KfW Development Bank

››› Perspectives on Development Financing

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Development requires more than just money, and development banks offer more than just financing

Author: Simone Sieler
Editor: Friederike Zeitler

The discussions surrounding the "2030 Agenda for Sustainable Development", which was ratified at the end of 2015, highlighted the enormous content-related and also financial challenges facing the global community in the next 15 years. Efforts to fight poverty and climate change alone will require investment of between USD 5 and 7 trillion.

Financing these measures will require national funds from the relevant countries, international development aid and private capital, and all of these components will have to be better interlinked. Many governments use development banks which – as a market-compliant economic policy tool – act as a link between the state, society and the financial markets and can therefore mobilise additional funds and direct them into the right applications.

What are development banks?

Development banks are state-owned financial institutions with a mandate to promote economic, social and ecological development.
They therefore operate on behalf of the government. Their goal is not to maximise their profits, but rather to finance projects that are particularly worthy of promotion from the perspective of society as a whole but usually do not receive (sufficient) private financing due to market imperfections. Development banks that operate almost exclusively in their own countries are often referred to as "national promotional banks".

››› Types of development banks[1]

National promotional banks, such as the new British Business Bank, are owned by the government of a single country, within whose territory they operate.

Bilateral development banks like the Japan International Cooperation Agency are owned by the government of a single country and operate on a global level.

Regional development banks, such as the Asian Development Bank, are owned by several governments, usually from a particular region. In most cases, they operate exclusively within the region in question too.

Multilateral development banks like the World Bank are owned by the international community or a large number of countries, and operate globally.

[1] The descriptions given in this paper provide a simplified form of categorisation. In practice, there are a large number of hybrid arrangements in terms of ownership structure, intervention region and functions. Germany's KfW and the AfD / CDC in France, for example, act as both national promotional banks and bilateral development banks.

Development banks can be helpful in many different fields

Development banks can often use market economy resources to compensate for market imperfections (such as external effects, information asymmetries and competition deficits). They are particularly important for the long-term financing of projects that are beneficial from a macroeconomic perspective but are not (yet) profitable (or are too risky for the private sector) at a microeconomic level. They are often used for structural policy purposes or to correct market outcomes that are unsatisfactory from the perspective of society as a whole – to compensate for regional, sectoral or social inequalities, for example.

The most important fields in which development banks operate are as follows:

Development banks are traditionally involved in **promoting economic development** by providing basic economic infrastructure such as power supplies or roads, for example. However, they also work to directly or indirectly promote private sector activity. Direct interventions often relate to the financing of employment programmes, vocational training establishments or individual, large-scale investments with a particularly pronounced impact on development such as irrigation perimeters. Indirect interventions are generally implemented via the local financial sector, for example by providing credit lines to finance start-ups, small and medium-sized enterprises or other activities that are particularly worthy of promotion (social entrepreneurship, innovations, etc.).

Another important area of activity for development banks is **promoting measures to protect the climate and/or environment.** In the field of climate protection, they support measures to reduce the increase in atmospheric CO2 (such as energy efficiency programmes or the promotion of renewable energies and reforestation) and projects aimed at climate change adaptation, such as flood control or climate risk insurance.

Environmental protection often deals with preserving biodiversity, avoiding environmental damage (e.g. wastewater treatment) and making sustainable use of scarce natural resources (e.g. protecting water catchment areas and recycling). Development banks also help to raise awareness of climate and environmental protection among the population, and promote the shift towards using more "green" technologies in the private sector.

The aim of **promoting social development** is to ensure that the basic needs of poor and disadvantaged groups of the population are met in terms of nutrition, drinking water, health care, education and living space. Typical examples include constructing wells, health units and schools, as well as expanding social security systems.

No less important is the **promotion of favourable framework conditions for development and crisis aid.** Development banks support economic, political and sectoral reform programmes (e.g. fiscal stabilisation, free elections, administrative reforms or the introduction of educational reforms) as part of their efforts to promote good governance. Disbursements in this regard are tied to the implementation of steps in the reform process rather than to individual investments. The ongoing development of financial systems (e.g. regulation, credit agencies or deposit guarantee schemes) can also be the subject of promotion.

In the event of natural disasters and armed conflicts, development banks assist with efforts aimed at swift stabilisation, reconstruction, getting supplies to refugees and tackling the causes of war and displacement.

In times of recession or financial crises, development banks increase their financing activities in an anticyclical way so as to offset the contractionary impact of the reluctance of private banks and to help to stabilise the situation rapidly.

Needs-based financing solutions: efficient and fair

The core product offered by development banks is the provision of financial resources for purposes that are particularly worthy of promotion. The products range from grants and soft loans with different terms to market-consistent loans, mezzanine financing, private equity and guarantees.

Development banks offer soft loans (i.e. loans that are cheaper than commercial loans), which are often the only way for many projects to be realised. The willingness to accept a higher level of risk is often just as important as the concessionality level, however. Long maturities in particular, which are above all required for infrastructure projects, are frequently not offered at all by private banks for risk-related reasons. This is where the need for development banks is particularly acute.

