

# Public development banks: towards a better model

April 2017

A Eurodad discussion paper  
co-sponsored by Afrodad and Latindadd

## THE KEY COMPONENTS OF AN IDEAL

# PUBLIC DEVELOPMENT BANK

### MANDATE AND ROLE

- Strong development mandate
- Targeting finance where it is needed most
- Responsible social and environmental standards
- Stable, long-term perspective
- Support for national strategies

### OPERATIONAL STRATEGY

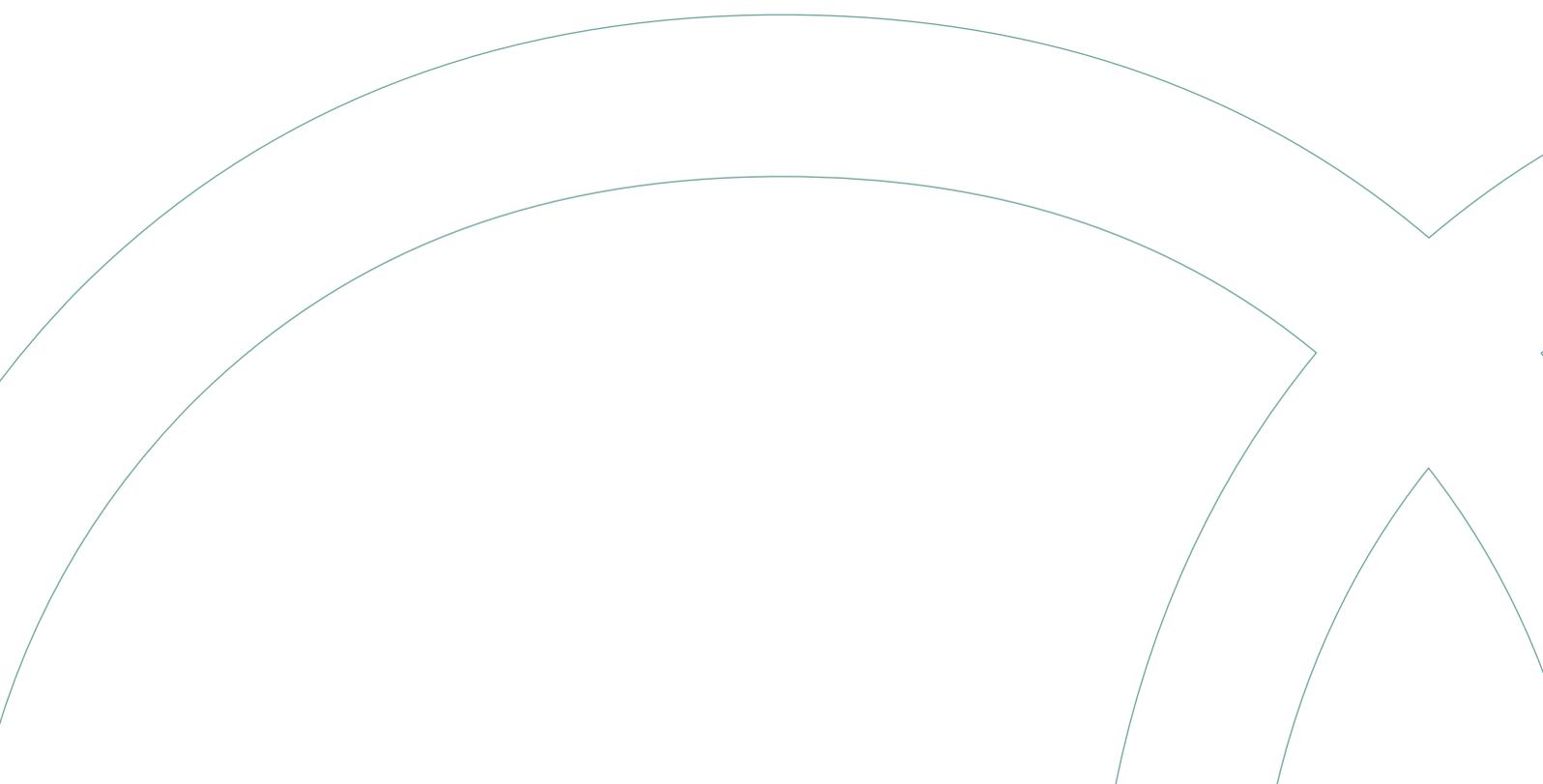
- Right mix of public and private funding
- Careful choice of methods of investing
- Internal systems to focus, assess and monitor

### FINANCIAL SUSTAINABILITY

- Prioritise development outcomes
- Reinvest any profits
- Take care with public grants
- Incentivise staff to deliver for the public good

### GOOD GOVERNANCE

- Equal borrower representation at multilateral PDBs
- Strong transparency policies, based on the right to information
- Active participation of civil society and bank employees
- Insulation from political pressure
- Strong accountability systems



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### Acronyms

AAAA	Addis Ababa Agenda for Action	IBRD	International Bank for Reconstruction and Development
AiIB	Asian Infrastructure Investment Bank	KfW	Kreditanstalt für Wiederaufbau, Germany
BPI	Public Investment Bank in France	MNE	Multinational enterprise
BRIC	Brazil, Russia, India, and China	MSME	Micro-, small- and medium-sized enterprise
BRICS	Brazil, Russia, India, China and South Africa	NDB	New Development Bank
CSO	Civil society organisation	NGO	Non-governmental organisation
DBE	Development Bank of Ethiopia	ODA	Overseas development assistance
DFI	Development finance institution	PDB	Public development banks
EBRD	European Bank for Reconstruction and Development	SDG	Sustainable Development Goal
EIB	European Investment Bank	SME	Small- and medium-sized enterprise
FfD	Financing for Development	SOB	State-owned bank
FPIC	Free, Prior and Informed Consent	UN	United Nations

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## Executive summary

Public development banks (PDBs) are enjoying a resurgence. The global financial and economic crisis has stimulated new interest in PDBs, particularly given the important role they play in providing counter-cyclical financing when private capital is in short supply. In recent years, several countries have established new national and multilateral PDBs, and at the global level they have been recognised for the role they play in the United Nations Financing for Development process.

However, not all PDBs succeed, and even the successful ones carry the risk of major negative impacts on development. This may be due to external factors, but significantly, the reasons for their inconsistent performance can also be found in the institutions themselves, which vary considerably, with diverse mandates, roles and operational strategies.

PDBs were major players in the financial sector of many economies as they developed, and they continue to play an important role today, particularly in emerging markets. The World Bank estimated in 2012 that state-financed institutions accounted for “25% of total assets in banking systems around the world”.<sup>1</sup> Unlike other kinds of state-owned financial institutions, such as state-owned commercial banks or insurance companies, PDBs have a specific mandate to deliver on public policy objectives that support the economic development of a country or region. Although PDBs are concerned with financial returns, profit is not their overall goal.

We need PDBs because the commercial financial sector is unlikely, of its own accord, to provide the finance needed to support rapid economic development. There are four main ways PDBs can complement the commercial financial sector:

- Directing finance to important sectors or regions.
- Building the financial sector, by filling gaps in credit supply or demand.
- Promoting economic stability, by playing a counter-cyclical role.
- Improving standards, by insisting on, for example, social or human rights safeguards.

Despite the growing amount of work devoted to studying PDBs, a comprehensive approach to analysing these institutions was still missing. This report proposes institutional and governance reforms which challenge PDBs, and the governments which back them, to get better at supporting development, becoming more accountable and learning from past mistakes. The framework for improvement set out in Table 1 should be seen as a complete package – improving one area in isolation is unlikely to deliver development results.

**Table 1: Core features of a model Public Development Bank**

Core features and key components	Explanation/Detail
<b>A: MANDATE AND ROLE</b>	
i. Strong development mandate	The mandate of the PDB is to deliver sustainable development outcomes, avoiding vague or dual mandates.
ii. Targeting finance where it is needed most	The PDB targets regions, sectors or clients that are most in need, or that have the highest development pay out.
iii. Responsible social and environmental standards	The PDB takes responsibility for the social and environmental outcomes of all its activities. The PDB ensures that companies they work with, as clients or partners, do not avoid or evade taxes.
iv. Stable, long-term perspective	The PDB's focus is on long-term, sustainable, predictable and counter-cyclical funding.
v. Support for national strategies	The PDB aligns its activities to democratically determined national plans, to ensure that the PDB helps to improve the financial sector as a whole.
<b>B: OPERATIONAL STRATEGY</b>	
i. Right mix of public and private funding	The PDB receives some public funding, so it is not a purely commercial institution.
ii. Careful choice of methods of investing	The PDB invests in ways that ensure their development mandate takes precedence over generating financial returns.
iii. Internal systems to focus, assess and monitor	The PDB has the internal capacity to assess and systematically show the impacts of their policies and investment decisions, and has effective due diligence procedures, accompanied by supervision and monitoring mechanisms.
<b>C: FINANCIAL SUSTAINABILITY</b>	
i. Prioritise development outcomes	The PDB should ensure development outcomes take precedence over profitability.
ii. Reinvest any profits	The PDB should reinvest any profits to support the development focus of the institution.
iii. Take care with public grants	Strong public accountability must be in place if PDB operations are subsidised by public funds beyond initial capital injections.
iv. Incentivise staff to deliver for the public good	The PDB draws on its development focus to recruit and motivate staff, without copying the bloated salary and bonus culture of parts of the commercial financial sector.
<b>D: GOOD GOVERNANCE</b>	
i. Equal borrower representation at multilateral PDBs	The multilateral PDB has a governance structure that gives, as a minimum first step, equal voting power to borrowing countries.
ii. Strong transparency policies, based on the right to information	The PDB has a strong and carefully implemented transparency policy based on: the right of access to information; automatic disclosure of information with limited exceptions; the right to request information; and public access to decision-making.
iii. Active participation of civil society and bank employees	The PDB has open channels for the meaningful participation of civil society groups, including trade unions and bank employee unions, in its decision-making processes.
iv. Insulation from political pressure	The PDB has governance arrangements that protect it from undue government pressures that might be contrary to the bank's mandated purpose.
v. Strong accountability systems	The PDB has well-implemented accountability systems including: independent evaluations; meaningful participation of external stakeholders; and effective, user-friendly, independent complaints mechanisms.

