A private affair

Shining a light on the shadowy institutions giving public support to private companies and taking over the development agenda

Summary

Development finance has changed substantially over the past decade. Private finance has replaced aid at the centre of global and national development initiatives, for both governments and international bodies. Development Finance Institutions (DFIs) have become some of the most important players in today’s development arena. They are government-controlled institutions that invest billions of euros in private sector projects in developing countries every year – often using scarce aid money to ‘leverage’ this finance.

Eurodad’s principal concern is that almost all DFIs are owned and controlled by rich country governments, with little effective input or influence from developing country governments, and even less from other developing country stakeholders. This imbalance in power structures means, among other things, that companies from wealthy nations have often received the lion’s share of contracts.

Eurodad finds that:

- DFIs show minimal support for companies from low-income countries.
- The financial sector has been favoured by DFIs in recent years, receiving on average more than 50% of funding that has been allocated to the private sector.
- DFIs contribute to foreign private investments flowing into developing countries by supporting foreign companies or by investing their own (foreign) capital directly in local businesses. However, positive impacts of foreign investment can be accompanied by many risks, including macroeconomic problems.
- DFIs face serious transparency problems, especially when dealing with financial intermediaries. DFIs’ transparency to the general public is limited, which in turn constrains the ability of stakeholders to effectively exercise external control.

2015 is a crucial year for the future of development finance. The Third International Conference on Financing for Development took place in Addis Ababa in mid-July and the post-2015 agenda – including new goals and targets – will be agreed in September in New York. As existing global public resources will not be sufficient to meet the world’s development needs, many are increasingly turning to private actors – using scarce official development assistance (ODA) to ‘leverage’ this sector. Eurodad recognises that there is a critical role for the private sector to play in development. However, foreign-owned and controlled institutions are not going to provide the country-owned and effective strategies necessary for developing countries to harness the private sector’s power for development.

Therefore, Eurodad recommends that a full review by developing countries should be carried out before DFI operations are increased any further. This review should consider carefully the many concerns Eurodad and partners have consistently raised, including that:

- DFIs should align their investment decisions to developing countries’ priorities and national development plans.
- DFIs should demonstrate clear financial and development added value.

- DFIs should comply with the guidelines of responsible finance, as outlined in Eurodad’s Responsible Finance Charter. You can find these guidelines at www.eurodad.org.

Introduction

The landscape of development finance has changed substantially over the last decade, particularly in terms of volume, actors, motives and instruments. After the economic and financial crisis, aid budgets were squeezed by many donors and most donor countries will not meet the target of spending 0.7% of Gross National Income (GNI) on overseas development assistance (ODA) by 2015.

At the same time, the largest flows to developing countries in aggregate are commercial or private, although resources also flow out of developing countries in the form of repatriated profits on foreign direct investment (FDI), repayments on loans and illicit financial flows.

In addition, flows from Development Finance Institutions (DFIs) in support of private sector operations have grown rapidly since the start of the millennium. This is on the basis of non-ODA sources of revenue, which gives these institutions a greater role in the field of development finance.

Given the dramatic increase in the balance sheets and relevance of these institutions in the development agenda and the broad framework of the post-2015 financing debate, there is a need to analyse the way DFIs operate and the main challenges that they face in order to be considered a development actor.

This briefing presents the main features of DFIs’ operations, including who holds the power in these institutions and who benefits from these institutions’ investment decisions, and the several challenges that DFIs must tackle. It also makes concrete recommendations for reform.
What are DFIs and how do they work?

DFIs are government-controlled institutions that invest in private sector projects in developing countries. They support the private sector and mobilise additional private finance. Most DFIs are funded by donors’ development agencies, and can raise additional funds through private banks and capital markets.

There are bilateral and multilateral DFIs. The former refers to national institutions with mandates linked to their government’s international cooperation policies. In Europe, 15 bilateral DFIs are members of the Association of European Development Finance Institutions (EDFI). The latter are the private sector arms of multinational or regional development banks, such as the International Finance Corporation (IFC) of the World Bank Group (WBG) and the private sector activities of the European Investment Bank (EIB), and the Asian Development Bank (ADB), among others.

The mandates of today’s DFIs are not homogeneous. Some DFIs’ mandates explicitly include development as the overarching objective of their interventions, whereas others prioritise support to an efficient private sector. While most DFI’s mandates promote development, they are organised like private corporations with commercial profitability considerations, often implying a trade-off between these goals.