Development banks can adapt the conditions of financing to the performance capacity of their partners and projects as needed. Projects that do not generate any income (such as primary schools) and are implemented in very poor countries are generally promoted using non-repayable grants.

In contrast, projects that generate income through the sale of their products (such as water supply and power) and are implemented in more developed countries are able to repay a loan, as at least some of the income can be used for debt service purposes.

Each project only receives exactly as much promotion as is required to successfully implement it. Not only is this efficient; it is fair too, as the weaker receive more support than the strong.

But development banks do more than simply close gaps where no private financing is provided. They also mobilise additional private capital, which they divert into applications that have high priority in terms of development policy. This takes the form of different instruments ranging from the conventional co-financing of individual projects or public-private partnerships to collecting capital in structured funds that appeal to financial investors with different motives and risk preferences.

Development banks do much more than "just" finance

Another aspect of their work that is at least as important as providing affordable financing (and another important difference with respect to commercial banks) is that development banks also provide extensive assistance to their partners as regards the identification, design, implementation and operation of new projects. On account of their work in a number of similar countries and thanks to the development experts and technical experts they employ, they have gained valuable experience in these fields which they systematically apply to the planning of new projects.

This starts with an analysis of high-priority developmental bottlenecks and the requisite sector policy reforms. And it continues with a comparison of different alternative solutions, not only with respect to their value for money but also with respect to the use of robust and customised technologies and their follow-up costs, while also taking into account their impact on the climate and the environment, the working and social standards, the local availability of personnel and equipment and the connection to sales markets.

The analysis also covers aspects such as the involvement of the local target group, social standards, the identification and compensation in favor of people who may be negatively affected, the establishment of complaint mechanisms and any necessary organisational adjustments to partners' structures. That is why, in addition to the investment itself, many projects also entail complementary measures in the field of implementing sector reforms, capacity building, environmental protection and target group participation.

While projects are being implemented, development banks often help with the competitive bidding process for goods and services in accordance with transparent international standards, as well as with monitoring the proper fulfilment of contractual obligations.

Once the measures have been completed, development banks work with the local partners to assess not only whether the planned measures are physically functioning perfectly but also whether the intended developmental impacts have materialised, and they draw conclusions for future projects.

Three key functional principals for "good" development banks

Development banks can play an important role in supporting and expediting development processes. A growing number of governments are therefore opting to set up their own national development banks, and we are also witnessing a veritable renaissance in these financial institutions at the regional and global levels.

There are a number of functional principles that should be taken into account in connection with both the establishment and the activities of development banks to enable them to make a real, positive impact. The three most important are market compliance, subsidiarity and "bank-like conduct".

Market compliance means that development banks should attempt to offset existing market deficits and undesirable market outcomes by offering market-compliant, financial incentives, for example in the form of affordable loans for energy-efficient construction. The lending and borrowing process remains a genuine market process between two market participants, but the lower interest rates result in the construction of many more energy-efficient buildings than would have been the case without such promotion. This indirect influence is usually much more efficient than direct intervention or implementation by the government.

The **principle of subsidiarity** means that development and promotional banks should, if possible, focus exclusively on areas where there is no adequate offering from private financial institutions (no displacement effect).

The subsidiarity principle does not prevent development banks from entering into co-financing arrangements with commercial banks in suitable cases (for example if the financing would fall through without the structuring and risk-absorbing role of the development bank), or from involving the branch network and local know-how of private financial institutions in the planning of measures so as to enhance efficiency (for the local assessment of standardised credit programmes in the field of SME promotion, for example).

The most important functional principle, however, is the **"bank-like conduct"** of a development bank. The articles of incorporation should specify that individual decisions regarding the awarding of funds are independent decisions to be made by the bank's management team in pursuit of promotional policy goals, in compliance with banking standards, and taking sustainability considerations into account.

Bank-like conduct should secure a favourable rating for the bank (potentially backed by a government guarantee), and therefore allow it to take out funds on the capital market under particularly favourable conditions which it can then use for the promotional business. In the case of tasks that require additional elements of promotion (such as grants, further discounted interest rates or the assumption of increased risk), the owners must provide the funds from government budgets or via risk exemptions, as the bank would quickly "bleed out" financially otherwise.

Conclusion

Development banks are not "cure-alls" but they can mobilise a substantial volume of financial resources on the capital markets, which they can combine intelligently with budget funds and private sector finance ("gearing") so as to fulfil government promotional functions in a way that has a broad impact, is market-compliant, is efficient and conserves budgets, and to support the achievement of international goals such as Agenda 2030.

Photos

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Contact

KfW Group
KfW Development Bank
Palmengartenstrasse 5-9
60325 Frankfurt am Main, Germany
Telephone +49 69 74310
Fax +49 69 7431 2944
info@kfw-entwicklungsbank.de
www.kfw.de