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## Introduction

This report focuses on public development banks (PDBs), state-owned financial institution that has the overarching objective, or mandate, to deliver on public policy objectives that normally support the economic development of a country or region. This policy mandate distinguishes these banks from other kinds of state-owned financial institutions, such as state-owned commercial banks or insurance companies. Although PDBs are concerned with financial returns, as financial institutions, profit is not the overall goal of their activities.

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PDBs are important for two reasons. First, they were major players in the financial sector of many economies as they developed, and they continue to play an important role today, particularly in emerging markets. World Bank researchers estimated in 2012 that state-financed institutions accounted for “25% of total assets in banking systems around the world” and that “in the so-called BRIC countries alone – Brazil, Russia, India, and China – the market share of [state-financed institutions] is substantially higher”. The same research shows that PDBs “are typically the largest type of state-financed institution”.<sup>1</sup>

Second, there are good reasons why PDBs have been major players in the financial sector of economies as they develop. The underlying rationale is that the commercial financial sector is unlikely, on its own, to provide the finance needed to support rapid economic development.

There are four main roles that PDBs can play to improve the impact of the financial sector on development:

- *To direct finance* – or provide it on better-than-market terms – to sectors or regions that are important for a national development plan.
- *To build the financial sector*, either by filling gaps in the supply of credit (lending to households or businesses that cannot access credit from commercial banks), or by helping to create demand (helping businesses or other customers to develop bankable projects).
- *To promote economic stability*, by playing a counter-cyclical role, to ensure a supply of credit when a financial or economic crisis causes the commercial financial sector to seize up.
- *To improve standards*, by insisting on, for example, social or human rights safeguards in the projects or institutions they finance.

PDBs are run at different levels, which can be grouped into three categories:

- **National:** including sub-national institutions such as local or municipal PDBs, and provincial or state-level PDBs.
- **Regional:** including both continent-wide PDBs, and those focusing on a sub-region.
- **Global:** including institutions with a world-wide scope of operations

Regional and global PDBs, owned by a group of countries, are known as multilateral institutions.

The global financial and economic crisis has reinvigorated interest in the role that PDBs can play in financing sustainable development,<sup>2</sup> particularly given the important counter-cyclical role played by many national PDBs during and since the crisis.<sup>3</sup> In recent years several countries have founded new national and multilateral PDBs, which add to the long list of existing PDBs.<sup>4</sup> Newly founded banks include: the New Development Bank (NDB) from the BRICS countries (Brazil, Russia, India, China and South Africa); the Asian Infrastructure Investment Bank (AIIB), a Chinese-created multilateral; and national institutions, such as the Public Investment Bank in France (BPI).<sup>5</sup>

At the global level, the relevance of PDBs has been recognised in the United Nations (UN) Financing for Development process since its inception in 2002.<sup>6</sup> The Third UN International Conference on Financing for Development in Addis Ababa in July 2015<sup>7</sup> saw governments “call on national and regional development banks to expand their contributions” and “urge relevant international public and private actors to support such banks in developing countries” (Paragraph 33).

However, not all PDBs succeed, and even successful PDBs can have major negative development impacts when projects fail or cause damage to human rights or the environment. While external factors, such as economic crises, can have major impacts on PDBs, a significant reason for the varied performance of PDBs is explained by the institutions themselves, which vary considerably, with diverse mandates, roles and operational strategies.<sup>8</sup>

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The key question addressed by this report is: how can PDBs be improved to realise their potential to support development, while avoiding the risks or problems that can be caused by badly run PDBs? It is clear that the 'right type of finance' needs to flow through 'good institutions' if PDBs are to play an important role in financing development - but what does this mean in practical terms? Despite the huge amount of work already devoted to studying PDBs, the overall and holistic approach of this report is in itself an important contribution to the current debate and we trust it will stimulate discussion on this timely topic across a broad range of stakeholders.

This report aims to provide a framework for institutional and governance reform that challenges the practices of existing and emerging institutions, and the governments backing them, to be better, aim higher and introduce reforms. Where possible, the report includes examples of existing good practices without endorsing any specific institution. None of the institutions meet all the requirements of this reform framework, which should be understood as a whole, not as a set of ideas that could be pursued in isolation. However, it is important to note the report does not attempt to evaluate the existing institutions against the core features we set out - this will be the subject of future research.

The report is structured around the following four core features:

- A. Clear development mandate and role
- B. Operational strategy
- C. Financial sustainability
- D. Good governance

Eurodad has monitored the practices and policies of multilateral and European PDBs for many years. Our work has been complemented by our active engagement with civil society groups working at the national level in the global north and the global south, and by intensive discussions with officials within multilateral institutions and elsewhere, as well as with academics and other stakeholders. The views included in the following pages build on this work, but also on a thorough analysis of reports and evaluations of different PDBs, a detailed review of the academic literature, a series of structured interviews, and an extensive peer-review process (for a full list of reviewers, see Acknowledgements at the end of this report).

The features presented in this report are intended to highlight the critical issues, but should not be taken as an exhaustive account of all PDBs' operations and activities. At the same time, the principles developed take into account reform proposals advanced by Eurodad and others in each area. There are some areas where the proposals are more advanced than others, so some go into detail, while others highlight key options, and note that further work needs to be done.

This report is structured as follows:

- Section 1 characterises PDBs and presents a brief historical overview of these institutions. It defines the **core features** of PDBs that are essential for the institutions to fulfil their mandate and deliver sustainable development outcomes.
- Section 2 develops **key principles** for each of the features presented in Section 1, including an analysis and relevant examples of current best practice.

The report ends with a short conclusion.

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## Section 1: Public development banks as key players in development finance

Public financial institutions have historically played a crucial role in development. Governments from both developed and developing countries have relied on national, sub-regional, regional and global PDBs to channel financial and non-financial support to public and private sector clients. These banking institutions have diverse mandates and roles, which have also evolved substantially over the last 30 years.<sup>9</sup> Notably, the global financial and economic crisis reinvigorated interest in the role that development banks can and should play in financing sustainable development. This section aims to present a brief historical evolution of these institutions, and then identifies different types of PDBs. It also defines core features that PDBs need if they are to fulfil their mandates and deliver sustainable development outcomes.

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### The historical evolution of PDBs

The history of PDBs reflects changing ideas in development finance, with a shift over the last 40 years from a focus on national industrialisation to the rise of a market-led development paradigm.

PDBs have a long history, and many European countries supported their industrialisation process with a wide variety of national PDBs.<sup>10</sup> This was not a universal experience, however, with the US notably not relying as heavily on PDBs, although some were created there, such as the Bank of North Dakota (see Box 1).

A significant increase in interest and use of PDBs occurred after World War II, when public banks featured prominently in both post-war reconstruction efforts, and as part of developing countries' national development plans (see Box 1 for examples from Germany and Turkey). At the regional and global level, PDBs were created to facilitate post-war reconstruction and development, pioneered by the International Bank for Reconstruction and Development (IBRD), now part of the World Bank Group. Initially the focus was on rebuilding European and other economies after the war, but by the 1960s, the focus had shifted to development finance: supporting development projects and providing advice to developing countries.

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#### Box 1: PDB Spotlight – the case of Germany, Turkey and the United States

##### **KfW, Germany**

KfW Bank in Germany was formed in 1948 to support World War II and European reconstruction efforts. The German government decided to create a bank to manage the incoming funds available from the US Marshall Plan. KfW has continued to grow and support the German economy at home and internationally by reinvesting retained profits and by borrowing funds through bond issuances. KfW has a large and complex operational structure that includes domestic and international projects.

##### **Iller (Provinces) Bank, Turkey**

Iller Bank in Turkey was formed in 1945 out of the pre-existing Belediyeler (Municipalities) Bank (1933) with the purpose of funding municipal and local infrastructure projects like water, electricity and drainage, and to provide expertise in the preparation of building plans. This development focus arose in response to Turkey's growing economy and wage labour force, which gave rise to new public infrastructure demands in the villages, towns, and cities. Unusually, Iller receives monthly capital injections of 2% of the total tax income of Turkey's special provincial authorities and municipalities. The Bank also has working relationships with many donor banks, including the European Investment Bank.

##### **Bank of North Dakota, US**

The Bank of North Dakota (BND), formed in 1919 to provide affordable credit for local farmers, ranchers and businesses and in response to the monopoly power of private bankers at the time, is the only state-level public bank in the US. Its contemporary operations include offering low-interest student loans and local credit for small- and medium-sized enterprises (SMEs) and other businesses. The BND also funds local governments by purchasing municipal bonds. The Bank benefits from an explicit government guarantee and by legal provisions that require all state revenues to be deposited in the Bank. This enables the Bank to lend for longer and more cheaply.

Sources<sup>11</sup>

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In the 1980s and 1990s a strong push for the privatisation and commercialisation of these institutions began.<sup>12</sup> This market-oriented push was driven by a narrative from the Washington-based Bretton Woods Institutions. They tended to dispute the developmental role and performance of PDBs on the basis of their public ownership, which supposedly encouraged corruption, inefficiency and a misallocation of resources. Privately owned banks at national or sub-national level were promoted as alternatives. However, as Spratt highlights, there has been a reassessment of the historical evidence against national PDBs, which shows that “what mattered was the quality of the institutional framework in which development banks operated, not whether they were publicly owned”.<sup>13</sup>

In practice, the privatisation process led to a reduction in the number of national PDBs globally, and a reduction in the size of many of those that were not closed. However, they still remained important actors in many countries that used PDBs to support national policy objectives.<sup>14</sup>

Since the 2000s, there has been a resurgence in PDBs. Some national PDBs have emerged as international actors by expanding their remit to financing development projects in other low and middle-income countries. A few are even bigger than multilateral institutions.<sup>15</sup> Currently, many of the most prominent national PDBs – particularly from BRICS countries (Brazil, Russia, India, China and South Africa) – finance exporters from their own countries, as well as infrastructure and energy projects in neighbouring countries.<sup>16</sup> In addition, after the 2008 financial and economic crisis, national PDBs played a very important counter-cyclical role, for instance, in the case of national PDBs in Brazil, China, Russia, Mexico, Germany and Finland, among others.<sup>17</sup>

This expansion has not been free from controversies. Many civil society organisations and academics point to the challenges that these institutions face in terms of: delivering sustainable development outcomes; decreasing inequalities; being accountable and democratic; and protecting human rights and the environment, both inside and outside their national borders.<sup>18</sup>

Owing to this reassessment of the role of PDBs, several countries have established new development banks. Examples include: SME Development Bank of Thailand (2002); the Agencia Financiera de Desarrollo (AFD) in Paraguay (2005); the Banco de Desarrollo Productivo (BDP) in Bolivia (2007); and Bpifrance in France (2012), which merged and expanded existing institutions.