The last few years have seen a sharp increase in DFIs’ annual commitments as part of the increased interest in, and funding for, private sector development by most donors. Globally, the IFC’s investment commitments are now six times greater than they were in 2002 with an average annual growth rate of 15%. In 2013, with more than $18 billion in commitments, it became the biggest arm of the WBG, although this fell slightly in 2014 to just over $17 billion. The IFC is often used as a standard setter for other DFIs.

At the European level, several bilateral institutions have boosted their financial capacity. From 2003 to 2014, the consolidated portfolio of EDFI members more than tripled from €10 billion to almost €33 billion, over a 200% increase. This dramatic increase is backed by two important facts. First, most DFIs have sovereign guarantees from their governments, who will bail them – and their creditors – out should that prove necessary. Second, in many cases DFIs also benefit from de facto preferred creditor treatment – meaning they will be paid even in the event of a currency crisis in the developing country where they are supporting private investment. These two facts protect DFI investments in a way that no other financial institution can compete with.

DFIs: dominated by rich countries

Multilateral DFIs get their capital base from member state governments, which are represented in the institutions’ governing boards. Voting power is based on this capital stock, which has political implications for who has power in decision-making processes. As of June 2014, in the case of the IFC, high-income countries account for 70% of voting power. In the case of the ADB, they hold 60%, which includes 15.7% from Japan and 15.6% from the United States.

Bilateral DFIs’ ownership can vary between fully state-owned and fully privately owned. Most DFIs have mixed ownership, divided between governments, large financial institutions and commercial banks, private companies and individual investors. In most cases, however, governments hold a majority of shares. There is no formal representation of developing countries’ governments on their boards, which undermines developing countries’ governments’ ownership in the institutions’ strategies and investments decisions.

Who gets investment from DFIs?

DFIs cover all regions with their operations, but middle-income countries receive the vast majority of DFI loans and investments. Although some DFIs strategically prioritise by region, in practice DFIs show minimum support for companies in low-income countries (LICs) and the majority of DFI investment goes to middle-income countries (MICs). Eurodad’s Private profit for public good? report showed that only 25% of all companies supported by the EIB and IFC during the period 2006-2010 were domiciled in LICs. The case for DFI investment in MICs is much harder to justify as they have much better developed financial sectors, and attract significant foreign capital already. Moreover, DFIs invest mostly in companies based in rich countries and some in tax havens, which casts doubt on their development impact. This investment pattern focuses on ‘low hanging fruit’ and casts doubt on whether DFIs truly support the most credit-constrained companies in the world’s poorest countries.

In addition, on average over 50% of public finance flowing from DFIs to the private sector goes to the financial sector. Though multilateral and bilateral DFIs invest in a wide variety of sectors, including infrastructure and agribusiness, they are increasingly focusing on the financial sector and concentrating on commercial banking. This is either to support financial institutions directly or to use them as an intermediary that lends to other companies. However, serious questions have been raised about the development impact investments in the financial sector have and what their real impact is on the ground. There is also a high opportunity cost associated with these investments, as the money invested in the financial sector is not available to invest in other kinds of projects.

Figure 1: Ownership and shareholding voting power by country income groups of selected institutions

<table>
<thead>
<tr>
<th>Institution</th>
<th>High-income countries</th>
<th>Middle-income countries and low-income countries</th>
<th>Other high-income country actors</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADB</td>
<td>60.4%</td>
<td>39.6%</td>
<td></td>
</tr>
<tr>
<td>EIB</td>
<td>98.6% EU member states</td>
<td>1.4% EU member states</td>
<td></td>
</tr>
<tr>
<td>IFC</td>
<td>71.8%</td>
<td>28.2%</td>
<td></td>
</tr>
<tr>
<td>DEG</td>
<td>100% German state</td>
<td>57% Dutch state</td>
<td></td>
</tr>
<tr>
<td>FMO</td>
<td>42% owned by large Dutch banks</td>
<td>7% employers' associations, trade unions and other private actors</td>
<td></td>
</tr>
<tr>
<td>PROPARCO</td>
<td>57% French state</td>
<td>29% French financial organisations</td>
<td></td>
</tr>
<tr>
<td></td>
<td>13% international financial organisations</td>
<td></td>
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</tr>
</tbody>
</table>

Source: DFI website and WIB country and lending groups database
What are the challenges for DFI operations?

