

Rethinking the Role of National Development Banks

Revised background document¹

Abstract

This paper is a revised and updated version of the informal background document prepared for the Ad Hoc Expert Group Meeting on “Rethinking the Role of National Development Banks” (New York, 1-2 December 2005). Its goal is two-fold. First, it aims to provide a possible framework for analyses at follow-up regional meetings, with a view to deriving conclusions and recommendations. Second, it includes a number of examples and specific cases – from best practices to failures - that may serve as points of reference in the envisaged discussions and further analyses. The consultative process is expected to result in a consolidated publication on the role of national development banks as a renewed tool of development finance. Accordingly, the paper consists of three parts. Part I describes the consultative process and presents its likely outcomes. Part II provides an overview of national development banking, its history, rationale and missions. Part III examines the evolving role of national development banks in the following key areas: filling gaps in financial sector development, in particular through long-term loans; improving the business climate, in particular for SMEs; and capacity-building to realize the potential of NDBs in financing for development.

¹ The original version of this paper was prepared by the staff of the Financing for Development Office of UN-DESA as an informal background document for the Ad Hoc Expert Group Meeting on “Rethinking the Role of National Development Banks” (New York, 1-2 December 2005). The current version is still a working document and is not intended for quotation. The views expressed herein are those of the authors and do not necessarily reflect the position of the United Nations. Comments and suggestions on the text should be addressed to Julien Serre (e-mail: serre@un.org)

Contents

Executive Summary	iii
I. Multi-stakeholder Consultations	1
A. Introduction	1
B. Consultative Process on NDBs	2
1. <i>Approach</i>	2
2. <i>First Step</i>	3
II. Overview of National Development Banking	3
A. Historic Overview	3
1. <i>Origins and Evolution</i>	3
2. <i>Structural Variations</i>	5
B. Rationale and missions	7
1. <i>General Definition</i>	7
2. <i>Actions and Lines of Activity</i>	9
3. <i>General Framework of Analysis</i>	11
III. The Evolving Role of National Development Banks	12
A. Filling Gaps in Financial Sector Development	13
1. <i>Providing Long-term Financing</i>	13
2. <i>Providing Other Financial Products for Development</i>	17
3. <i>Building Inclusive Financial Sectors</i>	21
B. Improving the Business Climate	25
1. <i>Promoting and Supporting SME development</i>	25
2. <i>Reducing Volatility</i>	27
3. <i>Acting as a Catalyst</i>	28
C. Capacity-Building of NDBs	31
1. <i>Improving Prudential Regulation and Supervision</i>	31
2. <i>Enhancing Governance and Management</i>	32
3. <i>Measuring and Monitoring Results</i>	35
Index of Stakeholders	37
Bibliography	39

TABLES, BOXES AND FIGURES

TABLE 1: THREE OBJECTIVES FOR NDBS	8
TABLE 2: THE "FIVE A'S"	10
BOX 1: LIQUIDITY MANAGEMENT FOR LONG-TERM LOANS	16
BOX 2: BNDA AND VILLAGE BANKS: AN INNOVATIVE APPROACH BY KfW	22
BOX 3: THREE SCENARIOS FOR LOCAL FINANCING	23
BOX 4: EGYPT'S NATIONAL BANK FOR DEVELOPMENT AND MICROFINANCE	24
BOX 5: CATALYTIC ROLE OF NDBS: CASE OF WATER INFRASTRUCTURE	29
BOX 6: STANDARD & POOR'S METHODOLOGY FOR RATING GOVERNMENT SUPPORTED ENTITIES	32
FIGURE 1: A PYRAMID OF NATIONAL DEVELOPMENT BANKING ACTIVITY	9
FIGURE 2: EXAMPLE OF CONSTRAINTS FOR A SPECIFIC PROBLEM	11

Executive Summary

I. The Consultation Process

1. How can the role of NDBs in promoting economic and social development be enhanced? This fundamental question will be addressed through a set of multi-stakeholder consultations during 2006-2007. The process will be organized by the Financing for Development Office of UN-DESA, in collaboration with NDBs, International Financial Institutions (IFIs), Regional Development Banks (RDBs), United Nations regional commissions and other interested parties from the official and private sectors, as well as academia and civil society. As a first step, an Ad Hoc Expert Group Meeting was convened on 1-2 December 2005, with a view to identifying and exploring key substantive issues to be addressed during the consultation process.

II. Overview of National Development Banking

2. NDBs evolved over a long period of time in both developed and developing countries, in order to meet important financing needs. Their evolution was influenced by the changing global and national financial architecture. After WW II, the concept of NDBs went through several phases ranging from “Development Finance Companies” to “Development Funds”.
3. A National Development Bank can be defined as a “Financial institution primarily concerned with offering long-term capital finance to projects generating positive externalities and hence underfinanced by private creditors”. This definition is coherent with empirical observations of statutes, history and current activity of such entities. However, focusing on the various organizational set-ups of banks adds complexity to efforts towards finding a more precise definition. Diverse structures (first-tier, second-tier, sectoral, global, export-import banks) and differences in ownership (public and/or private) expand the scope of analysis.
4. NDBs often design and implement their development objectives through rather similar approaches: (i) *Appraising* the economic and social impacts of development projects that seek financing; (ii) *Accompanying* investors over the long run through long-term loans; (iii) *Assisting* sectors that are key to growth through technical assistance; (iv) *Attracting* investors by playing a role of catalyst for large financing operations; and (v) *Alleviating* the negative impact of financial crises through financing that does not follow cycles, by offering loans even during downturns and by pooling efforts with regional financing institutions. Lines of activity evolved significantly since the 1990s, as a result of deeper global integration and a reshuffle of national development banking strategies. The focus on industrialization or import substitution, prevalent in the 1960s, was abandoned or significantly amended, while new objectives of social development, export promotion, support to small and medium size enterprises (SMEs) and innovative credit and loan policies led to the development of new functional activities.
5. A general analytical framework may focus on priority constraints to be addressed by NDBs. It is based on the identification of the causes of a market failure, in particular the main cause

or ‘primary constraint’. Focusing mainly on such constraints will reinforce the efficiency of policies in a context often characterized by scarce political and financial capital.

III. The Evolving Role of National Development Banks

6. The quest for sustainability may well be at the heart of the challenges facing NDBs in the 21st century. The economic sustainability of a project means the provision of essential services on an affordable basis for clients and on a profitable basis for operators. From this perspective, improving the availability of long-term loans and developing financial engineering will not be enough if the economics of the projects are insufficient, i.e. if the loan portfolio does not bring sustainability to the bank. It is thus difficult to approach the challenges of NDBs independently of the issues related to the qualitative and quantitative assessment of development projects and the subsidization of lending or guaranties.

III.A Filling gaps in financial market development

Providing long-term financing

7. NDBs have often been orienting their mission towards long-term projects and providing the corresponding loans. Funding of infrastructure projects indeed is prone to different kinds of failures and requires support from financial institutions. When long-term financing is not offered by domestic or foreign commercial banks, the need for development banks to fill the gap may seem justified. When long-term capital is available to a certain extent for large private enterprises in good standing, one may still envisage some complementarity between NDBs and commercial banks. Even for countries where capital is easily available, with investment grade and limited risks, there might still be a role for domestic development financing institutions: market failures include insufficient maturities for projects that require long-term time spans, maturity mismatches and large concentrations of investors within the banking sectors. The case of NDBs is therefore strong in long-term financing.
8. Developing countries’ needs for investment in infrastructure are estimated at \$450 billion per year in the medium term, an equivalent of 5% of their GDP. Increased efforts will thus be required to attract both private capital and official sources of funding for infrastructure projects. Since the 1990s, donors have tended to lend directly to governments and private banks. In order to get back their share of the available resources, NDBs need to improve their management, governance and overall credibility, and to develop cooperation with global, regional and national financial institutions.

Providing a range of financial products for development

9. In addition to long-term lending, NDBs can provide a range of other financial tools. First they can offer short-term loans. Indeed interest rates by private commercial banks are often very high, in particular for SMEs. Second, syndication can also account for significant financial commitments: with the support of private commercial banks, NDBs can indeed leverage important resources for domestic projects through syndication. Third, strategies can also aim to foster equity and quasi-equity: NDBs can provide funds for capital or operations in exchange for capital stock, stock purchase warrants or options, by partnering with the private sector or selling stocks to develop the equity market. Finally, multilateral and regional development banks also promote projects that can foster structured finance, for

instance by avoiding subsidized lending and focusing on market rate loans coupled with grants, to encourage marketable loans for future securitization.

10. Concomitant to offering long-term resources is the need for adequate guarantees to foreign investors. Added to foreign exchange guarantee mechanisms, some NDBs also aim at attracting foreign investors by extending maturities and reducing costs. Relevant mechanisms include Partial Credit Guarantee, Political Risk Guarantee or co-guarantee mechanisms with private sector guaranty providers. Efforts to develop risk mitigation products may include the creation of domestic guarantee agencies, probably requiring the technical assistance of international financing institutions.
11. In addition, there are tools that can reduce risks for local investors as well. First, many of them would like to find ways to suppress the currency mismatch of having to issue foreign currency denominated bonds and having local currency revenues. Hence, local currency bonds are gaining importance in emerging markets and their development could benefit from the involvement of NDBs. Second, sovereign guarantees for projects by municipal investors are difficult to obtain and costly, and therefore it might be useful for NDBs to contribute to efforts toward offering other guarantees than those of the sovereign. In that regard NDBs could be a channel for large mechanisms developed by regional and multilateral institutions.

Building inclusive financial sectors

12. An “Inclusive Financial Sector” implies that the vast majority of the population is offered sustainable access to a range of financial services that suite their needs. NDBs may contribute to creating inclusive financial sectors. This includes offering better access to finance for the micro and small entrepreneurs, in particular through technical assistance and support to access credit. Offering access to secure financial services for agricultural workers may be particularly important, since they are often “unbanked” despite significant financial needs.
13. Microfinance Institutions (MFIs) face multiple constraints that hamper their financial sustainability. Many MFIs worldwide are unsustainable and need continuous subsidies. In that regard, there are several costs for MFIs that may be subsidized by NDBs active in microcredit: start up costs, R&D costs, costs of high risk products, and costs of building capital access.

III.B Improving the business climate

SME promotion and support

14. There are two institutional ways to support SMEs. The first is to enhance the capacity of existing NDBs and the second is to create new development banks focusing specifically on SMEs. Whatever is the institutional choice made by governments, their aims are similar: the promotion, financing and development of SMEs. This can be pursued through the supply of low-interest funds directly to SMEs or through financial institutions, which in turn finance them under a refinancing system and thorough the promotion of medium- and long-term lending. Examples include the creation of equity funds, schemes for small projects, venture capital funds and guarantee funds for SME loans that often lack the necessary collateral.

15. Guarantees are also crucial to facilitate the financing of SMEs. For that reason, many NDBs spare no effort to develop specific tools with the country's financial authorities or multilaterals. Loan guarantee schemes for SMEs can contribute significantly to securing loans by participating institutions, in order for SMEs to develop their activity or increase their cash flow.
16. Another line of support is through technical assistance, for both technological and managerial needs. In this field, the expertise of NDBs can be enhanced. Technical assistance can also be provided through partnerships between national development financing institutions, business associations and networks of entrepreneurs.
17. NDBs should also be part of the increasing efforts to promote regional cooperation on innovation. There is a wide variety of regional research organizations and networks throughout the world that link together researchers and policy-makers. NDBs could join efforts to foster research, capacity-building, networking, education and training and would thus participate in increasing the gains from knowledge, through national, regional and interregional networks.

Reducing volatility

18. Private bank lending tends to react pro-cyclically to recessions and to amplify business cycles. These legitimate concerns call for improvements in prudential regulation, accounting standards, risk measurement and monetary policy, in order to enhance both financial system and macroeconomic stability. First, NDBs could contribute to improve the availability of information in good and bad times. One of the most frequently advanced explanations to the pro-cyclicality of the financial system is indeed information asymmetries between borrowers and lenders. Second, by internalizing the benefits of increasing credit during recessions, NDBs may play a useful role in smoothing credit cycles. While the main mechanism for counter-cyclical policy is in the hands of the Central Bank and the interest rates, NDBs can influence cycles as credit extended by state-owned banks in developing countries tends to be less pro-cyclical than private credit.
19. Efficient counter-cyclical policies require sufficient amounts of financial resources. This may call for more regional cooperation and the pooling of resources, as well as the establishment of different kinds of contingent credits with domestic commercial banks and the ability to borrow rapidly on international markets.
20. Several concerns also exist about the proposed Internal Ratings Based Approach of Basle II for emerging markets that could affect NDBs. It is feared that it could accentuate the pro-cyclicality of bank lending to developing countries vulnerable to strong cyclical fluctuations of financing.