At the regional and global level, the debate on the role of development banks has been recently energised by emerging markets, particularly the BRICS countries. In 2012, the BRICS group discussed the idea of setting up the BRICS’ New Development Bank, which materialised in the Fortaleza Summit in July 2014. In parallel, China led the process of setting up the Asian Infrastructure Investment Bank (AIIB), which was formally established in June 2015. These two institutions started operations in 2016. In many ways the new institutions replicate the old ones, and the creation of these institutions can be understood as a coordinated political response to the discontent of emerging countries with the lack of representation and the slow pace of governance reform, as well as frustration with the policy advice from the traditional multilateral institutions, particularly the World Bank.<sup>19</sup>

The historical evolution of PDBs has also been reflected in the UN Financing for Development (FfD) agenda that was launched in 2002 in Monterrey.<sup>20</sup> While the first FfD summit in Monterrey gave higher relevance to multilateral regional and global institutions,<sup>21</sup> the third summit’s outcome document – the Addis Ababa Agenda for Action (AAAA),<sup>22</sup> which was agreed in July 2015 – stressed the potential of national PDBs and mentioned a broader scope for the activities of these institutions. This is in line with the wider agenda of the Sustainable Development Goals (SDGs), which also focus on infrastructure. In the AAAA, governments acknowledged:

*“... that national and regional development banks play a valuable countercyclical role, especially during financial crises when private sector entities become highly risk-averse [... and called on] national and regional development banks to expand their contributions in these areas [sustainable infrastructure, energy, agriculture, industrialisation, science, technology and innovation, as well as financial inclusion and financing of micro, small and medium-sized enterprises], and further urge relevant international public and private actors to support such banks in developing countries.” (Paragraph 33)*

## The world of PDBs

State-owned financial institutions are extremely diverse and categorising them can be difficult; various typologies have been developed for these institutions<sup>23</sup> and sometimes different names are used interchangeably. Essentially, however, there are two main types of state-owned financial institutions: state-owned development banks – the focus of this report – and state-owned commercial banks. The defining characteristic of the first group – which we term public development banks (PDBs) – is its core development mandate, while the mandate of the second group is to provide broad financial services, such as savings and payment services, on commercial terms. The term development finance institution (DFI) is often used for a subset of PDBs, which includes multilateral PDBs and also PDBs established in one (normally high-income) country but operating in developing countries.

PDBs are very diverse in character, but there are three ways of categorising them:

1. By their scale (the size of their assets and lending) and scope (from local to global).
2. By their business model or operational strategy.
3. By the key features that can make them effective development actors.

The first two are traditional typologies, but the third is the most important. We will examine the first two categories briefly, before moving to the third, which is the focus of this report.

### Scale of operations

Table 2 shows that there is huge variation in the scale of PDBs – some have assets several hundred times those of others. There is also huge variety in the scope of their operations, ranging from local to global.

Provincial and national-level PDBs are normally run by the government that corresponds to their level of activity, while PDBs targeting lower level local municipal activities are normally formed at a higher level of state or national authority. Sub-regional, regional and global PDBs are usually identified as multilateral institutions and are governed by the member governments.

However, this classification may not be as important as it appears, as it is not just multilateral PDBs, like the World Bank's IBRD, that have a global scope. Some national PDBs, like the Chinese Development Bank, Germany's KfW, Brazil's Banco Nacional de Desenvolvimento Econômico e Social (BNDES) and South Africa's Development Bank of Southern Africa (DBSA) lend from the local to global levels. Other national PDBs target domestic borrowers only, for example, the Business Development Bank of Canada or the Mexican Banco Nacional de Obras y Servicios Públicos (BANOBAS).

**Table 2: Scope and scale of PDBs – some examples**

Level/Scale	Examples	Assets
Local and provincial	<b>KBN Kommunalbanken, Norway</b> (1926) ( <i>Owned nationally but funds municipalities</i> )	\$43 billion (2009)
	<b>Iller Bank, Turkey</b> (1945) ( <i>Owned by municipalities and provincial administrations</i> )	\$3.1 billion (2016)
	<b>North Rhine-Westphalia (NRW) Bank</b> (2004) ( <i>Supports municipal and state public tasks</i> )	€144 billion (2014)
	<b>Bank of North Dakota</b> (1919) ( <i>Owned by the state of North Dakota, but also serves municipalities</i> )	\$7.4 billion (2015)
	<b>Thüringer Aufbaubank (TAB), Germany</b> (1992)	\$3.6 billion (2009)
National	<b>China Development Bank</b> (1994)	\$900 billion (2011)
	<b>Bank Gospodarstwa Krajowego, Poland</b> (1924)	\$11.8 billion (2009)
	<b>Banco de Desarrollo Económico y Social de Venezuela (BANDES)</b> (2001)	\$15.5 billion (2009)
	<b>Export-Import Bank of India (Exim Bank)</b> (1981)	\$29 billion (2015)
	<b>Central American Bank for Economic Integration (BCIE)</b> (1960)	\$8.3 billion (2015)
Sub-regional	<b>Development Bank of Latin America (CAF)</b> (1970)	\$18.5 billion (2010)
	<b>East African Development Bank</b> (1967)	\$294 million (2014)
	<b>Inter-American Development Bank</b> (1959)	\$111 billion (2015)
Regional	<b>African Development Bank</b> (1963)	\$18.3 billion (2015)
	<b>Asian Development Bank</b> (1966)	\$29.5 billion (2015)
	<b>European Investment Bank</b> (1958)	€542 billion (\$743 billion) (2014)
Global	<b>International Bank for Reconstruction and Development</b> (1944)	\$352 billion (2014)

Sources<sup>24</sup>

## Business models

Table 3 shows the most relevant business model (or operational strategy) criteria that distinguish PDBs:

- a. Policy mandate
- b. Clients targeted
- c. Lending model
- d. Funding sources

However, some of these institutions have a mixture of the features mentioned in Table 3. For instance, many institutions target both public and private sector clients, such as the European Investment Bank (EIB), and some PDBs use a mixture of the two lending models mentioned (i.e. first- and second-tier operations).

**Table 3: Features of the business model of different PDBs**

Criterion	Features	
Policy mandate	<p><i>Narrow/specific</i></p> <p>For example, focused only on agriculture/SMEs/international trade/housing/infrastructure, etc.</p> <p>Example: National Agriculture and Rural Development Bank of India</p>	<p><i>Broad</i></p> <p>For example, the Development Bank of Philippines, established to “influence and accelerate sustainable economic growth through the provision of medium and long-term resources for the continued well-being of the Filipino People.”</p>
Clients targeted	<p><i>Public sector</i></p> <p>Example: Iller Bank, Turkey</p>	<p><i>Private sector</i></p> <p>Some target a specific type of client, such as other financial institutions, other state-owned enterprises, large private corporations, SMEs or individuals.</p> <p>Example: European Bank for Reconstruction and Development (EBRD)</p>
Lending model	<p><i>First-tier operations</i></p> <p>Lending directly to end-customers.</p> <p>Example: KBN Kommunalbanken in Norway</p>	<p><i>Second-tier operations</i></p> <p>Lending to other financial institutions and banks, which subsequently lend to end customers.</p> <p>Example: North Rhine-Westphalia (NRW Bank) in Germany; Croatian Bank for Reconstruction and Development</p>
Funding sources	<p><i>Deposit takers</i></p> <p>Accept deposits from customers.</p> <p>Example: the Rural Development Bank in Cambodia</p>	<p><i>Not deposit takers</i></p> <p>Do not accept deposits from customers.</p> <p>Examples: Uganda Development Bank; BNDES; China Development Bank</p>

Source<sup>25</sup>

### Key features of PDBs: a development perspective

This report presents a framework for assessing PDBs on the basis of key features that should be considered essential for the institutions to fulfil their mandate and deliver sustainable development outcomes. This framework builds on Eurodad’s research and policy monitoring of multilateral and European PDBs over many years, on members and partners’ work, as well as research undertaken specifically for this report.<sup>26</sup>

Table 4 presents the four core features (A-D) that will structure the rest of this report, each with respective key components identified.

**Table 4: Key features of PDBs from a development perspective**

A. Mandate and role	B. Operational strategy	C. Financial stability	D. Good governance
Mandate and role are derived from the explicit policy objective of the institution, linked to development outcomes. They drive the activities and clearly focus the institution’s investment decisions, such as clients and sectors to target. They also allow stakeholders, including civil society groups, to hold banks and management to account, particularly for the human rights and environmental outcomes of all their activities.	The business model of a PDB drives the processes that enable the institution to fulfil (or not) its core mandate of financing development projects.  The PDB invests in ways that ensure their development mandate takes precedence over generating financial returns.	The PDB is able to reproduce its work sustainably in order to deliver its development mandate in the longer term. This does not imply maximising commercial profitability: it means ensuring sufficient cost recovery and surplus to remain commercially viable, while focusing on delivering development outcomes.	Decision-making processes meet democratic norms by being open, inclusive, transparent and accountable. This requires examining who makes decisions, and how decision-makers are held accountable. Insulation from direct government influence is critically important.

