies to firms in nontradable sectors and offering contingent and structured debt instruments and risk management products

Lending in domestic currencies helps firms avoid currency risks for small and medium enterprises (SMEs) and firms in infrastructure and other nontradable sectors, but such loans and guarantees have only been around 10 percent of MDB lending to private firms in recent years (see figure 4). Only IFC and ADB reached a significantly higher share in 2008, although it was reduced sharply in 2009. Offering risk management products has been insignificant in most MDBs.

This is clearly a serious shortcoming, with two main causes. First, the highly risk-averse culture of MDBs has led them to avoid currency balance sheet exposures, a practice that limits their role in lending in domestic currencies (or in offering currency derivatives) to that of an intermediary to firms in countries that already have developed domestic currency markets.[3] In other words, firms in countries that most need this kind of support have been left without it.

Second, significant benefits from currency risk diversification can only be obtained with global pools. Only IFC is well placed among MDBs to keep and manage a global portfolio of developing countries' currency risk. Its MATCH program was designed to increase lending in domestic currencies in "frontier markets," taking advantage of diversification benefits associated with global risk pooling. Unfortunately, currency correlations increased significantly during the last crisis and IFC suspended this program. The suspension leaves TCX, a currency hedge fund promoted by the Netherlands Development Finance Company (FMO) that counts several of the MDBs as its investors and beneficiaries,[4] as the major initiative in this area today.

Lending and investing countercyclically

Lending and investing countercyclically helps relieve financial constraints that are deeper and broader during slowdowns and recessions and in periods of low liquidity in international financial markets, but aggregate MDB lending appears to have been strongly procyclical during the last decade.[5] ADB and AfDB have been partial exceptions. Equity investments were also procyclical, although less so, and guarantees showed an upward trend independent of the economic cycle and the situation of private international markets—a most welcome development.

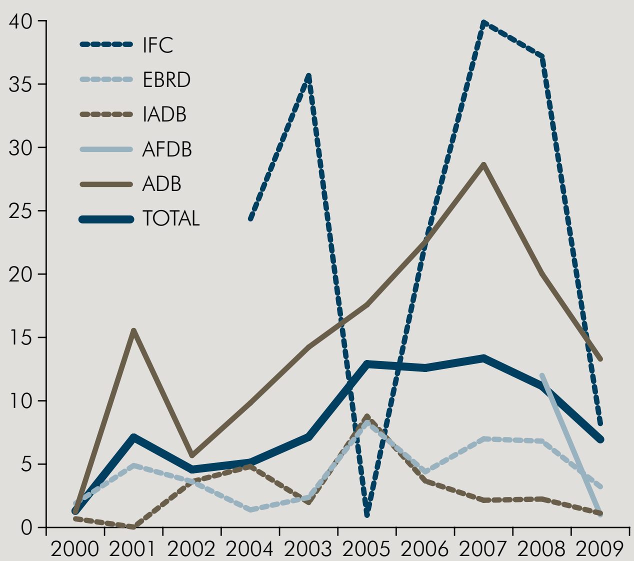
2. From seven to eight years on average for IFC, EBRD, and IADB. This average is somewhat lower for CAF, as an important part of its portfolio with private firms is represented by short-term treasury loans to local banks.

3. In such cases, MDBs lower the cost of firms to access currency derivatives by separating currency and credit risk and by keeping the latter on its books.

4. TCX is a currency hedge fund that swaps to domestic currencies the foreign currency loans that its members (which include EBRD, AfDB and IADB) extend to developing countries; that is, TCX takes the currency risk and members keep the credit risk. In addition, IFC and the World Bank are supporting the development of currency markets through an investment fund (GEMLOC) that seeks to attract new foreign investors to frontier markets. This initiative also provides benchmark indexes and technical assistance to country authorities.

5. As measured by the correlation between the cyclical component of MDB lending values and the cyclical component of either clients' GDP growth or private capital inflows, as is the standard practice.