Acting as a catalyst

21. Foreign direct investment (FDI) is critically needed for most developing countries. Fiscal discipline and sound macro-fundamentals are key to attracting FDI, which in turn might lower budgetary resources for NDBs. Governments are thus being squeezed between the demand for public expenditures on the one hand and a limited supply of budgetary resources

on the other, which may make private sector involvement all the more necessary. NDBs can act as catalysts to attract much needed foreign investments.

22. National development banks can make good use of Public-private partnerships (PPPs) and encourage their use in developing countries. Just as regional or multilateral development banks, some NDBs can act as facilitators, promoters or even investors. New funding packages are put forward to support PPPs, including equity financing, loan assistance, technical assistance and project debt finance. Risk transfer must be clearly understood though, as PPPs admittedly lower the overall level of operational and financial risk, but the viability of PPPs still rests on the public sector.
23. National development financing institutions should also pursue efforts to be part of the partnership with regional and multilateral institutions that play a catalytic role. Such institutions often support State, provincial or local projects. NDBs can also develop direct linkages with other NDBs to foster the regional impact of their activities and common strategies.

III.C Capacity-building for NDBs

Improving prudential regulation and supervision

24. Regulatory issues in infrastructure sectors have not been tackled in many projects. Costs were not properly disclosed, tendering and procurement policies were inadequate, tariffs were not scrutinized closely, and regulatory bodies were weak and lacked the technical expertise and power to enforce laws and regulations. Those difficulties go way beyond the analysis of NDBs. However these financing institutions, together with RDBs and IFIs, can provide support to regulatory bodies.
25. Building legitimacy with rating is another important part of a country's progress toward deeper capital and credit markets and requires strong and independent supervision mechanisms.

Governance and management

26. Addressing general issues of governance is difficult as the structure of NDBs can vary significantly. In order to develop an efficient institutional framework, NDBs need to be governed by standards of good governance away from political patronage and corruption. A related matter is the need for expertise in auditing and independent oversight of these institutions. Progress in that regard has been significant in the recent years. Management and organizational efforts include the establishment and adequate staffing of boards of directors and a large degree of autonomy in decision-making. Previous inconsistencies and bureaucratic complexity led some NDBs to manage resources under short-term criteria, resulting in a poor collection record with their borrowers. Management of risk and loan portfolios, as well as transparency of policies should be high on the agenda.
27. Another management challenge thus lies in the need for technical expertise. The lack of capability to retain and build on knowledge is often cited amongst the main difficulties encountered by NDBs. The challenge is therefore twofold. NDBs must develop and enhance cooperation with regional and multilateral institutions. Overall strategies should address

policy adjustments, budgetary issues, cooperation and coordination among institutions, human resource requirements, and technology innovation needs.

Measuring and monitoring results

28. A lot of efforts and initiatives are underway in a number of agencies to address the issue of development results. In that regard, it is important that NDBs work in the context of their national and regional development frameworks. A result-focused strategy requires expanding attention to circumstances and behaviors beyond the institutional boundaries of NDBs and focusing on the intended beneficiaries of development projects. It also requires concerted efforts to disseminate information about results among stakeholders in the development process, in order to promote accountability and to create feedback loops so that information can be used to adjust strategies and to improve policies.

29. Capturing the diffuse benefits of structural, institutional and educational change of development projects is a technically complex task. Economic spillovers or clustering effects may be significant and yet hard to assess. Benchmarking NDBs could help measuring results through comparison and might include the assessment of performing vs. nonperforming loans, staffing needs and customer service. Such methods have already been used to reform and modernize certain NDBs. The need to build monitoring and evaluation capacity of NDBS is thus crucial, and requires support from donors, RDBs and IFIs.

I. Multi-stakeholder Consultations

A. Introduction

In resolution 58/230 of 23 December 2003, entitled “Follow-up to and implementation of the outcome of the International Conference on Financing for Development”, the UN General Assembly requested the Financing for Development Office of the Department of Economic and Social Affairs to continue “*to organize workshops and multi-stakeholder consultations, including experts from the official and private sectors, as well as academia and civil society, to examine issues related to the mobilization of resources for financing development and poverty eradication*” and “*to convene activities involving various stakeholders ... to promote best practices and exchange information on the implementation of the commitments made and agreements reached at the International Conference on Financing for Development*”. Indeed, a unique feature of the International Conference on Financing for Development (Monterrey, Mexico, 18-22 March 2002), including its preparatory and follow-up processes, has been the engagement of multiple stakeholders.

In response, the Financing for Development (FfD) Office organized and co-sponsored, in 2004-2005, a total of 21 meetings in some fifteen cities throughout the world, and with close to five hundred participants. The consultations succeeded in attracting world-class experts from governments, international institutions, civil society, the private sector and academia. The program of those informal meetings covered five substantive areas: (a) building inclusive financial sectors for development; (b) sovereign debt for sustained development; (c) public-private partnerships for improving the reach and effectiveness of development assistance; (d) improving the climate for private investment; and (e) enhancing the coherence and consistency of the international financial, monetary and trading systems in support of development. The outcomes of those consultations provided inputs to the UN General Assembly’s High-level Dialogue on Financing for Development (27-28 June 2005), and the UN World Summit (14-16 September 2005). By building partnership for development, the multi-stakeholder consultation process has thus contributed to fostering the “*spirit of Monterrey*” and to reaffirming the Monterrey Consensus as the essential framework for international cooperation for development.

In resolution 60/188 of 22 December 2005, the General Assembly “*recognizes the work of the Financing for Development Office of the Secretariat in organizing, within its mandate, workshops, multi-stakeholder consultations, panel discussions and other activities aimed at better enabling member countries to implement their commitments as agreed in the Monterrey Consensus, and requests the Office, in collaboration with experts from the public and private sectors, academia and civil society, to continue its work in this area*”.

In the context of the Monterrey agenda, the role of national development banking is particularly important for growth and development at the domestic level, and for regional cooperation. For that reason, the Financing for Development Office initiated a new set of multi-stakeholder consultations on “*Rethinking the Role of National Development Banks*”, an issue for which considerable interest was expressed from various stakeholders involved in the consultations of 2004-2005. For instance, the final report on the consultations on systemic issues organized by New Rules for Global Finance Coalition (September 2005) recommended, inter alia, to

“establish national development banks in order to provide affordable long-term financing, as well as technical assistance, to areas and sectors not adequately serviced by the private sector.”

The present background document provides a broad overview of some of the key issues that could be addressed in this new set of consultations. The rest of this section briefly presents the consultative process envisaged for 2006-2007. Section II provides an overview of the history of national development banking and the profile of national development banks, in terms of their organization, lines of activity and financing environment. Section III outlines the various challenges facing the national development banks.

B. Consultative Process on NDBs

1. Approach

How can the role of National Development Banks (NDBs) in promoting economic and social development be enhanced? This is the broad question that will be addressed through a new set of multi-stakeholder consultations proposed for 2006-2007, organized by the Financing for Development Office of UN-DESA in collaboration with relevant stakeholders. The consultative process is expected to generate concrete recommendations on the potential of NDBs in promoting economic and social development. Summaries and findings of the consultations will be shared with UN Member States and all other interested stakeholders.

The issues to be addressed rest on several elements contained in the *“Leading actions”* of the Monterrey Consensus, in particular on the following three sections:

- Mobilizing domestic financial resources for development - *“We recognize the need to strengthen and develop the domestic financial sector, by encouraging the orderly development of capital markets through sound banking systems and other institutional arrangements aimed at addressing development financing needs”* [para.17]. *“Development banks, commercial and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance [to micro enterprises and SMEs]”* [para. 18] ;
- Mobilizing international resources for development - *“We will support new public/private sector financing mechanisms, both debt and equity, for developing countries and countries with economies in transition, to benefit in particular small entrepreneurs and small and medium-size enterprise and infrastructure”* [para. 24];
- Addressing systemic issues - *“We also underscore our commitment to sound domestic financial sectors, which make a vital contribution to national development efforts, as an important component of an international financial architecture that is supportive of development”* [para. 53].

The consultations will focus on the financing instruments and the rationale and missions of these banks and institutions with similar objectives. Best practices will be shared during the consultative process. Of course, knowing the national characteristics and the needs of the economy is essential to use such good practices efficiently. Micro and macroeconomic constraints to growth and development vary from one country to another and this should be taken into account by NDBs in their development strategy. It is crucial for policy makers to identify them before trying to apply practices that may not fit to their particular needs and circumstances. The consultations will involve sub-regional, regional and inter-regional development banking actors, drawing upon experiences of financial institutions in developing countries, countries with

economies in transition and developed countries. The World Bank, the International Monetary Fund, United Nations Development Programme and United Nations Regional Commissions are also invited to provide their inputs. Experts from the private sector, academia and civil society, as well as bilateral development agencies and interested governments are also engaged.

2. *First Step*

An Ad Hoc Expert Group Meeting on the theme: “*Rethinking the Role of National Development Banks*” took place at UN Headquarters in New York on 1-2 December 2005. The main purpose of this meeting was to seek intellectual inputs from a representative group of experts acting in their personal capacity for the launch, in 2006, of the research project, entitled “*Multi-stakeholder Consultations on Rethinking the Role of National Development Banks*”. To this end, participating experts were invited to engage in an interactive discussion, with a view to identifying and exploring key substantive issues to be addressed during the consultation process, including relevant national and regional experiences, and some organizational and logistical aspects. A report of the meeting is available at the following address: www.un.org/esa/ffd/ndb.htm.

Following this meeting, several partners agreed to host regional consultations throughout the world: in Latin America, Asia, Africa, Europe and North America. As part of the broader focus on the implementation of the Monterrey Consensus, this project is expected to produce a publication on the role of national development banks as a renewed tool of development finance. In addition, the main findings and recommendations will be reported to the General Assembly. More details are available in the Expert Group Meeting report and its annexes.

II. **Overview of National Development Banking**

A. **Historic Overview**

1. *Origins and Evolution*

The history of what is today known as NDBs goes back to the beginnings of the Industrial Revolution, but there is no unique track in their evolution – rather different national and regional experiences. In Europe, where NDBs first appeared, the economic and social development strategies varied and national development banks appeared there in only a hand few of major countries. From the middle of the nineteenth century and on, first in France, then in Germany and Italy, industrial or credit banks were formed to support industrialization. They successfully managed to provide large amounts of financing to their growing industries. Yet in the United Kingdom, the leading economic power at that time, regional stock markets were the main source of financing for industry needs in the Midlands. British “Merchant Banks” were more involved in trade financing and financing of foreign governments than in building the domestic industry.

Likewise, the United States had a distinctive approach to industry financing. Privately-owned “*Merchant Banks*” or “*Industrial Banks*” were performing some of the functions of modern-day NDBs. They provided long-term investment financing of projects that had exceptional risks through venturing into new fields of production promising to yield a high profit, such as the construction of the railroads. The sale of stocks and bonds at the stock markets was the primary source of finance for these banks, which often benefited from bond guarantees offered by the States. Often these States chartered banks that then issued bonds sold primarily in Europe, in the United Kingdom in particular. The proceeds were then used to finance development projects in the issuing State. In this context, Medici Bank, Rothschild and the House of Morgan –originally merchant bankers - and several other private banks thrived after the 1890s: by the early 1910s, they had gained control of a significant number of railroads and industrial firms (Cantillo Simon, 1998). Interestingly enough, at the heart of the late nineteenth century debate on financing infrastructure development in the United States, lay concepts that are still on the agenda today, including: the opportunity of relying on private finance, encouraging the growth of domestic financial markets, and choosing financial instruments that minimize the risk of dependence on foreign funds (Eichengreen, 1995).

At the same period, development banks were also created in certain developing countries. For example, Mexico already had its own development bank early in the nineteenth century, el Banco de Avio. Created in 1821, this bank contributed both to the construction of a North-South railway system and to smaller-scale financing: loans to cotton, iron, silk, wool, and paper manufactures, or lending for machinery purchased in Europe.