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## Section 2: Towards a better model of PDBs

This section highlights key principles for each of the key features defined in Table 3, showing why these principles are relevant for a sustainable development agenda, and for the implementation of development effectiveness principles. It presents examples of current best practice, where possible, to show that the principles are practically possible. Importantly, the principles set out in this section need to be understood as a whole – in other words, each of the principles should not be pursued in isolation.

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### A. Clear development mandate and role

PDBs need clear mandates and roles that focus the whole institution on delivering development-focused outcomes. This is essential if PDBs are to serve the sustainable development agenda, supporting the delivery of the SDGs – which focus on poverty eradication, the fight against climate change and environmental degradation, and combatting inequality, including economic and gender inequalities. We have identified five key components:

- i. **Strong development mandate:** The mandate of the PDB is to deliver sustainable development outcomes, avoiding vague or dual mandates.
- ii. **Targeting finance where it is needed most:** The PDB targets regions, sectors or clients that are most in need, or that have the highest development pay out – for example, through increased domestic resource mobilisation.
- iii. **Social and environmental standards:** The PDB takes responsibility for the human rights and environmental outcomes of all its activities.
- iv. **Stable, long-term perspective:** The PDB's focus is on long-term, sustainable, predictable and counter-cyclical funding.
- v. **Support for national strategies:** The PDB aligns its activities to democratically determined national plans, to ensure that the PDB helps to improve the financial sector as a whole.

### i. Strong development mandate

By definition, PDBs have a public policy mandate: this is what distinguishes them from purely commercial institutions, including those that are state-owned. However, the clarity and development focus of the mandates of PDBs can vary considerably. An explicit focus on sustainable development outcomes should be an essential element of any PDB: ensuring that the public good is 'baked into' the way the institution sees itself and its overall goals. Of course, sustainable development is a broad term, and it is possible to focus on a 'narrow' mandate (see A ii) with a sector or client focus that is in itself more likely to yield development results. However, for 'broad' PDBs, clarity of purpose is essential: vague mandates should be avoided, as they reduce focus and increase risks of replicating – and therefore competing with – the activities of purely commercial institutions. Dual development and non-development mandates, such as those held by some DFIs, that aim to both promote development and support exporters in developed countries should be avoided, particularly where governance structures bias the institution towards the developed country interests (see Section D.)

In essence, if PDBs do not explicitly aim to act in the public good by supporting development projects where social and environmental impacts are prioritised, not just market returns, then the justification for their existence is significantly weakened. Remaining insulated from profit-maximisation imperatives is essential if PDBs are to play their special role. This is not to suggest that PDBs should not make returns – the issue of how to remain financially viable is discussed in Section C. This also implies having a strong ethos and systems to prevent corruption and the influence of private interests and interest groups.<sup>27</sup>

## ii. Targeting finance where it is needed most

**One key justification for PDBs is that they can direct public and private capital to developmentally important sectors or clients, but to do this they need to be well focused and develop a strong skill set.**

PDBs can add value by targeting strategic sectors of the real economy. In practice, this normally means that they should support the diversification of the economy by targeting sectors that provide 'value-added', and a way out of the natural resource dependency that affects many developing countries. In cases of 'narrow' PDBs, this focus is defined in the mandate. For example, some PDBs target agricultural diversification, but for 'broad' PDBs, this focus is a result of the strategy or business model of the institution.

Supporting clients whose values and practices contribute to fulfilling the PDBs' mandates can play an important role in helping PDBs deliver high development impact. National PDBs can, for example, set concrete targets to serve the needs of local communities and vulnerable groups, including women's groups, or to cater for clients who often do not have sufficient access to finance, such as cooperatives or micro-, small- and medium-sized enterprises (MSMEs), which often are the type of companies that contribute to domestic resource mobilisation the most. In many cases, the role of 'market-maker' will be important: for example, PDBs can provide technical assistance to MSMEs, to improve their business models and access to markets, or their environmental, social and governance practices – a service that commercial financial institutions are unlikely to provide.

This example shows why PDBs cannot be solely focused on fixing failures within specific markets, but also often need to contribute to the creation of new markets.<sup>28</sup> This is important because historical experience of development shows that the barriers to the creation of new markets can be significant, and are unlikely to be explored by purely commercial actors acting of their own accord.<sup>29</sup>

In addition to targeting strategic sectors or clients, PDBs need to develop a strong skill set and expertise in investing in these sectors. This means that, in some cases, PDBs will select their areas of work according to their thematic expertise. As not all PDBs will have the capacity to develop their internal expertise in all areas, a focused approach will increase effectiveness and also public accountability if it helps to avoid outsourcing the management of important bank operations to external parties such as commercial banks. This means moving beyond a risk management approach – which aims to protect communities from harm – to a framework that also seeks to improve development outcomes. For example, PDBs can explicitly include objectives that strengthen, secure and prioritise the tenure rights of vulnerable and marginalised people, with particular attention to the rights of women.

## iii. Social and environmental standards

**A key area where PDBs should lead the way, and develop systems that others could follow, is in responsible environmental and social standards.**

This is not only important in terms of maximising the development impact of all activities and minimising negative impacts, but can also help to improve investments and promote long-term sustainable project outcomes.<sup>30</sup> Social and environmental safeguards should cover a broad set of issues that allow for human rights protection and the protection of the environment, and should apply from the design to the implementation and ex-post phase of projects.<sup>31</sup> In addition, they should have a wide scope, covering communities that are broadly diverse, and should be spelled out in a clear and user-friendly manner for communities to be able to access recourse, if they are contravened.

Civil society groups have set out in detail the kinds of safeguards and standards that responsible financial institutions should follow,<sup>32</sup> but it is worth providing more detail on a few key components:

- *Respect for human rights*: National, regional and global PDBs and their private sector clients should adhere to principles enshrined in international conventions that relate to human rights. As the UN Guiding Principles on Business and Human Rights make clear, these obligations apply "to all states and to all business enterprises, both transnational and others, regardless of their size, sector, location, ownership and structure".<sup>33</sup> This means that activities financed directly or indirectly by PDBs should not contribute to the violation of human rights, as set out in international human rights treaties and conventions. PDBs should also put in place all the necessary measures to fulfil human rights obligations: both overall policies as well as day-to-day activities should be guided by a human rights-based approach. In particular, regional and global multilateral PDBs should develop clear principles in order to identify baseline conditions in terms of human rights and legal systems before considering and approving an intervention in a particular country.
- *Respect for social, labour, gender and environmental standards*: PDBs should adhere to international standards on social, labour, gender and environmental protection. Additional emphasis should be placed on respecting these standards if lending through financial intermediaries occurs, due to the fact that it is all the more difficult to ensure effective implementation of environmental and social protections through third parties, especially for high-risk projects or sectors, such as extractives. In order to be able to do this, PDBs should ensure adequate staffing of environmental and social specialists and key positions, such as Chief Compliance Officer, and provide adequate budgeting and resourcing plans.

- *Financial transparency and responsible taxation:* PDBs should ensure that companies they work with, as clients or partners, do not avoid or evade taxes. PDBs, like all banks, have a duty to conduct due diligence to ensure the projects they fund comply with the legal tax requirements, but they should go further than this. Given the huge importance to the development agenda of tackling widespread illicit financial flows and tax avoidance, PDBs that deal with multinational companies should use their leverage power (or 'seal of approval') to insist on financial transparency from their clients in order to reduce the risks of being involved in assisting tax dodging, corruption or criminal activities. Two simple financial transparency issues are the 'litmus test' of whether PDBs that engage with multinationals are serious about this agenda. First, they should support publication of beneficial ownership information – about who really owns companies, trusts, foundations and similar legal structures, for example, by only supporting clients that are willing to make beneficial ownership information public.<sup>34</sup> Second, they should support public country by country reporting that publishes an overview of multinational enterprise (MNE) activities in each jurisdiction where they operate, the value of their assets, sales and purchases, profit or loss before tax, tax on profit or loss, number of employees and public subsidies received. For example, they should set a deadline for when they will ensure that all their multinational clients and partners annually publish 'country by country' data.<sup>35</sup> In addition, PDBs and their private sector clients should adhere to the highest integrity and anti-corruption standards. Clients found to have violated anti-corruption guidelines should be debarred from contracts.

#### iv. Stable, long-term perspective

**PDBs that provide long-term and predictable financing can help bolster financial stability and support the sustainable structural transformation process of national economies.**

As outlined above, this is one of the key rationales for PDBs: to provide the kinds of financing that may be undersupplied by commercial actors and the financial sector as a whole. This can cover a number of important kinds of financing:

- *Long-term financing:* sometimes known as 'patient capital' that supports investments that may take longer to pay off, but can be crucial for national development.
- *Counter-cyclical financing:* to supply finance when a shock or economic problem has caused private capital to dry up. This helps provide financial stability to countries, especially developing countries, and also to public and private sector companies. This role is especially relevant in the case of large PDBs, which may be able to affect demand across the whole economy.

In addition, the type of financing supplied by PDBs can have macroeconomic impacts, if the scale of PDB operations is large enough. Perhaps the most important is the currency risk of the financing. PDBs that provide loans in the local currency (or regional currency arrangements such as the South American 'Unified System for Regional Compensation', known as SUCRE)<sup>36</sup> do not pose such risks. However, regional and global PDB activities normally entail an inflow of foreign currency in the national economy, which can pose a currency risk for companies, if the loans they receive are denominated in foreign currency, or for the country if the scale of the financing is significant. This is one reason why it is important for regional and global PDBs to provide local currency financing – and equally important, to take into account their impacts on the financial sector of the country, and their impact on the overall national development plan.

#### v. Support national strategies

**PDBs have the ability to have a significant development impact if they support strategic economic sectors and improve the financial sector as a whole.**

One key question is, of course, who decides which sectors are 'strategic' and in need of PDB investment and lending in order to improve the overall allocation of finance by the financial sector? The most satisfactory answer is that PDBs should be aligned to support democratically developed national development strategies. This is important not just for accountability purposes, as outlined below, but also for development reasons. Historically, many successful countries, and successful PDBs, have been guided by strong plans. For regional and multilateral PDBs, the importance of supporting national priorities is magnified by the fact that the governance and decision-making in these institutions largely takes place outside the country in which investment or lending occurs (see Section D).