No clear development outcomes

DFIs face important challenges demonstrating causal effects on poverty reduction in developing countries, including impacts on reducing inequality, on women’s rights and on marginalised groups. This is partially due to the nature of investing in the private sector, where social outputs are not normally the objectives of the private sector partner, and are difficult to measure. DFIs have developed different systems for assessing the impact of their operations, but despite recent efforts to harmonise practices and systems, it is still very difficult to compare ‘development impact’ on the basis of the available data.

Some evaluation reports have cast doubt on the real impacts of DFI operations and challenged the way DFIs decide their investment strategies. Regarding the IFC, an IEG evaluation report from 2011 states that “fewer than half the projects reviewed for [the] evaluation included evidence of poverty and distributional aspects in project design”. In addition, existing responsible finance standards are insufficient. While the IFC Performance Standards are globally recognised as a benchmark for environmental and social risk management, they are criticised for being too weak on human rights due diligence, and important challenges remain with their implementation.

Little developing country ownership over DFIs and their strategies

Ownership by developing countries is a key principle for development effectiveness, and it often determines the success of any development intervention. However, due to the nature of DFIs’ shareholding and/or voting power structures, DFIs are driven by developed countries. Recipient countries are either not represented, or are only very weakly represented in DFIs’ governance structures. In addition, DFIs are not conducive to meaningful participation of governments and citizens from developing countries, to whom they ought to be accountable. Their operations are unlikely to be aligned with national development strategies and priorities. A more effective way for DFIs to operate could be to fund national or regional publicly-owned institutions that support private sector actors at the national and regional level, in line with development strategies.

Seriously inadequate transparency and poor accountability

Currently, transparency standards are not consistent with development effectiveness principles, especially when dealing with financial intermediaries. Independent evaluations have concluded that DFIs’ transparency vis-à-vis the general public is limited, which constrains the ability of stakeholders to effectively exercise external influence. This lack of information is often attributed to banking secrecy and protection of DFIs’ and business partners’ commercial interests. As DFIs are publicly backed institutions with development mandates, they should adhere to transparency standards applicable to other development actors.

On top of this, most DFIs have poor accountability mechanisms in place to ensure that they are accountable to a broad range of actors. Dialogues with CSOs, both in donor and beneficiary countries, and governments and parliaments of beneficiary countries, are unusual. DFIs often claim that, at the project level, stakeholder consultations are required by the IFC Performance Standards, including the establishment of grievance mechanisms both at the level of project-affected stakeholders, as well as the personnel of the investee companies. However, questions often arise regarding the implementation of these practices. While the IFC and other multilateral DFIs have already put in place independent redress mechanisms, European bilateral DFIs rarely have them, or are in the process of developing them.

Providing additional finance or crowding out others?

DFIs’ heavy focus on countries and sectors where private capital is relatively abundant, instead of on the poorest countries or under-served areas and sectors, they may not provide new finance for the private sector, but simply crowd out other possible financiers and as such damage the domestic financial sector. It is also not clear whether the private finance that DFIs co-invest with was brought in by the DFIs’ involvement, or whether it would have happened anyway. DFIs frequently quote ‘leverage ratios’ that assume that all co-financiers would not have made any investments without the DFIs’ involvement, while in fact, higher leverage ratios might imply that the project is more likely to have been funded without public sector involvement.

Macroeconomic risks

DFIs contribute to the foreign private investments flowing into developing countries by supporting foreign companies or by investing their own (foreign) capital directly in local businesses. However, foreign investment should not be seen as an end in itself, as positive impacts are often accompanied by many risks and problems, including macroeconomic problems. By promoting foreign capital inflows, DFIs can increase the exposure of developing countries to foreign capital markets and investors, which has proved to be highly problematic, particularly the experience of Asian countries during their last financial crisis. In fact, developing countries have spent the last decade and a half building huge stockpiles of reserves to protect themselves from instability caused by inflows and outflows of foreign capital.

Box 1: Hard to justify – IFC investments without clear development outcomes

Investments in five-star hotels owned by multinational chains

In Ghana and Jamaica, for example, the IFC invested in Mövenpick ($26 million) and Marriott ($53 million) respectively, two multinational hotel corporations. These investments were justified by their potential to create jobs, but several actors have raised concerns in relation to their questionable development impact or need for public subsidy. These include impacts in crowding out other sources of funds and even “entering into direct competition with the people [the IFC] claims it wants to lift out of poverty”.