In this varying environment for development financing, there were little resemblance in the evolution of NDBs, at least until they faced similar crises in the international financial architecture. The collapse of the stock markets in 1929 indeed had led to a shortage in funds to finance development projects and to a rethinking of the institutional needs for development financing. But while this had led some countries to close these institutions that had often gone bankrupt, still other countries opted for an opposite strategy and built new NDBs to foster the development of capital market. For example, Nafin in Mexico was created in 1934 to promote the capital markets development and to channel funds to productive sectors of the economy.

After World War II, the lack of long-term funding for investment projects encouraged many countries to establish Development Finance Institutions by using public funds. Specific stages in this evolution included “*development finance companies*” (public entities with non-banking activities), “*development funds*” (usually based on special accounts from the Central Bank), ending with what is today known as “*national development banks*”. In the past, the literature often used the term development finance institution (DFI) that is still used today to include a greater number of entities than only NDBs, including sub-national and regional development banks and funds. Developing countries that accessed to independence often created their bank, public or private, such as Banque gabonaise de développement in 1960 or the Botswana Development Corporation Limited established in 1970 to be the country's main agency for commercial and industrial development. Of course, the significant expansion of intergovernmental institutions also influenced development financing at that time. NDBs linked up with bilateral donors, Regional Development Banks (RDBs) and global finance institutions such as the World Bank.

Later, the focus on industrialization or import substitution policies, prevalent in the 1960s, was abandoned or significantly amended, while new objectives of social development, export promotion, support to SMEs or innovative credit and loan policies led to the development of new functional activities. Since the 1980's indeed, changes have been provoked by financial crises, governance and management problems. For instance a 1974 World Bank study of delinquency rates in agricultural banks reported that the average arrears rate was 41 per cent, while another 1983 World Bank report had indicated that 39 percent of the development finance intermediaries were experiencing serious portfolio problems (Caprio, 1997). In consequence, international financial institutions dramatically reduced their lending to development finance intermediaries in the early 1990s. But change was also due sometimes by the successful outcomes of NDBs in their core activity that called for their branching out in other sectors in need.

Most of these institutions have thus profoundly evolved in the last two decades. Some were privatized or even closed, as detailed in the next sections of this document. Others, in particular in Latin America and Asia, managed to diversify and to adapt to a changed financial environment. By adding the provision of other financial services including working capital, advisory services, leasing, insurance, entrepreneurial development and provision of technical assistance, they often turned into large, diversified, nation-wide banks. Through the use of new products such as syndication, equity and quasi-equity, often turned into sophisticated financing tools (such as guarantees or synthetic securitization), some banks steadily increased their loan portfolio in the economy.

More than just an evolution or modernization of lending operations, this has sometimes led to a change in structures and missions of these banks, through a branching out – either toward export-import financing or investment banking activities. Successful institutions developed in the last decade a capacity to compete with private commercial banks, while others managed to downscale their activities and provide adequate financial services for microfinance institutions in the country. For example, the Development Bank of Southern Africa (DBSA), created in 1983, moved away from being solely focused on development finance and has become by the end of the 1990s a large national development institution with a threefold function of financier, advisor and partner. In a similar vein, the Brazilian development bank BNDES in Brazil was first established in 1952 as a bank for the financing of infrastructures; later it became a bank for the industry and, afterwards, for the capital goods and intermediate products industry, which led in the end to the creation of a diversified bank.

The next sections of this document reflect this variety of historical evolutions, activities and performance by NDBs. Today's landscape is the result of this profound evolution in national and multilateral development strategies that started two decades ago. Today there are around 750 NDBs around the world with varying regional distribution, different characteristics and forms of ownership, private, public or mixed.

2. Structural Variations

Three main variations amongst NDBs deserve to be briefly described. First, there has been a profound shift of development banks from their traditionally State-owned nature. Reasons for this evolution include changes in governments' strategies and donor preferences, added to rapid

growth of capital markets and of availability of long-term lending from the private sector. Another key factor is related to the performance of State-owned banks and parastatals that triggered a strong rebuttal from IFIs that pushed for their restructuring or closing. Those elements are studied in more details in the last part of the document. Therefore there are now various kinds of ownership models and it is getting difficult to distinguish between public, private and public-private structures that often evolved significantly through time:

- A majority of NDBs are State-owned, but within public ownership models the structure varies. Some have their resources drawn from a special account from the country's Central Bank, Treasury or Ministry of Finance, and in such cases tend to be only development funds rather than banks;
- Some banks have mixed federal and state ownerships, such as the German Bank of Development Kreditanstalt für Wiederaufbau (KfW), which became a major development agency;
- Some have mixed national, foreign and multilateral ownership. In such cases the development banks act as vehicles for international cooperation, in particular regarding private sector development, and official development assistance. For example the Development Bank of Kenya (DBK) is owned by the Government of Kenya, Netherlands' Fin.-Maatschappij voor Ontwikkelingslanden N.V. (FMO), the Commonwealth Development Corporation (CDC), Development Bank of Germany (DEG), and the International Finance Corporation (IFC);
- Some are private entities, often a result of privatization since the 1980s encouraged by national and international decision-makers in view of poor economic, social and financial results. The belief that there is a negative relationship between economic growth and state ownership (La Porta, Lopez-de-Silanes, Shleifer, 2000) may continue to play a role in this evolution;
- In developed countries, there are also a wide variety of ownerships: the Dutch government for example owns 51% of FMO while the government of Norway owns only 15% of Eksportfinans ASA. In Austria, Oesterreichische Kontrollbank AG is owned entirely by leading Austrian banks and in the United States, Private Export Funding Corp. is owned by American banks and companies, while Eximbank of the United States is wholly owned by the government;

Second, NDBs are further split between models of first-tier or second-tier banks. Second-tier banks are prohibited to use public deposits for lending to the private sector. Banco de Comercio Exterior de Colombia S.A. for instance is a semipublic corporation, a rediscount bank that provides financial services to foreign trade companies and micro enterprises, to SMEs and large companies targeting the domestic market. It is also a second-tier bank, the second largest in Colombia in terms of assets and the largest in terms of loan portfolio (Source: Inter-American Investment Corporation). Some institutions evolved from one stage to another, such as for instance COFIDE in Peru (Corporación Financiera para el Desarrollo), a state-owned financial institution acting as a second-tier bank, which used to be a first-tier bank until 1992. COFIDE thus only uses resources from multilateral development banks, foreign commercial banks and the capital market, and uses a national coverage of more than 40 first-tier financial institutions for its operations.

Recent NDBs tend to be second-tier banks, in particular due to the fact that, often, first-tier banks performed poorly and appeared politicized in their decision-making. However there are cases of countries considering the creation of first-tier banks – such as Nicaragua, about which certain development agencies expressed concern, especially regarding the consequences on the microfinance sector (CGAP, 2005).

Third, a last organizational difference deals with the mandates of the banks, between ‘sectoral’, ‘universal’ and ExIm banks. Details regarding the specific lines of activity associated to these types of banks are given in Section II.B and Part III of this document. Generally speaking, ‘sectoral’ banks focus on specific sectors. The two main focuses of activity of sectoral banks are usually agriculture - such as BNDA in Mali - or SME development. Other sectors can include education, fishing, health, horticulture, manufacturing, mining or tourism. ‘Universal’ development banks are those working on all aspects of development banking. BNDES or DBSA belong to this group, as they offer a wide array of lending and non-lending services to many sectors of the economy. Finally, Export-Import banks carry out traditional activities of export-import financing. ExIm banks facilitate trade with foreign countries by providing financing or insurance for exports and imports. They usually borrow money from the Treasury. Given the cost of financing and insuring exports, in addition to considerations of regional trade priorities, a number of sub-regional or regional ExIm banks are being developed. The Afreximbank for instance was created in 1993 with the aim to offer short-term export trade financing to African exporters aimed at enhancing intra-African trade and exports.

In addition, a growing number of banks that carry commercial activities may also be considered in the analysis. Such NDBs, both ‘sectoral’ and ‘universal’, usually evolved toward profit-making objectives while, unlike those that were privatized, keeping a State-owned nature and a focus on development: this is the case for instance of the Malian Banque nationale de développement agricole (BNDA). In a different fashion, the National Bank for Development (NBD) in Egypt also illustrates this dim frontier as it is a commercial, profit-oriented bank that also remains development-oriented, in particular through innovative mechanisms of micro-lending that started back in 1987. Other banks though appear too distant from development banking to be included in these considerations, because they have become purely commercial entities. This is probably the case of the Romanian Development Bank for instance, created in 1923 to finance the local industry development, which developed its commercial activities and was fully privatized in 1999 to pursue as a commercial entity.

B. Rationale and missions

1. General Definition

A salient defining feature overall is the focus of NDBs on long-term financing to projects that foster development. This has been a permanent characteristic of these institutions after 1945 which continues to be of primary importance today. NDBs promote and finance enterprises in the private sector (Diamond, 1957), mainly for medium or long-term industrial projects (Boskey, 1959). Kane and Panizza both insist in their definitions on the long-term lending role of NDBs. According to Kane, it is “*a financial intermediary supplying long-term funds to bankable economic development projects and providing related services*”, while Panizza highlights

considerations of externalities: NDBs are “*financial institutions primarily concerned with offering long-term capital finance to projects generating positive externalities and hence underfinanced by private creditors*” (Panizza, 2004). Could we further refine this definition? An empirical approach may be useful to do so. Their statutes in particular contain a clear referral to a certain number of missions, either economic or social. There are three main objectives:

Table 1: Three Objectives for NDBs

Objective	Examples of general cases	Examples of specific cases
<p>Economic development</p> <p><i>The ‘common denominator’ amongst NDBs</i></p>	<p>Historically, development banks were first based on this objective. BancoEstado in Chile, one of the oldest Latin American development banks, was created in 1853 by an Organic Law stating the bank’s objective as the offering of banking and financing services to encourage the “<i>development of national economic activity</i>”.</p>	<p>Development banks can target specific sectors: the mission of the Banque agricole et commerciale du Burkina for instance is to foster “<i>agri-pastoral national development</i>”. Banks can also serve one-time missions, such as in support of privatization processes.</p>
<p>Social objectives</p>	<p>The Brazilian Development Bank (BNDES) activities ought to result “<i>in greater social inclusion and the decrease of inequalities</i>”. The Gabon Development Bank defines itself as the “<i>main instrument for Gabon’s economic and social development</i>” and its project assessments therefore include social considerations. At the regional level, most RDBs pursue both economic and social development objectives. For instance, the IADB, the world’s oldest regional development bank (1959), aims to “<i>contribute to the acceleration of the process of economic and social development of the regional developing member countries, individually and collectively</i>” (Charter of the IADB).</p>	<p>Some banks specifically concentrate on their social mission, such as the Council of Europe Development Bank (CEB, 1956), a European financial institution with a purely social vocation.</p>
<p>Regional integration</p>	<p>Statutes can also include broader objectives of fostering regional integration. BNDES’ activities for example ought to result also in “<i>the strengthening of national sovereignty and regional integration</i>”.</p>	<p>Some banks specifically focus on regional aspects of development. The Banque Régionale de Solidarité (BRS SA) aims to fight poverty on a regional basis with coordinated efforts between participating West African countries.</p> <p>Some specifically foster on regional efforts to develop trade linkages – as Caricom and the Caribbean Development bank or the Andean countries and the CAF development bank since 1969, that both work in cooperation with NDBs.</p>

Other particularities may be found in NDBs’ statutes. Some include objectives of profitability of their loan policy, as for instance the Andra Pradesh Development Bank in India. Others operate under the principle that they will not compete with financial institutions in the private sector (JBIC). However, such specificities do not per se constitute defining factors of NDBs.