However, such a plan may not always exist, or may be weakened by a range of factors including external restraints or lack of democratic legitimacy. In such environments, PDBs may find their role difficult or compromised, and a 'narrow' approach may be preferable.

PDBs' activities should serve democratically debated development strategies and accountable governing authorities. It is important that PDB linkages to national and local economies should be transparent, democratic and accountable to the relevant public constituencies. This will help ensure that funding strategies do not favour already privileged and powerful groups in society at the expense of other already disadvantaged and needy ones.

Regional and global multilateral PDBs may find this challenge greater than national PDBs, as this represents a problem of scale. At issue is, for example, how a national development strategy is translated into and substantively shapes the investment decision of a regional or global multilateral PDB bank in ways that ensure that the affected community's priorities are protected and that the PDB's mandates are met. In other words, when PDBs link to local and national economies, there is a risk of powerful PDBs overriding or ignoring democratically determined priorities. This risk can be magnified if a powerful PDB has a single approach to how a given economy should look, or how or where it wants to invest.

A strong case can be made for seeing national PDBs as the primary tools to implement development plans, while regional and global PDBs could also contribute by supporting these national institutions where they exist, or helping to build them if not. Importantly, the above means a change in the way that most regional and global multilateral PDBs currently channel their finance. As a result of working through national public institutions – rather than private sector companies or government clients directly – national stakeholders – including national and local governments, but also local private sector actors and workers' cooperatives, among others – are more likely to be empowered to drive their development path, and to hold PDBs to account.

One critically important point for multilateral PDBs is that they should not seek to influence economic policy making through conditionalities, as this damages democratic decision-making and can undermine genuine national ownership of reforms. It also has a controversial record in terms of the reforms that have been promoted.<sup>37</sup>

Multilateral PDBs should seek to improve and respect country systems, while maintaining high standards. The use of national country systems is a cornerstone of aid effectiveness, as it prevents the proliferation of parallel systems, focusing instead on improving the government's own systems through which the vast majority of public funds flow. However, the quality of national systems varies considerably, and many need improvement if they are to meet international standards and safeguards. Therefore, it is important for multilateral PDBs engaging with the public sector to ensure good practices, and to uphold internationally agreed standards, whilst working towards using country systems by helping to bring them up to the appropriate international standards. Multilateral PDBs should remain accountable for their respective responsibilities in monitoring and supervising projects that use national systems in part or in whole.

A different set of issues arises, however, when discussing the use of systems in the private sector. It may be that PDBs can play an important role in strengthening environmental and social systems in the private sector to improve overall compliance with international standards. They also need to use careful due diligence when relying on corporate clients' systems, and should not absolve themselves of responsibility for the quality of these systems and the impacts of the projects, for example, if their funding is through financial intermediaries.

Finally, it is important that redress mechanisms should apply regardless of the structure of the project or investment. In other words, communities that believe they have been harmed by a sub-project or a PDB-funded client's activities should be able to access and seek redress through the multilateral PDB's grievance mechanisms.

#### Box 2: Development Bank of Ethiopia (1970)

In the case of Ethiopia, as in many other low-income countries, investments with high social returns are less likely to attract sufficient capital if capital allocation is left purely to the market. The government thus had to find alternative ways of financing medium- and long-term projects.

**Mandate/Vision:** "The Development Bank of Ethiopia (DBE) is a specialized financial institution established to promote the national development agenda through development finance and close technical support to viable projects from the priority areas of the government by mobilizing funds from domestic and foreign sources while ensuring its sustainability."

**Link with national economy:** To align the bank's role with the government's development plans, the bank produces five-year strategic plans, which are then used to develop annual plans. To increase its effectiveness, the government has limited the bank's role to supporting priority sectors, to which it provides medium- to long-term credit. According to Schaefer and Abebe (2015), the DBE has had a major impact in the development of the Ethiopian cut-flower industry, one of the sectors that the government had defined as priority in its plans.

Sources <sup>38</sup>

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## B. Operational strategy

PDBs should be careful about how they raise money, as this can have a significant impact on their ability to remain true to their development mandate. Having some element of public funding can help insulate them from commercial interests, to preserve their development focus. However, they also need to pay attention to their investment methods, and ensure that staff motivation is geared towards delivering development benefits, not financial reward.

### i. Right mix of public and private funding

PDBs' operational strategies should ensure that a portion of their financing is 'public' in nature, which can then be complemented by private sources, principally borrowing on bond markets. If PDBs rely heavily on commercial financing, they may face similar market incentives and pressures as private institutions do: ensuring a role for public funding will help protect the development mandate, as this may conflict with purely commercial motives.

PDBs should carefully assess the different sources of funding available and the pros and cons of each, as their funding sources can have a significant impact on their ability to remain true to their development mandate. Potential PDB sources of funding are listed in Table 5.

Public financing can insulate PDBs from market pressures. The use of public money is important because it can help to generate more stable, low-cost and long-term forms of finance and to reduce pressures to prioritise maximising profit over the PDBs' developmental mandate. Many PDBs receive their core capital from public coffers, but there are other ways that public financing can help. For example, public authorities are unlikely to withdraw savings at times of economic instability (eg, Bank of North Dakota); and public enterprise depositors may not receive interest payments (Halk Bank, Turkey).<sup>39</sup> Public funding can also help to reduce the impact of financial crises on PDBs, insulate the institutions from shifts in market priorities and contribute to overall economic stability of the institution and of its investments.

Public guarantees also mean that PDBs can access private finance on favourable terms. PDBs should have the option to raise private sources of finance capital, for instance, through bond issuances in national and global financial markets. PDBs are often backed by a sovereign guarantee, which means that their governments will bail them and their creditors out, should that prove necessary. This, in addition to the fact that their core capital is likely to be provided by the government, means they often receive a stronger credit rating than similar private institutions, and therefore have the capacity to raise money cheaply: paying a lower rate of interest to the private sector bondholder than commercial institutions. PDBs are then able to pass that lower rate of interest on to their borrowers.

The use of private sources of finance by PDBs boosts lending capacity, expanding the impact of the institution. However, it can also contribute to an improvement in the allocation of private capital, by mobilising it to promote specific types of investments that have high development impacts.

More attention needs to be paid to the impacts of the specific method of raising capital on the ability of PDBs to be effective development actors. PDBs that rely on private sources of capital are likely to be strongly influenced by those financing sources. For example, PDBs that rely on bond markets need to make sure they maintain good scores from credit ratings agencies. This impacts, for example, on their risk appetite and potentially the sectors they might invest in. The importance of also having a good source of public finance helps to mitigate the risk that private financing sources might influence PDBs so heavily that they come to resemble purely commercial institutions.

However, PDBs also have an opportunity to go further and examine ways in which they can be agents to 'definancialise' the economic system – that is, to mitigate the global trend towards the increased prominence of financial motives, financial markets and financial actors in the operation of national and international economies. For example, PDBs could develop long-term relations, under terms and conditions crafted to advance development purposes, with particular types of investors, such as sovereign wealth funds and pension funds.<sup>40</sup>

Finally, strong governance systems are also needed to preserve the 'public ethos' of PDBs against political capture: this is discussed in Section D.

### ii. Careful choice of methods of investing

PDBs should invest their finance capital in ways that ensure their development mandate takes precedence over generating financial returns.

There are justifications for PDBs to invest at both market (non-concessional) and below-market (concessional) rates. Both ways can serve a PDB's mandate, be democratically driven, and be in the public good. When justified by the PDB's mandate, non-concessionary lending at market or profit-making rates can generate returns for the PDB, which can be justified if they are used to increase the bank's investment capital or to subsidise concessionary lending. In practice, this has been the case for many multilateral PDBs that lend both to private sector companies – at market rates – and to low-income countries – on concessional terms.

**Table 5: Potential PDB sources of funding**

Public sources of funding		Private sources of funding
Direct capital injections	Money that has to be paid back	
<ul style="list-style-type: none"> <li>• Dedicated resources from annual budgets or from a percentage of annual tax revenue</li> <li>• PDBs' retained earnings</li> <li>• 'Callable capital' – official promises to pay, should funds be requested</li> </ul>	<ul style="list-style-type: none"> <li>• Selling bonds to other public sector enterprises as well as to central banks</li> <li>• Loans from regional and global multilateral PDBs, in the case of national PDBs</li> <li>• Deposits from state-owned enterprises and public service providers</li> </ul>	<ul style="list-style-type: none"> <li>• Deposits from individuals (similar to retail commercial banks)</li> <li>• Selling bonds in the private capital market (either national or global)</li> <li>• Investors such as pensions funds and sovereign wealth funds</li> </ul>

Concessional lending can include PDB discounts on market interest rates. If the interest rate charged falls below a profit-making level, and therefore fails to make a real return, after including ongoing operational costs, such lending losses need to be compensated by cross-subsidisations within the PDB itself. This can be done by being blended with grants, including government transfers. At the international level, official development assistance (ODA, or 'aid') is increasingly being used to subsidise PDB activities. This issue is discussed further in Section C.

Demonstrating the development and financial additionality of PDBs' interventions are particularly important for multilaterals. Multilateral PDBs should provide clear documentation that identifies the need for the loans/ investments to take place with support from a public institution and how this contributes to the national development plan, and what the additional development impacts are. In other words, PDBs should carefully evaluate the development 'additionality' of their activities, and not just assume it. Demonstrating 'financial additionality' – showing that a national financial institution could not have made the same investment – is important for multilaterals, as they are an external influence on domestic financial sectors. Without a demonstrated financial additionality, there is a risk that multilaterals can undermine the development of national financial sectors by limiting the market for national actors, including national PDBs.