Investments through financial intermediaries harmful to local communities

In Cambodia the IFC has been instrumental in alleged ‘land grabbing’ following the acquisition of vast amounts of land by IFC-backed Vietnamese companies for producing rubber. In 2002, the IFC invested in the private equity fund Dragon Capital Group, which then lent money to two of Vietnam’s largest companies, Hoang Anh Gia Lai (HAGL) and the Vietnam Rubber Group. These companies acquired more than 200,000 hectares of land through a series of obscure deals with the Lao and Cambodian governments. In February 2014, local members of 17 villages and five Cambodian non-governmental organisations (NGOs) filed a complaint to the IFC’s Ombudsman (CAO), raising environmental and social concerns and claiming that these acquisitions have been harmful to their standard of living and the environment. The CAO is currently facilitating a voluntary dispute resolution process between both parties.
The way forward

Bilateral DFIs should not be seen as the default option for supporting private sector development, as they are controlled by developed countries, with little input into strategies or governance from developing countries. Not only does this make them less likely to align their investments with national plans and needs, but this also means they will always be likely to be influenced by the desire to support companies from their home country. Multilaterals currently suffer from the same problem, with a governance structure heavily biased in favour of developed countries and their investment strategies not driven by national development plans. Only major governance reform can rectify this situation.

Instead, democratic ownership of any development intervention should be seen as the starting point, on the basis of national strategies and institutions of the recipient country. It will be more sustainable in the long run to help build national or regionally owned institutions than to expect donor-owned institutions to take the job. However, there is very little information about what developing country governments and stakeholders at the national level think of DFIs or what they expect from them. Before increasing and deepening DFI operations further, a full review from a developing country perspective should be conducted, for example by a committee of independent experts from government, civil society organisations (CSOs) and the private sector in developing countries. Issues that this review should consider include:

Making development outcomes the overriding criteria for DFI project selection and evaluation. To ensure this, DFIs should:

- Mainstream development objectives into all investments, with clear outcome indicators and effective monitoring of projects from the project selection phase to its completion.
- Require that the development outcome of all projects should be disclosed at project – not aggregated – level. This is crucial to improving accountability to external stakeholders and affected communities.
- Establish policies that ensure all contracts comply with high responsible investment standards, such as those outlined in Eurodad’s Responsible Finance Charter.

Aligning to developing countries’ investment priorities to respect country ownership. To achieve this, DFIs should:

- Develop a coherent framework that sets clear guidelines for how DFIs will align to country owned development strategies, developed by national governments in consultation with parliaments, civil society groups, communities and other stakeholders. DFIs should not attempt to influence these strategies.
- Report clearly on how country investment portfolios align with national strategies.

Setting high standards for transparency and accountability:

- DFIs should make special efforts to ensure affected people can actually access information about projects that affect their lives, which includes, for example, translating key documents into local languages, and ensuring effective consultation processes, respecting the internationally agreed principle of free prior and informed consent.
- All DFIs should set up independent complaints mechanisms with a mandate to carry out independent investigations of financed projects.

Improving transparency of financial intermediary investments and reviewing their use:

- Understand the limitations of financial intermediaries and investment instruments by undertaking further research on their leverage potential and impact in developing countries.

Improving donors’ policy coherence for development by preventing tax dodging, observing high corporate standards and supporting environmentally friendly projects. This would mean that DFIs must:

- Ensure that the investing company is domiciled in the country of investment, or in cases where the company is not domiciled in the country of investment, the reason should be clearly stated.
- Require all companies and financial institutions involved in DFIs’ transactions to disclose reliable annual information related to sales, employees, profits made and taxes paid in the country.
- Require all companies and financial institutions involved in DFIs’ transactions to disclose information regarding beneficial ownership of any legal structure directly or indirectly related to the company.
- Implement effective systems to ensure international social, environmental and human rights standards.

To read the full report go to: www.eurodad.org/aprivateaffair.

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Eurodad

The European Network on Debt and Development is a specialist network analysing and advocating on official development finance policies. It has 46 member groups in 20 countries. Its roles are to:

- research complex development finance policy issues
- synthesise and exchange NGO and official information and intelligence
- facilitate meetings and processes which improve concerted advocacy action by NGOs across Europe and in the South.

Eurodad pushes for policies that support pro-poor and democratically-defined sustainable development strategies. We support the empowerment of Southern people to chart their own path towards development and ending poverty. We seek appropriate development financing, a lasting and sustainable solution to the debt crisis and a stable international financial system conducive to development.

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