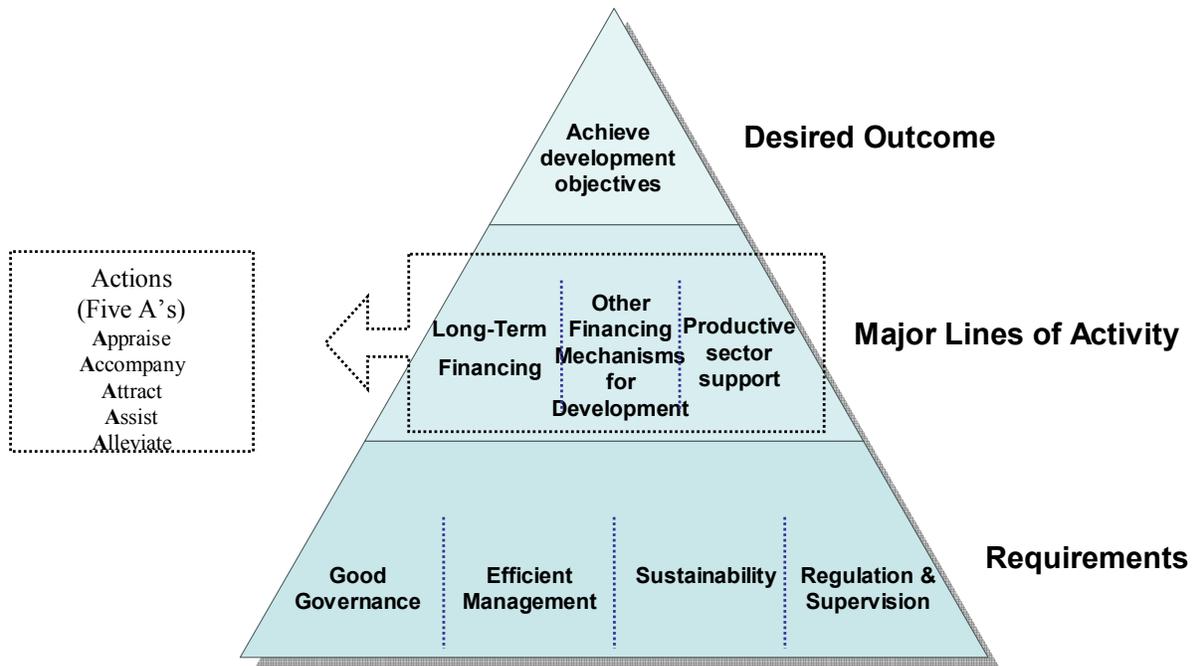
Therefore, although the definition given by Panizza is by no mean contradictory with those considerations, it may be refined: national development banks can be defined as “*financial institutions set up to foster economic development, often taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities*”.

2. Actions and Lines of Activity

Despite these variations, the activity and success of national development banks rests on several requirements that do not significantly differ from one bank to another. They include (Figure 1) good governance and good management, adequate financing products, sustainable policies and regulation and supervision. NDBs also design and implement their development objectives through rather similar *actions*, as illustrated below:

- (i) *Appraising* the economic and social development impacts of projects looking for financing;
- (ii) *Accompanying* investors over the long run through long-term loans;
- (iii) *Assisting* sectors that are essential to growth through technical assistance;
- (iv) *Attracting* investors by playing a role of catalyst for financing operations;
- (v) *Alleviating* the negative impact of financial crises through a financing that does not follow the economic cycles, by offering loans even during downturns and by pooling efforts with regional financing institutions.

Figure 1: A Pyramid of National Development Banking Activity



Source: author

Table 2: The "Five A's"

Action	Target	Mechanism	Challenge
<i>Appraise</i>	Projects	A unique characteristic of NDBs is that they consider the financing opportunity of projects not only by taking into account financial returns, but also economic and social development impact.	Conciliating development objectives and sustainable lending policies
<i>Accompany</i>	Investors	By providing long-term financing, national development banks are a key element in the providing of capital resources for projects on long time spans, up to 20 or 30 years, required for infrastructure projects.	Offering adequate long-term products on a sustainable basis
<i>Attract</i>	Capital	By acting as catalysts, NDBs can help attracting foreign investors, guarantors and counter-guarantors, regional and multilateral financing institutions.	Developing a role of catalyst for large financing operations
<i>Assist</i>	Productive Sector	Technical assistance is an increasingly important part of activities of national development banks to support the productive sector and foster export industries.	Offering and pooling expertise
<i>Alleviate</i>	Financial crises	NDBs can offer acyclical financing by providing the credit and capital markets with resources even at times of crisis, and by pooling with regional development banks.	Fostering cooperation and understanding of countercyclical potential of NDBs

The major lines of activity, visible in the second layer of the pyramid, can be described as the priorities around which the bank is organized. They usually encompass some, or all of, the following elements: infrastructure financing, the historic focus of development banks; other financing mechanisms, increasingly developed with the private sector and international institutions; productive sector support, which focuses on building a competitive industrial base.

- *Infrastructure financing* is provided through the pooling of mid-term and long-term government and private financial resources. This usually constitutes most of NDBs' lending. Such a focus, although critical for development in many countries in need for infrastructure financing, should not be detrimental to other lines of activity such as productive structure support, the social sector, export promotion activities or the development of financial intermediation;
- *Other financing* can be offered by NDBs in complement to, or in support of, long-term financing. They include short-term financing, equity and quasi-equity, bond banks-type financing, securitization, syndication;
- *Productive structure support* is implemented to support structural changes according to development strategies, and to create an environment conducive to the improvement of the quality and competitiveness of goods and services in the domestic and world markets;

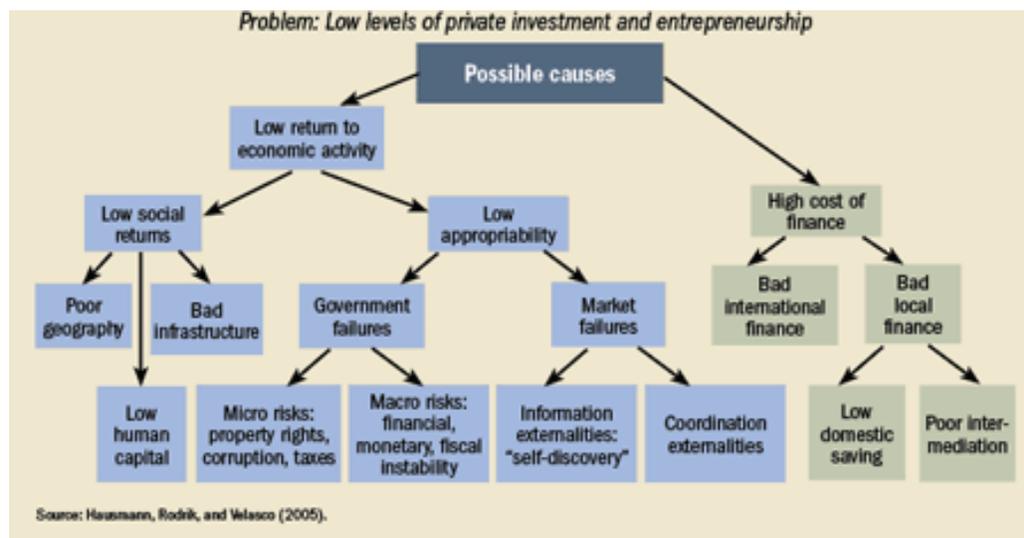
3. General Framework of Analysis

NDBs can contribute to solving a number of market failures. In particular they can promote financial sector development (III.A) by offering long-term loans and other financial products and by helping to create inclusive financial sectors. They can also enhance the climate for business and attract private sources of capital in the domestic economy (III.B), including by reducing economic volatility in the country, acting as a catalyst and promoting and supporting SMEs.

Nevertheless NDBs need to act on the right constraints, in order to avert renewing past mistakes. Many of them used to intervene either in sectors that (i) were not crucial for economic take-off or for the development of the country, or (ii) in sectors where these institutions did not have satisfactory competencies and capabilities, and (iii) in an unsustainable, politicized or poorly managed fashion. It might thus be necessary to carry an in depth micro, macroeconomic and strategic analysis before advocating for a specific intervention by NDBs. Due to the relative inertia inherent to any development project, from the preparatory phase to the disbursement, it is all the more important not to make any strategic mistake.

A general analytical framework may focus on priority constraints, as illustrated by the following decision tree (Figure 2). This figure shows the variety of causal explanations to any given symptom. In this example, the analysis is provided for a country in which private investment and entrepreneurship are low: what should be done to remedy to this problem? It might be that while an NDB in country A may have no role to play, contrary to the bank in country B. It would be the case for instance if the problem is due to poor geography or low human capital in country A, and to high cost of finance or coordination externalities in country B.

Figure 2: Example of constraints for a specific problem



This approach can be used for analysis of NDBs rationale and missions and builds upon two types of information:

- The various causes to an identified constraint: market failures ought to be identified so that tailored solutions may be applied that might require public intervention;

- The primary cause or “main constraint”: knowing a whole set of causes is not enough indeed – except for attempts to conduct ‘wholesale’ reforms’, which are difficult to implement and had limited results in experiences conducted in Latin America in the 1990s. The goal is to remove the barriers that hamper growth the most in a country, by focusing on the economic constraints with the highest “shadow prices” in the economy, whether it be for health, education, basic infrastructure, SME support or financial sector development. Focusing mainly on such constraints will also reinforce the efficiency of policies in a context often characterized by scarce political and financial capital of reformers (Hausmann, Rodrik & Velasco, 2005).

Such analysis should be carried with a long-term view. Even though evidence may be found to identify constraints in the current environment, knowing what the next constraints will be is more difficult. In that regard, the process of adapting policies to changing circumstances was successful in Korea for instance over the past three decades, where bottlenecks to growth were identified early. The Korea Development Bank and the Industrial Bank of Korea were key to this forward-looking approach. The rationale of NDBs may thus include a necessary set of capacities (financial, technical), to react quickly and contribute to an efficient identification of the main constraints in the economy, actual and future.

Finally, once this analysis is over, a final step before deciding of an intervention may be to assess if an NDB would be the relevant institution indeed to respond to the identified problem. It is well-known, in particular, that some NDBs used to overlap with a number of private financing tools or actors when offering loans, financing to SMEs or equity.

III. The Evolving Role of National Development Banks

Transverse to all the considerations that follow is the quest for sustainability of national development banks. It is indeed the belief that some of these institutions carried unsustainable lending practices under heavily subsidized conditions that led to criticisms and, sometimes, dismantling. The World Economic and Social Survey (WESS) 2005 lists a few of the non-sustainable activities that some development banks have followed: *“some development banks in many developing countries have subsidized interest rates heavily, sometimes making them negative in real terms, and have directed loans to monopolistic enterprises, many of them established by the government. In such circumstances, development banks do not put enough effort into collecting information on borrowers and monitoring their activities.”* Overall, one can say – but this may be discussed - that the economic sustainability of a project means the provision of essential services on an affordable basis for clients and a profitable basis for operators/lenders, requiring overall an efficient monitoring of the bank and its borrowers. In this perspective, discussing to improve the availability of long-term loans and to develop financial engineering will not be enough if the economics of the projects are insufficient and the loan portfolio is unsustainable for the bank. It is thus difficult to approach NDBs’ challenges independently of important issues that include the qualitative and quantitative assessment of development projects and the optimal approach to the subsidization of lending or guarantees.

A. Filling Gaps in Financial Sector Development

The needs for inclusive financial markets and long-term financing are high on the development agenda. This necessity was highlighted in the Monterrey Consensus which recognizes “*the need to strengthen and develop the domestic financial sector*” [para. 17] and that “*development banks, commercial and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance, including equity financing, for such enterprises, as well as an adequate supply of medium- and long-term credit*” [para. 18]. The WESS 2005 also underlines that “*national development banks can play a role in both the creation of markets for long-term financing and in guaranteeing access to financial services by the poor*”.

1. Providing Long-term Financing

In the past, sources of long-term financing to governments tended mainly to come from fiscal resources and aid. Yet today, developing countries are increasingly getting funding outside of the government budget, from private sources. This move is being accomplished in part by the increasing use of bond financing, in particular in South-East Asia. But it is also partly being done through the banking sector and NDBs have a crucial role to play in that regard: they can help bridging the gap of domestic credit provided by the banking sector between developing and developed countries. By reducing credit rationing they can also reduce interest rates and thus reduce risks of adverse selection and moral hazard (Stiglitz, 1981).

Creating a long-term market is needed only if this market is deemed important for development and if, indeed, long-term capital is insufficiently provided. Efforts can only be successful under certain specific conditions: the macro environment must not be too volatile, the legal system, regulation and supervision must be in place.

The use of long-term financing is mainly considered thereafter in the context of infrastructure financing that require very long tenor. However it should be noted that recent literature has shown that improved ability to enter into long-term loans had a positive impact on firms growth rates (Demirg-Kunt and Maksimovic, 1996). This is certainly an important element to take into account to assess the potential missions of NDBs for economic development.