Figure 4. Loans in Local Currencies as a Percentage of Total Loans



Source: IFC, CAF, EBRD, and IABD information to authors; AfDB: Mid-term review of the 2008–2010 business plan for private sector operations.

It can be argued that this procyclicality is largely demand driven:[6] firms demand more resources from both private and public sources during good times than during bad times. However, firms' financial constraints are more binding in bad times, so the development impact of MDB lending to private firms is much larger during those periods. MDB lending should be countercyclical at least when measured with respect to the behavior of private capital flows, but it is apparent that MDBs have fallen short of this goal.

Two things may explain this apparent shortcoming. First, internal incentives in the MDBs are to lend more in good times, when risks appear to be lower, than in bad times, just as happens in private banks.[7] As private banks, MDBs are "deal chasers," and there are more deals in good times. Second, MDB stakeholders often push the banks to lend more to private firms during booms (when most MIC sovereigns have easy access to private markets) and give preference to sovereign lending needs in bad times. This was clearly the case during the recent crisis, with managers of several MDBs fighting hard to avoid a larger crowding out of support to private firms.

The MDBs' response to the last crisis has a lot to commend and may indicate a departure from previous practice. First, there was an unusual level of cooperation through joint or coordinated programs. Second, most MDBs crafted well-thought-out crisis response programs to support the more stressed private firms in developing countries. The programs included recapitalization and restructuring funds for banks, support to private infrastructure projects that had difficulties achieving financial closing, enhanced support to microfinance institutions and SME lending programs, and augmented trade finance lines. Disbursements were, however, lower than expected in many cases, probably because of a combination of factors. On the one hand, the financial effects of the crisis were milder than expected in many developing regions, while demand for trade finance dropped sharply as trade flows collapsed. On the other hand, some of the programs came out late in the game, when the worst of the crisis was over. This indicates the need to have these programs designed and enacted ex ante, as permanent contingent features of MDB direct support to private firms. The jury is still out.

Implications of MDB Direct Support to Private Firms for Corporate Policy and Organization

Measuring and evaluating development impact and priority goals

MDBs must use and incorporate processes in their decision making that are adequate to evaluate the development impact of their private sector operations, in order to guarantee that they do not just become a profitable business line. EBRD led the way by devising its so-called Transition Impact Methodology as early as 1997. IFC afterwards enacted the DOTS (Development Outcome Tracking System), and other MDBs followed its approach, with some variations. These are welcomed developments, though it is not yet clear how much they actually influence the composition and design of operations, as evidenced by the preliminary assessment presented above.

MDBs should also set and monitor the attainment of precise goals with respect to the seven priorities listed in Table 1. Some have been increasingly following such a procedure.

6. This was a position expressed by several MDBs at the CGD Roundtable October 2010.
7. See G.Perry, *Beyond Lending* (Washington DC: Center for Global Development, 2009).

2. Developing adequate capacities for risk analysis and risk management and changing the excessively risk-averse culture of MDBs

Lending to or investing in private firms without sovereign guarantees substantially increases MDBs' financial risks. Indeed, MDB lending to sovereigns has been a very low-risk activity, given their de facto preferred creditor status. MDBs that used to lend mainly to sovereigns have had significant difficulties developing an adequate culture of risk taking for dealing with private firms. Further, the influence of their excessively risk-averse culture has frequently introduce biases against focusing on the priorities discussed above. Thus, MDBs have been hesitant to take on risks other than credit risk in their balance sheets. This attitude has severely limited their lending in domestic currencies and their offer of risk management products, thus missing significant opportunities to enhance their development impact with respect to both private firms and sovereigns.[8]

MDBs that were created to lend exclusively (IFC or IIC) or primarily to private firms (EBRD) have had to develop stronger capacities for risk analysis and risk management and an altogether different financial culture. However, this organizational option also has its drawbacks. It requires a significant dedicated capital base and broad country coverage in order to take advantage of economies of scale and potential diversification benefits of risk pooling. In addition, having an autonomous agency makes it more difficult to maximize potential synergies between operations in support to governments and to private firms, as discussed below.