If multilateral PDBs are to be genuine longer-term partners for a country's development, they should seek to empower national PDBs. Obviously, to receive multilateral financing, national PDBs need to be well run and governed – to apply the principles set out in this paper. However, multilateral PDBs can also play a role in helping to improve the stability, governance and effectiveness of national institutions. When this happens, they are more able to serve democratically decided national development strategies and the development of a local private sector.

Supporting the development of national PDBs is a better model for multilaterals than developing their own national portfolios, for a number of reasons. First, once well established, national PDBs can become significant sources of stability for the national financial sector, and become drivers of economic development, supporting national development plans. Multilaterals' commitment to any particular country cannot be so long term, as their funding is likely to be volatile – responding to opportunities in the recipient country based on comparison with similar opportunities elsewhere – their own financial health, which will be affected by factors outside the country, as well as the changing political and policy priorities of the multilateral. As long as they are well structured, and depending on the democratic situation in the country, national PDBs can also provide a much more direct accountability route for their activities than multilaterals headquartered in a different continent, whose governance is dominated by foreign governments with their own trade and geopolitical interests. This is particularly important for redress mechanisms, as most multilaterals cannot be taken to a national court, as noted in Section D (v).

Multilateral PDBs' use of commercially structured financial intermediaries has been controversial. In general, civil society organisations (CSOs) are sceptical of the use of private financial intermediaries, such as large commercial banks or private equity funds, as the experience of existing institutions has posed great challenges for the delivery of PDBs' mandate, transparency and accountability of these institutions.<sup>42</sup> In addition, PDBs making loans and investments through commercial banks tend to replicate and interfere in commercial banking. This also implies outsourcing a great deal of their operations to other entities that might or might not share the same values and principles. Where going through national PDBs is not possible, multilateral PDBs could make careful use of certain other types of financial intermediaries, such as public commercial banks, cooperative banks and mutual banks where these are well run (see Box 4 on Banco Popular from Costa Rica).

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### iii. Internal systems to focus, assess and monitor

PDBs should have the internal capacity to assess robustly and show clearly and systematically the impacts of their policies and investment decisions. The main objective should be to ensure that the PDB's resources are being used effectively, appropriately and accountably, in line with the development mandates of PDBs. It is important that an analysis of the impact of PDBs' policies and financing is done, with a timeframe long enough to allow for measuring and reporting development results. In the case of regional, global and large institutions, it is preferable that this analysis is done independently.

At the same time, PDBs should not restrict assessment of developmental impacts to conventional metrics. In other words, impacts should not only be measured by narrow economic indicators, such as economic growth, the amount of money invested in a particular country, or the additional employment created. Instead, assessment should also consider the quality of the investment and intervention, its contribution to the common good, innovation potential, contribution to capacity building or knowledge transfer at country level, contribution to reducing carbon emissions or social inequities, impacts on gender, inequality or well-being, and other qualitatively or quantitatively assessable factors.<sup>43</sup> Ultimately, overall development impact is what matters.

Effective due diligence procedures, accompanied by supervision and monitoring mechanisms, are important. PDBs have a fiduciary responsibility to ensure that any activities financed are legal and viable. Banks should perform – or require supported companies to perform – such comprehensive ex ante impact assessments, considering human rights impacts as well as environmental and social impacts and adverse impacts on women, land tenure and food security. For multilateral or large PDBs, and for large projects or those in sensitive sectors, such assessments should be independently undertaken or verified, to ensure appropriate rigour and credibility. These assessments should be publicly disclosed and accessible to the affected local communities prior to the approval of the loan or investment in a language understood locally. Loan/investment contracts should clearly state who bears the costs of possible risks associated with the project as identified in the ex-ante assessment. Supervision and monitoring mechanisms should also be long term and broad in scope in order to follow the whole project/investment cycle.

## C. Financial sustainability

PDBs aim to be financially sustainable in the long run: financial sustainability allows them to deliver consistently on their development mandate. However, there can be a tension between development outcomes and financial returns, so PDBs need to have clear systems and structures in place to ensure that sustainable development outcomes remain the overall focus, and are never sacrificed for financial returns.<sup>43</sup> In addition, the fact that PDBs can receive public financing and public guarantees means there is a risk that financing arrangements damage good governance (see Section B above) by allowing government influence over the day-to-day operations and strategic decisions of PDBs.

### i. Reinvest any profits

If PDBs are set up to earn a profit, this should be reinvested to support the development focus of the institution. PDBs can operate on a broad profitability spectrum: from covering the costs of their operations to generating a profit: the choice of which will depend on the precise design and purpose of the PDB.

PDBs can perform their mandated duties sustainably in two different ways:

1. On a not-for-profit basis, which implies that returns cover basic operational costs and the remainder is re-invested by the bank, or
2. Loss-making operations, which implies that either:  
(a) the government is subsidising these operations to ensure the bank's long-term sustainability; or  
(b) the bank uses profitable services in one area to compensate for non-profitable services in other areas.

A third option where PDBs make a profit and remit this back to their shareholders should be ruled out on good governance grounds. Given that shareholders tend to be governments, this creates an incentive for governments to see PDBs as a revenue-generating tool, and therefore greatly increases the likelihood of political interference, which, as Section D argues, represents a fundamental threat to the ability of PDBs to deliver on a sustainable development mandate.

In other words, the long-term financial sustainability of a PDB should not undermine its ability to invest in higher risk areas, or focus on projects where development returns are high but profitability may be low. It can achieve this sustainability through various methods including: accepting lower than market rates of return; internal cross-subsidisation between profitable and less profitable sectors or projects; and because of the financial advantages of public funding and guarantees.

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This focus on overall financial sustainability – rather than profitability – should allow PDBs to fund areas such as more risky 'venture'-type lending. This could include lending premised on innovation and directionality – for example, ventures making significant leaps forward in green technologies. This type of lending involves some degree of risk that commercial lenders may not be willing to take on.

### ii. Prioritise development outcomes

The crucial factor is to ensure that development outcomes should take precedence over concerns for financial returns, while at the same time ensuring the PDB earns sufficient returns to guarantee its long-term reproduction.<sup>44</sup> If concerns for financial returns take priority, then the risk is not just that the PDB replicates (or potentially undermines) commercial banks, but that development outcomes may be hindered, for example, if the PDB invests without due consideration of debt sustainability levels in a given country, or if the PDB avoids investing in areas with high development impact because profit levels are deemed too low, or risks are considered too high.

Accordingly, appropriate incentives and training need to be put in place to incentivise PDB management and staff to approve projects according to this practice of financial sustainability in the public good, which qualitatively differs from purely commercial operations.

### iii. Take care with public grants

Great care must be taken if PDB operations are subsidised by public funds beyond initial capital injections: ensuring high levels of national accountability is crucial. ODA is increasingly being seen as a method of subsidising PDB operations, through the blending of ODA grants with loans, or through the provision of additional guarantees. In some cases, national PDBs are also subsidised by government funds. In addition, as already noted, direct and indirect official government guarantees tend to enhance the credit ratings and financial stability of PDBs. This is because they enable PDBs to access cheaper and longer-term sources of capital and to act counter-cyclically at times of crisis, by providing credit when funds are hard to come by.

However, caution must be exercised as such guarantees and ODA or national public funds can change the sustainable funding model of the institution, potentially opening up avenues for lending that is not fit for purpose, that contradicts the PDB's mandate and mission, or that renders the PDB financially unsustainable.<sup>45</sup> In particular, extreme caution must be exercised at times of crisis when counter-cyclical lending is rolled out. For example, the World Bank praises the counter-cyclical lending and provisioning of debt guarantees by PDBs in Mexico during the 2008-09 global crisis.<sup>46</sup> However, critics charge that such public guarantees and lending went to covering the external debts of a mere eight of Mexico's largest corporations, thereby socialising massive private sector debts at times of crisis.<sup>47</sup> Hence, powerful democratic oversight and governance processes (see Section D) must be put in place to make appropriate use of public subsidies for PDBs at all levels.

### iv. Incentivise staff to deliver for the public good

Operating costs must be managed while ensuring that staff are able to operate efficiently, and maintain high levels of morale and focus: for institutions focused on the public good, this is possible without matching the bloated salary and bonus culture of parts of the commercial financial sector.

Financial sustainability is also linked to operating costs, which include fixed capital, IT infrastructure and staff costs. This issue needs careful attention as PDBs must provide the necessary physical infrastructure and retain qualified staff in order to ensure successful mandate-driven investments and long-term financial sustainability, but without losing sight of the need to operate in the public good. These considerations must be exercised with a view to avoiding the runaway compensation offered to some financial professionals in the private sector, especially senior management. Non-monetary motivations associated with working in the public sector and for the public good should be mobilised. Likewise, setting transparent fixed pay ratios between the highest and lowest paid PDB employees and instituting staff participation in PDB decision-making and governance processes can be strong motivators for staff retention in ways that support financial sustainability.

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## D. Good governance

Governance arrangements have a major impact on how the banks operate and their overall ability to deliver on their mandate. PDBs should work on the basis of a representative and democratic governance structure and open, inclusive, transparent and accountable decision-making processes.

### i. Equal borrower representation at multilateral PDBs

In the case of PDBs that include in their membership borrowers and non-borrower countries, they should ensure a governance structure that gives, as a minimum first step, equal voting power to both groups of countries.<sup>48</sup> Most regional and global PDBs have an undemocratic structure that links the voting power to the capital of countries contributing to the institution.<sup>49</sup> This in turn has been the result of a series of ad hoc agreements. In general, the current system is closer to a 'one dollar-one vote' rule and gives disproportionate influence to the wealthiest countries and serves to ensure their political control over regional and global PDBs.<sup>50</sup> The first stage must be to move to borrower countries having a minimum of half of the vote and board seats.

One additional reform that Eurodad and other CSOs have called for is a reform of the decision-making of global PDBs through the introduction of a 'double majority voting' system, which requires both shareholding and member state majority, thus giving developing countries a larger part in decision-making.<sup>51</sup> The transformative change is to balance the 'one country-one vote' system, ie, the member state majority, with a principle that grants those countries with people who are most affected by funding from the institution a greater say in the decisions it makes.