Importance of infrastructure financing

Long-term financing is mostly needed for infrastructure projects, considered key to economic and social development in many developing countries. The importance of investments in basic infrastructure is recognized in the Monterrey Consensus, which states that “*investments in basic economic and social infrastructure (...) are vital for enabling people, especially people living in poverty, to better adapt to and benefit from changing economic conditions and opportunities.*” [para. 16]. Across the world, more than 2 billion people lack access to sanitation, about 2.5 billion people do not have access to energy supplies, 1.2 billion people lack access to safe drinking water, and 1 billion people do not have access to roads and railways. It is estimated that developing countries need to invest 5% of GDP in infrastructure, which amounts to at least \$450 billion per year in the medium term (source: World Bank) or \$250 billion for the Asia-Pacific region (source: ADB). The World Bank (2004f) estimates that the financing needs for new

infrastructure investment and maintenance expenditures are about 7% of GDP for all developing countries and up to 9% of GDP for low-income countries.

Yet long-term funding for infrastructure goods is affected by different kinds of difficulties. First, especially in Latin America, despite financial reforms to enhance intermediation and increase saving rates, the problem of insufficient saving persists. This means that the engagement of development banks continues to be necessary to strengthen the market (ECLAC, 2003). Second, long-term lending faces a number of well-known market failures (lack of information, excessive collateral requests, lack of credit guarantees, mismatch between assets and liabilities maturities in firms, legal inefficiencies or cost of contracting). This requires from governments a holistic approach to create the adequate environment for long-term projects, including sectoral reforms to reinforce competition and facilitate entry by new producers. Entry barriers are often an important obstacle to growth (Tybout, 2000), in particular regarding regulatory constraints. Market failures also require: better regulatory arrangements and supervision; efficient tariff regimes based on cost recovery; predictable policies for key sectors of water and sanitation, or energy; and effective mechanisms to allow for the resolution of disputes which arise in sectors such as infrastructure, where contracts are often valid for a 15 or 20-year time period. All these elements depend on national policy-making that goes much further than what NDBs can accomplish, but that are nevertheless crucial to their success.

As a result, some NDBs tend focus heavily their long-term loans on infrastructure. Some have geared almost all their resources to this purpose. For instance, from the time when the China Development bank was established in 1994 to the end of 2005, nearly 90% of its lending was directed towards infrastructure in eight key industries - power, road construction, railway, petrochemical, coal mining, telecommunications, public facilities, and agriculture.

Certain developed countries' banks also use long-term infrastructure loans as a form of official development aid, for instance the Japanese Bank for International Cooperation (JBIC) whose "ODA loan operations" focus in supporting the development of East Asia and the Pacific, and especially in providing economic infrastructure support. Since 1990, the cumulative amount of its commitments is over \$120 billion, 60% of which went to finance infrastructure projects in electricity, transportation, communication, irrigation, water and sanitation.

Some governments also decided to create funds specifically dedicated to infrastructure financing. For instance the Rural Infrastructure Development Fund was created in 1995-96 in India from out of the shortfall of commercial bank lending to priority sectors and agriculture. It was used by the National Bank for Agriculture and Rural Development (NABARD) to partner with State Governments in the creation of rural infrastructure. The initial mandate under the Fund was to support projects where partial investments had been made but which could not be completed because of constraints. There are of course many other examples, in particular in Latin America – for instance in Mexico, with BANOBRAS, a State-owned bank for infrastructure financing that created the Fondo de Inversión en Infraestructura (FINFRA) to attract private capital.

Lending over the long term for infrastructure projects is obviously a complex challenge that requires proper project finance assessment. This is true in particular for energy projects, for which typical public-private partnerships, or more sensitive independent power purchase projects, have sometime been disappointing in terms of revenues (user tariff setting difficulties) and consumer satisfaction. Thus, it might be advisable for an NDB willing to take part in such projects to wait, for instance until the construction phase is over in order to partially reduce their exposure. This is what BNDES did in the case of the Norte Fluminense Light Project in Brazil, a 780MW electricity deal (distribution and generation) where most private sponsors had left by the end of the construction phase: BNDES offered project finance (70% of the financing through loans, the rest being equity provided by the sponsors) only when commercial operations started.

Private vs. official resources for infrastructure financing

The financing of infrastructure is very much linked to opportunities of private sector resources mobilization. Historically, about 70% of infrastructure investment in developing countries was funded through the public sector, in part only through national development banks. Only about 22% of infrastructure investment in developing countries has been financed by the private sector and 8% by official development assistance (source: Oxford Analytica). Considering that fiscal constraints in a number of countries limit the ability of governments to set aside funds for investments to be channeled through NDBs, and that private sector resources are much more important in volume, increased efforts will be needed from NDBs to attract private capital. This is discussed in more details in the next section (including syndication, equity financing, risk management tools) and in Part B.(business environment), both of which illustrate the close relationship between public and private sources of capital for project finance.

Foreign official sources of funding can be a significant resource for long-term projects. In order to reverse the trend observed since the 1990s, characterized by a tendency from donors and international bodies to directly lend to governments and private banks, some NDBs still need to enhance their management, governance and overall credibility, and to develop cooperation with IFIs, regional development banks and other financing institutions. Some recent good practices in the field of infrastructure projects and PPPs indeed tend to involve all these partners together for the financing of the deal. The hydroelectric Nam Theun 2 project, in Laos, is a good illustration of the role of foreign official sources of financing and of efficient partnering. The project involved domestic financing institutions (Thai ExIm), with debt investors such as ADB and AFD/Proparco and commercial lenders, as well as international donors for the equity part. Guarantees were provided by multilateral institutions and bilateral agencies, such as the COFACE (France), GIEK (Sweden) and EKN (Norway).

Financing Choices

For long-term financing, NDBs need to make a number of strategic choices, including deciding whether they ought to:

- Offer subsidized lending and to what extent: examples of successful development banking experiences in developed countries (Germany, France, Japan, Korea) show that often the NDBs provided relatively small subsidies through low interest loans, to a large number of borrowers. This is to compare to cases of NDBs offering negative interest rates in real terms, amounting to significant levels of subsidy;

- Offer long-term loans to domestic investors or also to foreigners. This has significant impact on the bank’s activities and ownership. For instance, the National Development Bank of Botswana decided that both foreign and domestic investors would be eligible for long-term loans and equity capital. Nearly a third of the bank’s loan value is owned by foreign sources (Source: NDB of Botswana);
- Pool resources: this is true not only at the regional level but also at the local level. The so-called “Bond banks” pool underlying loans to municipalities by consolidating them into a size that is marketable. Bond banks offer two important advantages: the reduction of risks and the economies of scale. Although they differ from the traditional nature of NDBs – they are intermediaries that can finance themselves on the market- they provide an interesting case for analysis. Developed countries offer interesting bases for discussion, such as KommuneKredit in Denmark, Crédit Municipal in France, or the Finance Corporation for Municipal Enterprises in Japan.
- Develop far-fetched instruments: co-financing, credit lines, equity, mezzanine finance (subordinate loans or participation certificates) or syndications, possibly with regional financial institutions;
- Go as far as acting as a market-maker -admittedly in a smaller extent than their regional and multilateral counterparts. As stated in the WESS 2005, *“it may be desirable to design institutional arrangements in which development banks play an essential role in the creation of new markets, including different mechanisms for long-term lending”*;

A number of additional innovative instruments could also be developed by building fully or partially on the private sector. In particular long-term, fixed-rate loans for infrastructure projects could be bought by national development institutions from private lenders, thus creating a new secondary market for long-term financing (Dodd, 2005).

Risks

Long-term loans increase liquidity risk, and therefore require lenders to maintain sufficient long-term liabilities, equity, or other sources of funding. This might call for increasing the amount of equity and donor grants. Also, for banks using various funding sources such as savings, domestic bond issues or bank loans, sophisticated asset-liability management is necessary to manage interest rate, liquidity, and foreign exchange risks, as described in the next part (A.2);

Box 1: Liquidity Management for Long-term Loans

Long-term loans account for more than half of outstanding loans of the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, which uses long-term deposits and government-negotiated loans from the World Bank or ADB to match these assets. “About two-thirds of the bank's long-term loans are financed by domestic borrowing and long-term deposits. BAAC has actively promoted time deposits, including a three-year fixed deposit product, to fund its long-term lending operations. Access to long-term loans and client time deposits has allowed BAAC to better match the profiles of its medium- and long-term loans, and to improve the term match between its assets and liabilities.”

Source: CGAP, 2005

2. Providing Other Financial Products for Development

Short-term financing

Many NDBs used to provide significant amounts of short-term loans and less for long-term projects. Admittedly this was not systematically the case – BNDES for instance was specifically created in the 1950s in Brazil to offer long-term loans that were insufficiently provided in the economy. Yet this was a frequently used mechanism, in particular by agricultural development banks in the past. Unfortunately, these short-term loans used to perform poorly and contributed to the poor financial health of a number of development financing institutions starting in the 1970s: repayment rates were too low, lenders were insufficiently screened and loans were rolled over too easily. The development impact was low.

Therefore short-term loans seem not to have the favor of policy-makers, all the more as this kind of lending is more readily available from private commercial banks. Moreover, in a context of increasing interest for infrastructure development, there is today less focus on short term financing. This evolution is visible in particular by the fact that second tier banks are used to increase the maturity of loans to businesses, by providing funds to first tier development banks for longer periods of time.

Yet, simply put, short-term markets remain a priority for financial sector development. If there are no short-term markets, there cannot be long-term markets – just as there ought to be a secondary market. There is thus still ground for NDBs to provide this type of products and most of them do offer short-term loans, for several reasons including:

- Because even for infrastructure development there are several much-needed short-term products not readily available from the banking sector in certain developing countries. This includes trade finance, working capital, personal loans and treasury services;
- Because interest rates by private commercial banks are often high for SMEs;
- Considering the growing link between certain NDBs and existing microcredit institutions, the short-term loans that characterize microcredit are being added to the portfolios of these NDBs;
- And because exporting firms face particular needs: most Ex-Im banks thus provide shipment short term financing to exports and other short-term loans to provide collaterals and working capital, in particular for SMEs.

Securitization and structured finance

Securitization can be a key instrument in developing domestic medium to long-term debt markets, by offering credit-enhanced securities to domestic investors. It consists in issuing debt against income generating assets. It is a way to access capital markets, improve liquidity of the bank and lend more money, and to better manage risk. In particular it can be a way to finance infrastructure projects and PPPs: an NDB (or, more often, a Special Purpose Vehicle) can sell securities backed by its assets to private investors, and then use the proceeds to finance the PPP. But developing a bond market requires a stable macroeconomic environment and an adequate regulatory framework, and there has to be a secondary market for bonds in the domestic economy, all of which go beyond the scope of this analysis.

Multilateral and regional development banks are currently promoting projects that can foster securitization and structured finance. IFC for instance works in emerging markets to establish specialized institutions and provide advisory services to clients in structuring securitization transactions. The IADB's approach is to avoid subsidized lending and focus on market rate loans coupled with grants, to encourage a competitive environment for private sector bank lending and marketable loans for future securitization.

Syndication

Syndication is underdeveloped in many developing countries and needed in a number of emerging markets. Syndicated loans are credits granted by a group of banks to a borrower. They are “*hybrid instruments combining features of relationship lending and publicly traded debt*” (source: BIS). They enable the distribution among institutions of bank loans and securities, in order to share risk and future returns. Credit syndication appeared in the mid 1970s, and at the time of Mexico's sovereign default in 1982, syndicated loans amounted to most of developing countries' debt. After the restructuring of the Mexican debt in 1989 (Brady bonds), emerging market borrowers shifted their preference toward bond financing. Only since the last decade has the market for syndicated credits thrived again.

In certain international and regional development institutions, syndication now accounts for significant amounts of financial commitments: for instance, loan syndications at the IFC account for nearly 13% of its commitments, accounting for more than a billion dollars a year. Several development banks have set up project pipelines for syndication, which are constituted of development projects receiving MDB or RDB loans, not only A-loan type but also B-loans, with long tenor. NDBs can co-finance such projects. For example, the IADB co-financed the energy project “ATE II Transmission Line” in 2005 with BNDES: IADB brought \$60 million in A-loan and \$10 million in B-loan with a 13 year tenor. Such co-financing, opening the door to large syndication deals, should be promoted for infrastructure projects.

Syndication also accounts for a growing share of the activity of NDBs, which, with the support of private commercial banks, leverage important resources for domestic projects. There are complex examples – like the above-mentioned case of ATE II - and simpler ones: syndication can use only one NDB and one main bank – such as Banque de Développement du Mali and Société générale for instance who had syndicated a total amount of \$288 million in 2003 for the Compagnie Malienne pour le Développement du Mali.