3. Maximizing synergies with support to sovereigns, while avoiding conflicts of interest

The most effective way to overcome financial constraints and increase access to risk management products is, in the long run, to achieve deep and broad domestic financial sectors in developing countries. Supporting governments to improve institutions and policies to achieve this end must be a key priority of MDB actions. However, building efficient and responsive governments takes time, and developing economies may in the meantime forgo investment and growth opportunities because of financial and other constraints faced by private firms, which could be partially alleviated through MDB direct support. Thus, MDBs should both help improve the functioning of governments and directly support worthy private initiatives that would otherwise be impaired for a long time.

In addition, the presence of stronger and better managed financial (and real sector) firms may create incentives and domestic lobbying in favor of adequate regulations and overall government efficiency and responsiveness. Also, being directly involved with firms may give MDBs a deeper knowledge of regulatory and investment climate problems and opportunities, and thus could lead to improved advice to governments.

Most MDBs work with private firms either through an autonomous organizational structure, as is the case with IFC, or through one or more separate departments. Such a separation helps develop adequate risk analysis and procedures and a different risk-taking culture. It also facilitates avoiding conflicts of interest, but it makes it more difficult to take advantage of potential synergies with lending to and advising sovereigns. There is no easy solution to these dilemmas, which may help explain why very different organizational solutions co-exist across MDBs.

Conclusions and the Future Agenda

In summary, while there are development-related reasons in favor of MDB direct support to private firms, a tentative evaluation indicates that actual practice is not fully consistent with the priorities derived from those arguments. The summary scorecard below indicates that the glass can be seen as half full or half empty. Readers can find arguments in this scorecard and the previous analysis either to support or oppose present trends of increased direct operations with private firms in developing countries.

However, as this trend is likely to continue, it may be more constructive to focus the debate on what should be improved. According to the previous analysis we would recommend a six-point future agenda:

1. Increase the share of MDB lending to private firms in domestic currencies, as well as the share of equity investments, guarantees, and risk management products in their overall financial operations with private firms.
2. Reduce the procyclicality of MDB lending to private firms and improve the ex ante design of crisis response programs.

8. See on the latter point G.Perry, *Beyond Lending*.

3. Deepen efforts to help MSMEs increase their access to finance.
4. Continue focusing on financial intermediaries, but make sure that such MDB support has significant impact on domestic financial development.
5. Increase support to firms in infrastructure and social sectors and to those introducing new products, exports, or technologies. Strengthen current trends to support environmental protection activities.
6. Enhance the influence of development impact evaluations in actual decision making; improve capacities for risk analysis, risk management, and coordination procedures to take advantage of synergies between operations supporting sovereigns and those supporting private firms.

Achieving some of these objectives requires important changes in the highly risk-averse culture that still dominates in some MDBs, as well as reinforcing cooperative solutions to maximize impact and to take full advantage of diversification benefits through risk pooling. Responsibility for such changes lies not only with MDB management, but equally or even more with stakeholders, who often give management conflicting instructions and promote the maintenance of inadequate incentives and an excessively risk-averse culture.

Table 1. A Tentative Scorecard: Are MDBs Meeting Their Stated Priorities?

Criteria	Average Rank	Best Performers*
Increasing attention to LICs, though still a high concentration in MICs	D	AfDB
Growing focus on MSMEs, though percentages still low in most MDBs	C	IFC
High concentration in domestic financial sectors; but how much contribution to financial sector development?	B	IFC/EBRD
Low shares in infrastructure and social sectors Increasing support to environmental protection activities	C E B	ADB/CAF none IFC/EBRD
Concentration in long-term debt, but small shares in equity and guarantees in most MDBs	B	IFC/EBRD
Low shares of lending in domestic currencies and offer of RMPs.	D	IFC/ADB
Generally procyclical lending, though progress in response to the recent crisis	D B	ADB, AfDB IFC, EBRD/IADB, AfDB
Progress in development impact evaluation, but still modest influence	B	EBRD, IFC/AfDB

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