However, it is important to recognise that institutions governed on the basis of a truly democratic governance structure should find ways of including other actors – not just governments – in the decision-making process. The current imbalance of power between the different economic and social groups inside countries does not help to ensure that the voice of governments fully reflects the priorities of disadvantaged and vulnerable groups. In order to address this properly, PDBs should put in place additional measures to reinforce the democratic nature of their governance structure and to establish open, inclusive, transparent and accountable decision-making processes (see following sub-section).

### ii. Insulation from political pressure

It is also important to implement institutional and governance arrangements that protect PDBs from undue government pressures that might be contrary to the bank's mandated purpose. This means that the institutions should aim to support democratically determined strategies, which therefore entail supporting the plans designed by governments, but at the same time, be completely operationally independent according to set mandates. The risk of using PDBs as political pawns, for instance, to obtain short-term political wins, or having corrupt behaviours associated with them, particularly at the national level, should be reduced as much as possible.

A key option in this regard might be to establish a participative monitoring system involving oversight by democratically elected bodies, such as regional and national parliaments. Two concrete ways of doing this are: a) to include members of national and/or regional parliaments on the board of regional and national PDBs; and b) to require that national and/or regional parliaments approve the accounts of respective institutions. As a matter of democratic principle, it is important to be answerable to the parliament of the country to which you are giving the loan.

The rules of how the PDB's board operates, as well as information about why and how individual projects are chosen and delivered, should be clearly spelled out in order to ensure transparent and accountable decision-making processes.<sup>52</sup>

It is essential to establish clear, transparent and fair guidelines for the recruitment of staff and presidents of PDBs. Staff of all PDBs should include diverse nationalities and professional preparations, but the emphasis must remain on selecting staff based on merit. In order to make sure PDBs live up to their principles, and also draw on the best talents, strong policies should be implemented to apply gender balance. The president of regional and global PDBs should be selected on the basis of an open, merit-based and transparent process, regardless of the nationality of the candidates. The legitimacy should be obtained from the backing of a majority of countries, as well as voting shares in the institution. This will ensure that they are broadly acceptable to the wider membership as well as the most economically powerful countries. If no candidate gains these majorities on the first round of voting, subsequent rounds should be organised, with the bottom candidate dropping out each time.<sup>53</sup> A process like this for the nomination of the president of regional and global PDBs is necessary to ensure public confidence in these institutions.



### Box 3: The Banco Popular y Desarrollo Comunal (Bank Popular and Community Development – BPDC), Costa Rica (1969)

The case of Banco Popular in Costa Rica shows how some of the principles highlighted so far could work in practice.

**Mandate and role:** To support communal, cooperative and municipal development associations and workers' associations.

**Operational strategy:** Banco Popular is a universal bank that deals in both commercial retail banking services and in development finance projects. Public deposits are a major source of funding and investments target workers, popular classes, MSMEs and various associations.

**Financial sustainability:** It is conceived around four pillars:

1. Accessibility
2. Innovation
3. Management of workplace environment
4. Management of social responsibility

That is, the public and social good is placed alongside the need to generate positive returns. In 2012, Banco Popular earned 2.1 per cent return on assets, in 2013 1.5 per cent, and in 2014 1.4 per cent. Notably, the 'public' provides an important source of funds. The Banco Popular accepts over 40 per cent of the payroll deposits from the public sector in Costa Rica and collects mandatory contributions to a complementary pension fund equivalent to 1.25 per cent of the total payroll of public and private sector workers.

**Good governance:** The Assembly of Workers, formed by representatives from ten social and economic sectors (artisanal; communal; cooperative; self-managed; independent; magisterial; professional; confederated syndicates; non-confederated and solidarity syndicates), is the highest governing body. It directs the National Directive (Junta), the highest administrative unit, whose members are elected for four-year terms and whose composition should reflect gender equity.

**Unionisation:** The Banco Popular has no restrictions on its workers participating in solidarity, union or cooperative associations

**Unique Development Features:** The BPDC is a participating bank in the new 'Development Bank System' in Costa Rica, composed of different public and private banks, that direct credits into viable, productive projects. In 2012, the BPDC established a special inclusive investment fund – the Fondo Especial de Desarrollo (FEDE) or the Special Fund for Development. The FEDE targets micro-enterprises and 'Organizations of the Social Economy' that do not have access to regular banks and that are investing in the environment, rural aqueducts, health and productive sector. The Banco Popular also has specialty environmental facilities, like the Eco-savings and Eco-credits, geared specifically towards MSME projects where the environment is a key element of the project.

Sources<sup>54</sup>

### iii. Active participation of civil society and bank employees

PDBs should open channels for the meaningful participation of civil society groups, including trade unions and bank employee unions, in their decision-making processes. Civil society participation is important not just in the implementation, monitoring and evaluation of projects financed by PDBs, but also as valuable inputs into the design of PDB policies. However, many CSOs are sceptical of having CSOs and/or local communities represented through a seat at the board level of PDBs. This is because independence of CSOs and local communities from the actual decision-making of the banks is key to holding the institutions to account for their policies and investment decisions. Instead, the creation of Civil Society Councils, composed of representatives of the different civil society groups and including a proper gender and ethnic balance, can help ensure that the different interests are represented. These councils could be guided by a CSO engagement framework with universal engagement guidelines, monitoring mechanisms and CSO controlled funding to facilitate CSO engagement.

Protecting the rights of employees is crucial to good governance of PDBs, but employees can also play other roles in the governance of PDBs. It is critically important to ensure the right of bank employees to be unionised and exercise collective action at all levels should be respected (in Mexico, for example, bank employees cannot strike). At all levels, employees should have the ability and right to submit their concerns to management in an open way without expecting any form of retaliation. The experience of some national PDBs has shown that they can play a useful role in the governance structure of PDBs, contributing in a meaningful way to the definition of policy orientations of the institution. For example, the State Bank of India (a public bank that has retail and developmental operations) has a governing board that includes one bank worker and another management employee appointed by the government.<sup>55</sup> While ideal staff representatives should be elected in a more bottom-up and democratic fashion, this approach does internalise employee representation.

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#### iv. Strong transparency policies, based on the right to information

The basis of transparency policies should be the right of citizens to access information held by public authorities. This is a fundamental right guaranteed under international law and recognised by, among others, the European Court of Human Rights and the United Nations Human Rights Committee. As public institutions mandated to deliver development results, national, regional and global PDBs should comply with these principles.

Transparency policies of PDBs should be composed of the following five main elements:

- 1. Right of access to information:** For example, PDBs should include transparency clauses in contract arrangements with clients that force them to publicly disclose important data, such as the names of sub-clients of financial intermediaries and the beneficial owners behind them.
- 2. Automatic disclosure of information:** All documents should be disclosed with a limited regime of exceptions (see point 3). PDBs should publish comprehensive information on the activities they finance, including environmental and social assessments, in a format and language that is accessible for those who will be affected by them. In the case of intermediated lending, PDBs should publish information regarding the sub-projects supported by their clients.
- 3. Limited exceptions:** When withholding information, PDBs should clearly demonstrate that there is an overriding public interest in doing so, and explain in detail what kind of harm disclosure of certain documents would cause. Decisions on exceptions should be made by the board of directors, not by clients or the management.
- 4. Right to request information:** Citizens, in general – and affected people, in particular – have the right to request information. PDBs should specify in a public register which documents they have at their disposal to allow citizens to know which data can be requested. The process to request information should be simple, rapid and free or low cost.
- 5. Access to decision-making:** For example, in the case of regional and global multilateral PDBs, the institutions should disclose detailed information revealing the different country positions within the board and how decisions on projects are actually made. This will allow citizens to hold the board members of PDBs accountable. Meetings where decisions are made should be made public, for example, through streaming and recording on PDB websites.

#### v. Strong accountability policies

The accountability policies of national, regional and global PDBs should be designed and implemented to allow for a variety of actors – including governments, parliaments, CSOs and local communities – to hold them to account.

PDB accountability policies should include the following three main elements:

- 1. Independent evaluations and lessons learned:** PDBs should allocate sufficient resources to finance independent evaluations, and put in place processes that enable them to take on board lessons learned from past activities.
- 2. Active and meaningful participation of external stakeholders,** including CSOs, affected communities, and national and regional parliaments. This means that these actors must have real-time access to information regarding pending loans, and board meetings should be publicly broadcast, with documents released in advance. Sufficient financial and human resources should be allocated to ensure well-defined and relevant consultation processes at national, regional and global level. In addition, the principle of Free, Prior and Informed Consent (FPIC), as a means to protect indigenous peoples' rights and in line with the United Nations Declaration of the Rights of Indigenous Peoples, should be included in the policies of all institutions, adopted and implemented as a necessary requirement for project approval.
- 3. Effective, user-friendly, independent complaints mechanisms:** In order to fulfil PDBs' accountability mandates, they should set up complaints mechanisms that are able to assess compliance against rules-based standards regardless of the activity that is financed. In principle, complaints mechanisms must not be seen as an impediment to development, but as a crucial element to achieving development outcomes. Affected people and groups should have the right to complain and seek redress, while PDBs should adopt protocols for protecting complainants from reprisals and responding to them should they occur. The complaints mechanisms should be easily accessible, user-friendly and independent, among other key features. The mechanisms should be provided with sufficient resources and recommendations should be binding. In more detail this means:

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- **Accessibility and user-friendliness:** Bank clients should be required to inform local stakeholders about the existence and operating procedures of the complaints mechanism and about the potential environmental and social impacts of the PDB-financed activity. Complaints mechanisms should be able to reach out to the public directly. Complaints should be accepted while the process is ongoing and after the project is closed. In addition, PDBs should make all possible efforts to inform people impacted by their projects on how to submit complaints, in a pro-active manner. The complaints mechanisms should allow complaints in the language of the complainant and information should be provided on PDBs' websites in all relevant languages.
  - **Independence:** Complaints mechanisms must also be encouraged to proactively initiate investigations. To ensure independence, there is a need for pre-employment and post-employment cooling-off periods between PDBs and their complaints mechanisms, and a recruitment procedure in which the PDBs' board selects candidates for the position of head of the complaints mechanism. Complaints mechanisms should establish official external stakeholder advisory groups to provide them with feedback and guidance on their work. In addition, complainants should participate in PDB board meetings when cases are discussed in order to express their views on the findings and/or recommendations of the complaints mechanisms and the adequacy of the management action plan. Those board meetings should also be live-streamed online so that project-affected people have access to the decisions that affect them.
  - **Predictability:** Complaints mechanisms must consistently meet their deadlines in processing complaints. They should provide regular status updates to complainants and a time-bound management action plan should be developed to address every finding of non-compliance made in investigations. Complaints mechanisms should be able to monitor whether the instances of non-compliance have been remedied and should publish monitoring reports at least once a year, which incorporates the information provided by complainants on the implementation of the commitments made by the PDB or its client.
  - **Equity:** Complainants should be given the same opportunity as the PDBs to review and comment on the complaints mechanisms' reports. The final report should be sent to the complainants at the same time as it is sent to the board, and it should contain the perspectives of the complainants. PDBs should develop and implement procedures for robust and participatory consultation with complainants prior to the development of management action plans. PDBs should create an appeals process for those complainants who are unsatisfied with the results of the complaints process or the implementation of commitments by the PDB or its client.
  - **Financial resources:** Complaints mechanisms must be allocated sufficient resources to deal with complaints adequately and to ensure that complainants can meaningfully participate in the process. The board – and not the PDBs' management – should determine the complaints mechanisms' budget and oversee the corrective actions taken by the PDB. In addition, the complaints mechanisms should have access to a fund or other financial instrument to provide compensation or financing for other remedial actions. For instance, PDBs could establish an 'accountability' fund linked to lending, where a small fraction of the returns on lending are hived off and accumulated in an independent fund in order to compensate potentially affected people.
  - **Follow-up actions:** Transparency following complaints should be provided and the implementation of complaints mechanisms' recommendations should be made binding. Recommendations should be linked to a system in which PDBs' management and boards can exclude or delay disbursements to poorly performing companies and no additional financing should be provided for similar activities to clients who have been found to be in non-compliance with environmental and social standards until those clients have rectified the non-compliance. PDBs should develop a publicly available management tracking system that documents how they have responded to complaints mechanisms' findings and recommendations, what lessons they have learned from cases, and how they will apply those lessons to future investments.

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**4. Enforcement mechanisms:** In order to ensure accountability at all levels, PDBs should be subject to both internal and external sanctions when bank policies are breached, whether by their clients, board members, management or employees. This means a shift away from the current structure of institutional incentives, but more importantly, an end to the conventional practice of granting privileges, exemptions and immunity to the staff of regional and global PDBs - a practice which makes it all but impossible for third parties to make a claim before a national court.

In addition, PDBs should abandon any claim to immunity for environmental and social harm. As SOMO and partners have argued in a recent report,<sup>56</sup> "The UN Office of the High Commissioner on Human Rights and the OECD have made it clear that financial institutions, including state-owned enterprises and minority shareholders, can cause or contribute to human rights abuses. There is no argument, development or otherwise, that DFIs [or PDBs] should be immune from liability for those harms." It is vital to ensure that communities which are adversely impacted by PDB-funded projects have the option of bringing a lawsuit to an independent court or arbitration tribunal.

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## Section 3: Conclusion

Public development banks (PDBs) are in a unique and powerful position to deliver on public policy objectives. They can - and should - play a very significant role in development. As this report shows, PDBs can direct finance to important sectors or regions, build national financial sectors, promote economic stability, and improve standards - for example, through environmental, social or human rights safeguards.

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However, PDBs face considerable challenges in performing their role, and some of them have been rightly questioned about the negative impacts of their operations. A significant reason for the inconsistent performance of PDBs is the nature of the institutions themselves, which vary considerably, with diverse mandates, roles and operational strategies.

This report proposes a framework for institutional and governance reform – a comprehensive package of recommendations to enable PDBs to fulfil their potential as drivers of positive development. It is intended as a major contribution to the discussion on this critical issue, but it is also a challenge to PDBs, and the governments backing them, to up their game. In order to meet the requirements of this framework, all PDBs will need to aim higher, be better and embrace reform.

Table 6 (shown earlier as Table 1 in the Executive Summary) lists the core features and key components of an ideal PDB, and these are examined in more detail within the pages of this report.

**Table 6: Core features of a model Public Development Bank**

Core features and key components	Explanation/Detail
<b>A: MANDATE AND ROLE</b>	
i. Strong development mandate	The mandate of the PDB is to deliver sustainable development outcomes, avoiding vague or dual mandates.
ii. Targeting finance where it is needed most	The PDB targets regions, sectors or clients that are most in need, or that have the highest development pay out.
iii. Responsible social and environmental standards	The PDB takes responsibility for the social and environmental outcomes of all its activities. The PDB ensures that companies they work with, as clients or partners, do not avoid or evade taxes.
iv. Stable, long-term perspective	The PDB's focus is on long-term, sustainable, predictable and counter-cyclical funding.
v. Support for national strategies	The PDB aligns its activities to democratically determined national plans, to ensure that the PDB helps to improve the financial sector as a whole.
<b>B: OPERATIONAL STRATEGY</b>	
i. Right mix of public and private funding	The PDB receives some public funding, so it is not a purely commercial institution.
ii. Careful choice of methods of investing	The PDB invests in ways that ensure their development mandate takes precedence over generating financial returns.
iii. Internal systems to focus, assess and monitor	The PDB has the internal capacity to assess and systematically show the impacts of their policies and investment decisions, and has effective due diligence procedures, accompanied by supervision and monitoring mechanisms.
<b>C: FINANCIAL SUSTAINABILITY</b>	
i. Prioritise development outcomes	The PDB should ensure development outcomes take precedence over profitability.
ii. Reinvest any profits	The PDB should reinvest any profits to support the development focus of the institution.
iii. Take care with public grants	Strong public accountability must be in place if PDB operations are subsidised by public funds beyond initial capital injections.
iv. Incentivise staff to deliver for the public good	The PDB draws on its development focus to recruit and motivate staff, without copying the bloated salary and bonus culture of parts of the commercial financial sector.
<b>D: GOOD GOVERNANCE</b>	
i. Equal borrower representation at multilateral PDBs	The multilateral PDB has a governance structure that gives, as a minimum first step, equal voting power to borrowing countries.
ii. Strong transparency policies, based on the right to information	The PDB has a strong and carefully implemented transparency policy based on: the right of access to information; automatic disclosure of information with limited exceptions; the right to request information; and public access to decision-making.
iii. Active participation of civil society and bank employees	The PDB has open channels for the meaningful participation of civil society groups, including trade unions and bank employee unions, in its decision-making processes.
iv. Insulation from political pressure	The PDB has governance arrangements that protect it from undue government pressures that might be contrary to the bank's mandated purpose.
v. Strong accountability systems	The PDB has well-implemented accountability systems including: independent evaluations; meaningful participation of external stakeholders; and effective, user-friendly, independent complaints mechanisms.

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50. The voting shares of the World Bank's IBRD – which offers finance to middle-income countries – are determined by countries' economic weight, their contributions to the World Bank's International Development Association (IDA) – which provides grants and concessional loans to the poorest countries – and a commitment to move over time to 'equitable voting power' between developed countries and developing or transition countries. Extra votes are being issued to certain countries in return for those countries making extra contributions to the Bank's capital. (See Bretton Woods Project. 2010. *Analysis of World Bank voting reforms. Governance remains illegitimate and outdated*. Accessed in November 2016: <http://www.brettonwoodsproject.org/2010/04/art-566281/>)
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## Acknowledgements

This report was written by María José Romero (Eurodad). Support was provided by Thomas Marois (SOAS, University of London), who provided valuable background research to inform this report, and Eurodad Director Jesse Griffiths.

Special thanks go to Eurodad's Jeroen Kwakkenbos and Mathieu Vervynct and Eva Hanfstaengl (Bread for the World), as well as to the following people, who provided insightful comments and guidance:

- Kjetil Abildsnes, Norwegian Church Aid
- Soren Ambrose, ActionAid International
- Carlos Bedoya, Latin American Network on Debt Development and Rights (LATINDADD)
- Fanwell Bokosi, African Forum and Network on Debt and Development (AFRODAD)
- Patrick Bond, University of KwaZulu-Natal's Centre for Civil Society in Durban, South Africa
- Lila Caballero, ActionAid, United Kingdom
- Margarita Florez, Ambiente y Sociedad, Colombia
- Paulina Garzon, China-Latin America Sustainable Investment Initiative (CLASII)
- Stephany Griffith-Jones, Initiative for Policy Dialogue at Columbia University, Columbia University, US
- Rayyan Hassan, NGO Forum on ADB
- Sara Jespersen, Oxfam IBIS, Denmark
- Manana Kochladze, CEE Bankwatch
- Patricia Miranda, Fundación Jubileo Bolivia/LATINDADD
- Manuel Montes, South Center
- Pedro Paez, Superintendency for Market Power Control, Ecuador; former Chairman of the Presidential Commission for the Design of the New Financial Architecture, 2007-2011
- Annalisa Prizzon, Overseas Development Institute, UK
- Xavier Sol, Counter Balance
- Stephen Spratt, Institute of Development Studies, University of Sussex, UK
- Antonio Tricarico, Re:Common/Counter Balance
- Oscar Ugarteche, UNAM/LATINDADD
- Elisa Van Waeyenberge, SOAS, University of London
- Luiz Vieira, Bretton Woods Project
- Bryan Ziadie, IBON International

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## Eurodad

The European Network on Debt and Development (Eurodad) is a network of 47 civil society organisations (CSOs) from 20 European countries, which works for transformative yet specific changes to global and European policies, institutions, rules and structures to ensure a democratically controlled, environmentally sustainable financial and economic system that works to eradicate poverty and ensure human rights for all.

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