By facilitating financing for healthy and growing companies, in particular through long-term engagements, partnering institutions also reduce the perception of political risk and facilitate future syndications with private commercial banks. This can be shown for instance by the cofinancing of Celtel, a pan-African telecom company, which received in early 2005 \$10 millions from the IFC, the Development Bank of South Africa DBSA, Proparco (France), Finnfund (Finland) and Swedfund (Sweden), in particular in order to facilitate future syndication operations. It is important to note the significant evolution in the mechanisms available for syndication since the 1990s to reduce these risks and attract the private sector. Covenants were developed; risk pricing techniques based on bond markets were increasingly used; synthetic securitization was created to reduce and transfer credit risks, etc. This accounts for the relatively steady increase in syndication in the last decade in emerging markets.

Syndicated loans have thus become a significant source of financing for emerging economies. The international market (i.e. for deals with one foreign lender) accounts for a third of all international financing, including bond, commercial paper and equity issues (Ganadecz, 2004). Following the wave of privatizations in emerging markets, banks, utilities, and transportation and mining companies (where syndication is widely used to reduce credit risks) have started to displace sovereigns as the major borrowers from these regions (Robinson, 1996). In this new environment, NDBs will need to assess and grow their capabilities to increasingly build upon such syndicated loans to finance infrastructure projects.

Equity and quasi-equity financing

Equity financing includes long-term subordinated securities with stock options and/or warrants. Once profits have paid back the return on investment, the financial institution can sell its share of the business. Quasi-equity includes convertible debt and subordinated loan investments, with a fixed repayment schedule, and preferred stock requiring less rigid repayments.

Strategies to foster equity can involve various actors:

- National development banks: instead of lending money for a development project, they can become a business partner. They will provide money in return for a share of project's profits. More specifically, NDBs can provide funds for capital or operations in exchange for capital stock, stock purchase warrants or options – without guaranteed return but with shared profits. They can do so in particular by:
 - Creating funds to foster equity investments in the country: for instance NAFIN in Mexico created a number of funds in the early 1980s (such as Fondo Mexico) to encourage foreign equity investments. The impact was visible and contributed in the growth of the MSE (Mexican Stock Exchange). NAFIN's direct participation in the Mexican stock market indeed remained significant until the 1990s (around 30% of total market capitalization in 1989, less than 4% today);
 - More specifically partnering with the private sector: for instance the Ayojana Fund Management Ltd. in Sri Lanka is a large private equity fund manager, established in 1996 as a joint venture between the National Development Bank of Sri Lanka and CDC Capital Partners (now Aureos Capital); other examples include a few cases in Africa, such as the Botswana Development Corporation, which has grown successfully to be the largest equity partner in the country;
 - Selling stocks to develop the equity market: by selling a portfolio of holdings in domestic companies to retail or institutional investors, an NDB can push forward exchange-traded stocks. BNDES has been playing a significant role in that regard recently and contributed to the take-off of Brazil's equity capital markets;
- Regional development banks: they can also enhance significantly the use of equity and quasi-equity financing. The Asian Development Bank has done so for certain investment projects (for instance in Sri Lanka through the Colombo Stock Exchange);
- Developed countries and donors: several developed countries have developed specific funds to address the lack of equity funds in emerging economies. They aim to mobilize and facilitate the participation of private capital. They usually support the creation of privately owned and managed funds making equity and equity-related investments. This

is the case for instance of the Overseas Private Investment Corporation (OPIC), established in 1971 as a self-sustaining United States government development agency, whose direct equity investments through its supported funds complement its insurance and project finance activities.

Risk mitigation tools

To attract foreign investors, important needs are unmet in many developing countries for risk mitigation. The technical challenge is significant. Through risk mitigation mechanisms, large NDBs, ExIm banks, regional and multilateral development banks and bilateral aid agencies, aim at attracting foreign investors by extending maturities and reducing costs. Tools include:

- Partial Credit Guarantees (PCG), which can foster capital market operations, increase supply of subordinated loans and mezzanine capital, and increase the tenor of instruments to better fit the development projects;
- Political Risk Guarantees (PRG), which are usually set up by international institutions and aid agencies. For instance, AFD jointly financed with the World Bank and MIGA a € 210 million guarantee scheme for small investment projects in the West African Economic and Monetary Union in 2004. This makes particular sense in the context of PPPs for which the risk of the government not respecting its commitments is not negligible. A development agency in that regard might be better placed to take such risk than a private company, considering the fact that it has more information and leverage on local governments (Jacquet, 2005);
- Co-guarantee mechanisms with private sector guarantee providers.

In addition to mechanisms reducing risks for foreign investors, tools geared to reducing risks for local investors are also needed. They look for ways to:

- Suppress the currency mismatch, consisting of having to issue foreign currency denominated bonds and having local currency revenues. Several options can be put in place in that regard, such as local currency bonds, which are gaining importance in emerging markets. Certain borrowers cannot hedge currency risks, in particular subsovereign entities that are increasingly active on capital markets. They have little capacity to manage forex risks, thereby requiring local currency financial solutions.
- Find alternatives to a sovereign guarantee for projects by subsovereigns. In that regard large mechanisms have been developed by some multilateral institutions. The World Bank created in 2003 a Municipal Fund together with the IFC that allows certain municipalities with good credit to invest in infrastructure without needing a costly sovereign guarantee. Therefore it might be useful for NDBs to contribute to efforts to offer other guarantees than those of the sovereign.

Regional and multilateral institutions could extend the use of risk mitigation tools by broadening eligible sectors. Furthermore, considering that complex deals may be difficult to tackle for NDBs, some international structures such as the Multilateral Investment Guarantee Agency (MIGA) may be usefully mobilized by developing countries. MIGA for instance offers innovative coverage of the nontraditional sub-sovereign risks that often come with infrastructure projects. These mechanisms include the coverage of interest rate hedging instruments or capital

markets guarantees. Similarly, the IFC offers sophisticated products of risk management, including hedging of currency, interest rates, and commodities.

The capacity to offer similar ways to support complex or unusual deal structures could only be developed by certain large NDBs, with sufficient available expertise on derivatives, a capacity to take risks over the long run, an excellent rating and good relationships with financial markets. Overall, NDBs should work with partners to advance further on technical risk mitigation projects. This can entail:

- Sharing project risks with private sector actors, multilaterals and agencies of donor countries: for instance the Rio Polimeros integrated ethylene and polyethylene project, in 2000 in Brazil, saw the three main lenders to the project, BNDES, Ex-Im Bank of the United States and SACE (Società italiana di Assicurazione dei Crediti all'Esportazione) group together to offer a combination of construction and commercial operating period comprehensive commercial risk and political risk guarantees.
- Working with multilaterals: in particular, the IFC and MIGA can be relevant partners for NDBs with strong assets. For instance in 2003, the president of BNDES announced the Brazilian government's intention to create an infrastructure investment fund, backed by the assets and shares of public sector companies and enjoying a multilateral guarantee by MIGA: the fund may be used to guarantee long-term public sector obligations and to issue debentures. The framework which Minas Gerais in Brazil has put in place also includes a fund based on the idea of using state-owned assets and shares as collateral for public sector obligations (source: PWC, 2003);
- Working with regional institutions: mechanisms implemented recently with success, for instance by ADB with the Philippines (PCG) for the power sector, offer valuable examples of good practices that could be developed in cooperation with NDBs.

3. *Building Inclusive Financial Sectors*

An "*Inclusive Financial Sector*" means that the vast majority of the population is offered sustainable access to a range of financial services suited to their needs. To ensure that the poor are included in the benefits of development, it may be necessary that they be given access to financial services "*that can translate into a key element of economic growth and poverty alleviation: options*" (Ocampo, 2004). Yet most of the world's population does not have such options today and private finance institutions in developing countries face several challenges. Banks do not trust clients when they have little or no information about them. They do not lend money if they cannot charge enough to cover costs. Such issues are addressed in depth by the United Nations' "*Blue Book*", an international dialogue process to identify key constraints and opportunities for the promotion of inclusive financial sectors.

Access to credit for SMEs

Entrepreneurs looking for financing face credit constraints and high lending rates from commercial banks. Financing difficulties are usually the main obstacle to their development,

especially in Latin America (World Business Survey 2002). That is why some NDBs provide support to SMEs in gaining access to both domestic credit and financial markets. In particular this means supporting microfinance institutions and fostering local financing and promoting entrepreneurial talent for industrial development. It is the prime objective of certain development banks, such as the Andhra Pradesh Industrial Development Corporation in India. These elements are further described in Section B.1.

Access to credit for rural development

For rural development, certain NDBs, in low income countries in particular, have a crucial role to play. The goal is to offer an access to financial services to agricultural workers that are often unbanked despite significant financial needs. Thus a number of agriculture development banks often offer a wide array of service to its poor clients, which can include credits, savings accounts, and administration of trust funds – as for instance with Banco Nacional de Desarrollo Agrícola (BANADESA) in Honduras. Yet for small institutions like BANADESA, carrying all these tasks can prove burdensome and sustainability therefore is hard to reach. This might therefore require stronger private sector participation: Banrural (Banco De Desarrollo Rural S.A.) for example in Guatemala managed to attract private resources and foster participation from cooperatives in the country, thus ensuring sustainability after being a few years ago on the verge of liquidation. Sub-regional and regional development banks could assist and advise these small agriculture development banks in difficult situation to evolve and change their structure by opening their capital.

Rural financial development indeed is a crucial part of the strategies to build inclusive financial sectors and is linked to issues of microcredit or remittances that are high on the global development agenda. Again Banrural can be used as an illustration: it is a fast-growing bank, the third largest in the country, providing economic development and financial services in rural areas through the nation's largest micro-finance operations. It complements the emerging remittance market by bridging the gap to the formal financial system (source: Wells Fargo). In some cases, rural experiences may include innovative cooperative processes, not only with donors but also, at the domestic level, with local institutions (Box 2).

Box 2: BNDA and Village Banks: an innovative approach by KfW

Some village banks in Mali found out in the mid 1980s that they could no longer cover the demand for loans only out of members' savings – a problem well known to most Microcredit institutions. These village banks were increasingly dependent on other refinancing sources. This was the starting point of a new approach in Germany's aid to domestic financial sectors development. Funds given to Banque nationale de développement agricole du Mali (BNDA), which had been supported by the KfW Reconstruction Loan Corporation since 1986, were no longer used exclusively for direct agricultural credits, but also made available to village banks. This concept was implemented from 1994 in Dogon land and in other rural regions of Mali.

Source: Inwent

Agricultural development banks face a number of operational and managerial constraints that are analyzed in the last part of this document in a more general context. Many such banks were indeed on the verge of liquidation in the 1980s and 1990s, due to poor management of their medium and long-term loan portfolios. Many of them, particularly in Africa, were closed. Some

were successfully reform like BankRakyat Indonesia (BRI) and the previously mentioned BAAC in Thailand and BNDA in Mali. Further analysis could be pursued on this issue.

Local financing

NDBs considering a shift of resources toward local financing should take into account local markets specificities, the need for advantageous financial products requiring State intervention, and understand the reason behind the disinterest by commercial banks regarding this market.

The last two decades saw a conversion of direct lending operations into “apex” lending mechanisms by IFIs and bilateral aid agencies. The process for apex loans is rather simple: firms looking for financing contact an intermediary bank, which sends the project for approval to an Apex bank. The Apex bank screens the projects, sometimes forward them to the IFIs or bilateral agencies, for approval. Only then does the intermediary institution disburse the loan. This has several benefits often not found under conventional loans, in particular by allowing for long-term loans, for instance by phasing payments of loans in smaller amounts over a long-term. Another significant advantage of such mechanisms for NDBs is that financial institutions that handle the resources also assume the credit risk on the loans they approved.

Apex banks led to an expansion of financing made available on a sub-national basis. Examples abound in that regard, such as NABARD in India, established in 1982 as an apex institution, accredited with all matters concerning credit for agriculture and other economic activities in rural areas. NDBs or RDBs provided a growing volume of funds for social or economic development projects on a wholesale basis and smaller banks in turn lend to small final borrowers. This financing approach has been favored by a number of donors in the recent years. For instance, the European Investment Bank (EIB) developed a Scheme with the government of Uganda (Uganda Apex Private Sector Scheme), financed by a Euro 40 million loan on advantageous terms. The funds facilitate SME investments in key sectors of the economy and are made available through a selected number of Approved Financial Institutions (AFIs), accredited by the Ministry of Finance, in consultation with the Bank of Uganda (BoU) and the EIB (Source: Delegation of the European Commission to Uganda). Similar mechanisms could be envisaged using the capacities of national development banks to coordinate such schemes based on donor countries or MDBs loan agreements.

This is just one of many forms of local financing that are being put forward today, at a time when strategies in that regard are evolving on both the side of donors and recipient countries (Box 3).

Box 3: Three scenarios for local financing

Scenario 1: Investment funds integrating a marginal share of credit from the city and thus with little or no revolving. This is typically financed by the State and ODA. Examples: MDA (Senegal), FPCL (Côte d'Ivoire), FEICOM (Cameroon), FICOM (Burkina).

Scenario 2: Institutions financed by the State and by ODA. This is done mostly for medium term long-term credit terms with attractive conditions. Examples: CPSCL (Tunisia), FEC (Morocco).

Scenario 3: Institutions financed partly on the bond and credit markets, supported by international backers without recourse to guarantee by the sovereign (non-sovereign loans). Usually for short,

medium or long-term loans with cities, at market rates and according to prudential rules in conformity with the country's bank laws. Examples: DBSA and INCA (South Africa and SADC).

Source: Agence Française de Développement (AFD)

Microfinance Institutions

Microfinance Institutions (MFIs) may contribute to the reduction in inequality, which is mostly but not solely due to income effects. Microcredit is also positively correlated with access to health and education. In Uganda for instance, the Foundation for Credit and Community Assistance's microfinance program has seen 95% of its low-income clients engage in improved health and nutrition practices for their children, compared to 72% of non-clients. As for education, positive effects are far-reaching; in particular, access at the household level to credit may act as a substitute for the income generated by child labor (Pritchett, 1998). In that regard, several NDBs focusing on economic and social development and aware of the need to reduce inequalities are shifting their attention away from traditional policies and more towards MFIs.

However, MFIs face particular needs as they face constraints that hamper their financial sustainability. As a consequence a majority of MFIs worldwide need continuous subsidies. Certain NDBs thus decided to include MFIs in their lending portfolio and to subsidize some of their costs. It is a growing practice within several African and Latin American banks that directly finance domestic MFIs, and many examples come to mind in that regard: the previously mentioned Malian BNDA is financing about 80% of Mali's domestic microcredit institutions; the Financiera Rural in Mexico is efficient in its microcredit agriculture support, as is BancoEstado in Chile, a development bank ranked amongst the largest microfinance institutions in Latin America with more than 150,000 clients; Egypt's National Bank for Development (NBD) is the only commercial bank in Egypt that has established a separate unit for providing finances to the entrepreneurial poor.

Box 4: Egypt's National Bank for Development and Microfinance

"The NBD was the first commercial bank to start microfinance operations in Egypt. Realizing the twin potential of micro lending for generating profits to the bank while helping to combat poverty in Egypt, the NBD, in collaboration with USAID, established the Small and Microenterprise Division in 1987 with microlending operations in four of its branches. By 2003, microlending services were being delivered in 44 branches to 22,600 active borrowers with about \$8.2 million in outstanding loans." NBD loans offered are typically small and with short maturities.

Source: Iqbal & Ryiad, World Bank 2004

NDBs active in microcredit might wish to focus their subsidies on 'smart costs' (Capital Plus, 2005) that include start up costs, research and development costs, costs of high risk products or costs for capacity-building. There are indeed strong potential gains in this business of microfinance that would justify these costs. The fact that private banks enter this activity by downscaling their business operations is proof of that -such as Bancolombia in Latin America or Finadev in Africa.

In the scaling-down toward microcredit activities, banks have much to bring, including their experience in financial risks management, fundraising capacities, and a retail network. They can

also help in establishing credit bureaus that are said to be a major drawback to building an inclusive financial sector. However, by so doing commercial banks need to adapt to a singular market. It is successfully managed by microcredit organizations because they resort to informal organizational structures; they know how to adapt to irregular cash-flows, and to sectoral and geographical heterogeneity (Rosengard, 2004). Thus NDBs interacting in the microcredit market will need to be careful in their strategy, as credit services that do not fit with needs will affect the poor clients they are supposed to serve.

B. Improving the Business Climate

1. Promoting and Supporting SME development

There are two institutional ways for domestic institutions to promote and support SMEs. The first is to enhance the capacity of existing NDBs, and the second is to create development banks focusing specifically on SMEs. This is the case for example of India, where the Small Industries Development Bank of India (SIDBI) was created in 1990 as a specialized financial institution of the Central Government. But whatever the institutional choice made by governments, the aim regarding SMEs is similar: the promotion, financing and development of SMEs. This can be conducted through the supply of low-interest funds directly to SMEs or through financial institutions, which in turn finance them under a refinancing system, and through medium and long-term lending as developed earlier in this paper.

In order to reach these objectives, certain development banks considered the reviewing of their strategy a necessity, by adopting a clear client oriented approach with SMEs. The relationship with the client is indeed an important element for NDBs willing to develop or focus on this segment. For instance, NAFIN in Mexico has redefined its strategy in depth in 2002, for operations as much as for management, to foster a client-oriented approach and enhance the quality of service.

Financial mechanisms

There are various financing mechanisms that can help support SME, from working capital loans to leasing or foreign currency loans and equity assistance. It can also include the provision of indirect financing, through refinancing of banks. There are several interesting examples in that regard in Latin America, noticeably in Mexico through NAFIN or Chile, through the second-tier banks Corporación de Fomento de la Producción (CORFO) and its Branch for technical cooperation Servicio de Cooperación Técnica (SERCOTEC). It is also true of Banco del Desarrollo or BancoEstado.

Examples on the financing side of SME support include the creation of equity funds schemes for small projects, of venture capital funds or, as mentioned previously, of guarantee funds for SME loans that often lack the necessary collateral. Under venture capital mechanisms, development banks usually create subsidiaries, partially based on successful cases in donor countries, in Canada (Development Bank of Canada), Japan (JBIC) or France (AFD/Proparco). Under equity arrangements, instead of providing loans to SMEs, NDBs take equity or shares in the enterprise. The share will be held in the name of the bank, which will receive as its remuneration a portion

of annual dividend that relate to the shares it has acquired. Equity participation usually covers up to 50% of project costs, with varying floors and ceilings for investments though. Shares acquired under this process can be held over long periods.

Guarantee mechanisms

There is no consensus on the advantage of mechanisms such as loan guarantee schemes that are accused of encouraging moral hazard and adverse selection, but also of having high administrative costs due to inadequate procedures, of delays in the payment of claims, and limited demand by SME borrowers. In the past many of the loan guarantee schemes failed due to mismanagement of the guarantee funds by executing agencies and banks (UNCTAD, 2001). For instance, the Guarantee Facility for the Financing of Small-Scale Enterprises in Lesotho was funded in 1991 by UNCDF in the form of a deposit to Lesotho Bank. Yet it had a very high loan default rate (58% on average) coupled with insufficient monitoring and lack of response to defaults, as noted in a subsequent evaluation of the project five years later. It might thus be fairly reasonable to think that guarantee schemes would be, whenever possible, better channeled through NDBs known for their good management and relationships with SMEs rather than directly to commercial banks with an unclear record for monitoring small businesses.

Guarantees are crucial to facilitate the financing of SMEs indeed and many NDBs spare no effort to develop specific tools with the country's financial authorities or multilaterals. Loan guarantee schemes for SMEs can contribute significantly to securing loans by participating institutions, in order for SMEs to develop their activity or increase their cash flow. Programs aiming at the development of risk capital in particular require significant guarantees – and thus for instance, through its Programa de Emprendedores (Entrepreneurs Program), NAFIN benefits from a guarantee scheme from the country's Secretaria de Economia.

Guarantee mechanisms for SMEs are particularly useful for exporting companies. Mechanisms can be created through a structure within an export insurance agency or can be linked to an NDB. They can either provide repayment guarantees to a lender in the event an exporter defaults (as traditionally done in most developed countries such as the United States and its Small Business Administration), or cover the exporter if the foreign buyer defaults on payment. Guarantee funds in particular that have sufficient resources can support SMEs by offering loans at preferential rates. They are useful in particular in the perspective of accession to the European Union of several Eastern European countries that receive large amounts of resources from structural European funds and that require adequate structures to use them.

Technical Assistance

The addition of non-lending services or the expansion of existing training and consultancy services has been characteristic of a number of banks in the last two decades. For instance, in fulfillment of its developmental role, IDBI performs different activities relating to development programs for new entrepreneurs and consultancy services for SMEs. It set up a network of Technical Consultancy Organizations (TCOs) covering all of India and played a prime role in setting up of the Entrepreneurship Development Institute of India designed to foster entrepreneurship in the country. It has also established similar institutes in Bihar, Orissa, Madhya Pradesh and Uttar Pradesh. Other similar examples abound, in particular in Asian countries

focusing on growth of human capital, knowledge and IT. For instance, Malaysia's development banks have put strong focus in the recent years on professional development, IT training and engineering centers, as illustrated in Malaysia by Industrial Development Finance Berhad, Sabah Development Bank Berhad or Bank Pembangunan & Infrastruktur Malaysia Bhd (source: Institute Bank-Bank Malaysia). Through cooperation among their members, associations of development financing institutions (ADFIMI, ADFIAP, etc.) are also providing advisory and consulting services.

Overall, enhancing technical assistance can be conducted through partnerships between national development financing institutions, business associations, and networks of entrepreneurs or business development service providers. It can focus on:

- Project development: to support the planning and design of projects. Grants can be applied towards project development costs, such as needs assessments, feasibility studies, or environmental assessments;
- Training: to offer workshops and seminars aimed at providing practical instruction in the financial administration and planning, as well as other essential management skills.

Looking at sectoral specificities on these issues, there is in particular a strong need for technical assistance in the agricultural sector, as mentioned earlier. Several Sub-Saharan African countries beefed up their focus on this sector, as for instance BNDA, which ceased focusing only on lending – a policy that had failed in the 1980s - and has been increasingly offering technical expertise in a successful commercial fashion. In Asia, the same process has been taking place since the early 1990s, as illustrated by the National Bank of Vietnam which provides support to the agriculture sector in collaboration with donors such as the Canadian International Development Agency.

2. *Reducing Volatility*

Private bank lending tends to react procyclically to recessions and to amplify business cycles. In developing countries, periods of capital inflows are associated with expansionary macroeconomic policies and periods of capital outflows with contractionary macroeconomic policies. In such countries, therefore, “when it rains, it does indeed pour” (Kaminsky, 2004). These concerns call for improvements that include better prudential regulation, accounting standards, to enhance both financial system and macroeconomic stability. But other improvements can be adequately offered through an active role by NDBs. First, they can contribute to improving availability of information in good and bad times. One of the most frequently advanced explanations to the procyclicality of the financial system is indeed information asymmetries between borrowers and lenders. At times of crisis even borrowers with profitable projects find it difficult to obtain funding, while during good times a large number of firms of uneven quality are able to gain access to external finance and this adds to the economic stimulus. This implies a “financial accelerator” mechanism (Bernanke, Gertler, 1995).

Second, by internalizing the benefits of increasing credit during recessions, NDBs may play a useful role in smoothing credit cycles. While the main mechanism for countercyclical policy is in the hands of the Central bank through interest rate variations, NDBs can also influence cycles, in

the sense that the credit extended by state-owned banks located in developing countries tends to be less procyclical than private credit (Micco and Panizza, 2004). Countercyclical policies may thus be considered as a promising feature for certain large development banks, although it should not replace or overlap monetary policy. NDBs, more precisely, are useful in the sense that they provide non-cyclical financing, rather than a countercyclical one. In any case, more cooperation between NDBs and regional banks could also be envisaged, as short-term financing may be coordinated to provide credit in case of Balance of Payments difficulties, urgent debt restructurings, liquidity crises, and for other contingency financings. Efficient countercyclical policies remains risky and difficult to implement: it requires coordination with monetary policy, which might be more efficient if it is the only policy used to smooth cycles; it necessitates sufficient amounts of financial resources, through regional cooperation and the pooling of resources; it also requires the establishment of different kinds of contingent credits with domestic commercial banks and the development of a rapid borrowing capacity on international markets.

Some concern was also expressed about the proposed Internal Ratings Based approach of Basle 2 for emerging markets that could affect National Development Banks. It is feared that it could “*accentuate the pro-cyclicality of bank lending, but particularly so for fragile developing ones, which are more vulnerable to strong cyclical fluctuations of financing*” (Griffith Jones, 2005).

3. *Acting as a Catalyst*

Attracting private sources of financing

As indicated earlier, developing countries need the equivalent of 5% of GDP for investments in infrastructure. Low-income countries cannot find such financing alone and official flows as well as FDI are crucially needed. While a good fiscal discipline and sound macro-fundamentals are key to attracting FDI, this, in turn, can imply lower budgetary resources for NDBs. Governments are thus in the uncomfortable position of having to respond to the demand for public expenditures on the one hand, and a limited budget on the other -which makes the need for private sector involvement all the more necessary. National development institutions can help in that regard by attracting external sources of financing.

The need to mobilize private sources of funding should also be high on the agenda in the perspective of sharing risks with other partners. By holding a heavy infrastructure projects portfolio, a national development bank may fail to diversify risks and run into an unsustainable tradeoff between expanding its loan portfolio and asset quality. If this bank's balance sheet is small, it will be all the more vulnerable to deterioration in asset quality. Thus the catalytic role of NDBs focusing strongly on infrastructure financing is certainly linked with the issue of sustainability, as attracting external investors and diversifying sources of financing can help reduce risks.

The banks' catalytic role can take the form of diverse facilitation processes for making business:

- Increasing linkages: successful infrastructure projects are made possible when they are not conceived as stand alone projects but are part of development plans. To do that, it is necessary to look at sectoral linkages and to develop the potential for synergies, for optimum economic and social returns;
- Facilitating investment: local investors need to be in relationship with foreign sources of capital and technologies, and foreign private investors require credit, political and foreign exchange risks to be addressed before they join in the projects. Some NDBs have thus put increased emphasis on this role in the recent years through:
 - Enhancing the attractiveness of the country to investors: For instance, the Lesotho National Development Corporation has a specific mandate to promote Lesotho as an attractive investment location for both foreign and indigenous investors;
 - Guarantee mechanisms: to enhance credit by fostering electronic factoring, guarantee funds and venture capital. Guaranty programs in particular can encourage the participation of private and public lenders in financing infrastructure projects by providing partial repayment protection against loans' commercial risks – as done for instance at a small scale by the North American Development Bank at the Mexican border;
 - Advanced financing mechanisms. Conventional securities based on loans, debentures, debt, and equity may be unattractive, unavailable or too expensive in certain emerging markets for specific projects. In that case NDBs with strong financing capabilities can foster structured finance deals. The mechanisms range from portfolio securitization (using cash flows from specific assets as collateral to borrow money), to collateralized debt, convertible bonds, and callable bonds.

Box 5: Catalytic Role of NDBs: Case of Water Infrastructure

According the Report of the World Panel on Financing Water Infrastructure chaired by Michel Camdessus (2003), “in principle, national development banks have a potentially important role as intermediaries between foreign lenders, central governments and sub-sovereign entities”. The report also made the following proposal: “In the light of lessons learned from previous experience, and with appropriately reforms made, national development banks or specialised financial institutions should be considered as intermediaries channeling external and central government funds, and funds raised in local markets, to sub-sovereign bodies operating in the water sector.”

Public-private partnerships

PPPs are “arrangements where the private sector supplies infrastructure assets and services that traditionally have been provided by the government” (IMF, 2004). They are a form of agreement between public and private parties that contributes to achieving international and national development goals for health, basic education, water and sanitation. Private companies can invest through concession agreements, in which financial commitments are shared and financial risks can be transferred to private investors. Other PPPs involve private sector delivery of public services, under specific construction, management or service contracts, often defined as private sector participation (PSP) rather than PPP.

Public-private partnerships (PPPs) have become more common for the financing of infrastructures (WEF, 2005). In developing countries, Mexico and Chile are among the first countries, in the 1980s, that used PPPs to promote private sector participation. PPPs represent a very significant potential for investment in infrastructure as they can contribute to leveraging important amounts of financial resources. In that regard, they account for a growing share in NDBs' strategy for financing infrastructure projects. Through BNDES for instance the Brazilian government, with Corporación Andina de Fomento (CAF), the Inter-American Development Bank and Fonplata, has been implementing recently a number of transport projects aimed at improving regional integration.

National development banks can make good use of PPPs to transfer risks and encourage large-scale financing operations in developing countries. Just as regional or multilateral development banks, some NDBs can act as facilitators, promoters or even investors. New funding packages are put forward to support PPPs, including equity financing, loan assistance, technical assistance and project debt finance, which for instance are all being implemented by South Africa's DBSA. Risk transfer must be clearly understood though, as PPPs admittedly lower the overall level of operational and financial risk, but the viability of PPPs still rests in part on the public sector. Regional integration can also be facilitated through public-private partnerships. For instance, the Rio Group of Latin American countries has envisioned in 2004 a regional approach to infrastructure development that would involve PPPs, based on examples found in the EU.

However, efficient PPPs require a proper legal and regulatory environment. Fiscal responsibility by the government is necessary and should include restrictions in assuming new liabilities without proper funding. This was for instance the purpose of a 2004 reform of PPPs in Brazil that, in particular, limited the exposure of State-owned banks and NDBs to PPPs. These measures "were intended to improve the public sector's payment credibility, which has been compromised by broken contracts in the recent past" (Harvard International Review, Spring 2006). Similar or stronger legislations in other developing countries are needed to extend the time period of payments through bond issuing, with cash flow securitization. It might also be useful to allow the use of market tools such as guarantee funds to facilitate some PPPs.

Regional integration

As illustrated by previous examples, national development financing institutions can also pursue efforts to be part of the partnership with regional and multilateral institutions that play a catalytic role. Such institutions often support State, provincial or local projects. Reading the IADB's Institutional Strategies, for instance, shows how regional entities may be willing to act as catalyst for domestic development projects, in which NDBs can take an active role. The IADB in particular works with borrowing governments to support projects sponsored by the private sector, NGOs and State, provincial and local governments that strongly contribute to the achievement of national development goals and in which IADB may play a catalytic role.

Further integration can be promoted by RDBs together with sub-regional development banks and NDBs. This is being done in many regions and in particular in the Middle-East and North Africa

region, for instance by the Islamic Development Bank. IDB indeed improved its operational relations with NDBs through a greater utilization of its lines of financing. Among these are the provision of ‘free limits’ in the approval of sub-projects of up to 25 per cent of the overall approved amount of the lines of financing, and the securing for the national development financing institutions of a margin of 3-5 per cent over and above IDB’s mark-up.

NDBs can also develop direct linkages with other NDBs to foster the regional impact of their activities and common strategies. For instance the Industrial Development Corporation (IDC) of South Africa and Lesotho National Development Corporation (LNDC) are now cooperating on capacity building, technical assistance, economic research and project financing.

C. Capacity-Building of NDBs

1. Improving Prudential Regulation and Supervision

Challenges of regulation

In the early and mid-1990s there was significant private sector participation in infrastructure projects in developing countries. After the East Asian financial crisis hit in 1997, it became clear that many of the projects carried large hidden public costs. This was partly due to the fact that regulatory issues in infrastructure sectors had not been properly tackled. Costs were not properly disclosed, tendering and procurement policies were inadequate, tariffs were not scrutinized closely, and regulatory bodies were weak and lacked the technical expertise and power to enforce laws and regulations.

Such issues go beyond this analysis and to address them it might be necessary, in addition to efforts by the banks and governments, to use technical assistance by the multilateral and regional banks as well as bilateral agencies. For instance, the ADB currently assists regulatory authorities’ institutional strengthening in Azerbaijan, India, Pakistan and the Philippines. These activities involve the provision of technical advice for tariff setting, regulatory judicial processes and settlement of disputes.

Bank regulation and rating

Building legitimacy of institutions through rating is another important part of a country’s progress toward deeper capital and credit markets and requires strong and independent supervision mechanisms. But before analyzing the specific need for rating of NDBs, one should also address country-level needs. By giving an independent assessment of the credit worthiness of a country, rating can indeed help attracting new investors – it is even a requirement for many of them. In that regard, rating is being increasingly used in loan markets, for bank regulation and domestic markets (Kotecha, 2004). Regional Development Banks are aware of this need and for instance the Islamic Development Bank was recently involved in the creation of an International Islamic Rating Agency (IIRA).

The rating of NDBs themselves is an important element for their activity. It is an efficient way to communicate the credit standing to all financial counterparties. The equalization between NDBs rating and their sovereign does not have to be automatic, as rating should depend on the degree of dependency of the institution with government finances and policy, and on their stand-alone strength. Nevertheless, most such institutions in developed countries and in emerging markets still have the equalized rating.

Box 6: Standard & Poor's Methodology for Rating Government Supported Entities

In recent years, S&P's adjusted its methodology for rating government-supported entities. Whereas twenty years ago, ratings of such institutions were often equalized with the ratings of their owner governments, S&P's analytical approach has shifted toward an increasing focus on the stand-alone credit quality of the entity, and on determining the durability of the entity's links with the government. This approach is aimed at ensuring that government support is measured consistently and, where there is evidence that support is being reduced, that greater weight is given to stand-alone credit factors when determining the appropriate issuer rating. Abrupt changes in ratings thereby are minimized.

Source: Standard & Poor's

Regulatory capital

Another important issue is the proposed new Basel accord (Basle II), which aims to better align regulatory capital with real risks. The recent Basel proposals will reduce required regulatory capital for loans to the highest rated borrowers. But because the overall level of regulatory capital is expected to remain at 8%, this can only be done by increasing required capital for lower rated borrowers. *“An unavoidable impact of the proposals will be to increase regulatory capital requirements for lower rated borrowers, with the lowest rated borrowers seeing the sharpest increase”* (Griffith Jones, 2005). As a consequence, developing countries and their development banks could be adversely affected by this proposed accord, not only in least developed countries but also in middle-income ones. Considering the particularities of national development banks, it was thus suggested that NDBs adopt more flexible prudential norms, incorporating the characteristics of the domestic economic cycles and the operative modalities of the development banks. (Rodríguez Batlle, 2004)

2. *Enhancing Governance and Management*

Addressing governance and management issues is a difficult task, as the structure of NDBs varies significantly: there is a wide array of different ownership structures in the developing and developed world. Yet the cases of failure among NDBs in the previous decades tended to rest on similar causes, some of which were spelt out in the 2005 WESS: *“not all the development banks established in developing countries to provide long-term credit for development purposes have been able to replicate earlier successes. Inadequate cost-benefit evaluation of projects, mismanagement and high arrears have often brought national and regional public development banks to the brink of collapse.”* Stakeholders in the consultative process may thus wish in this context to address issues of ownership, good governance and management of development banks.

Public vs. private nature of banks

Many development banks, when not simply closed, were privatized in the 1980s and 1990s. State-owned banks that were less capitalized relative to their private counterparts, were said to be less profitable and had less core earnings. This was believed to be true in particular of state-owned banks focusing on economic development, because these development priorities further undermined the sustainability of their banking activities.

Successful cases of privately-owned development banks were thus put forward to reinforce this opinion, such as the Banco del Desarrollo in Chile, often opposed to cases of bankruptcy in parastatals such as for instance BANADES in Nicaragua, closed in 1998 after it sustained significant, lasting losses and heavy credit subsidization by the Central bank. Similar examples were found in Africa, where successful private entities like the Gambia Commercial & Development Bank, privatized in 1997, were compared to public institutions facing difficulties.

Nevertheless, many development banks remain owned by the State today – in 2002, there were only 11 development banks with fully private ownership. Why is that so? Many successful publicly-owned NDBs exist to contradict the belief that they tend to be inefficient by nature. The Development Bank of South Africa, BNDES in Brazil or NAFIN in Mexico for instance have had a very positive track record in the last decade. Government sponsorship can be efficient and it can be enhanced if certain conditions are attached to it. This can be further proved by successful cases from developed countries, as shown by the successful public development banking experience of Germany, Spain and France (Aghion, 1999), in countries that targeted development interventions and systematized co-financing arrangements with private financial institutions.

Still the discussions should be pursued as to:

- Whether certain NDBs should keep their state-run nature: this is the case in particular of banks that have been historically successful in the past in fostering economic development and that are now evolving toward activities much closer to private sector banking. For instance, certain large state-run development banks in emerging markets are now expanding their investments in merger deals while, at the same time, maintaining tough policies for SME lending;
- Whether some commercial banks should be transformed into development banks, especially in some least developed countries: the Tanzania Investment Bank for instance is a case of a financial institution being transformed into a development bank.

Governance

Putting issues of ownership aside, it seems that in order to develop an efficient institutional framework, NDBs need to be governed by standards of good governance away from political patronage and corruption. Suffice to say such key requirements are highlighted in both:

- The Monterrey Consensus: “*Good governance is essential for sustainable development*” [para. 11] ; “*Corruption is a serious barrier to effective resource mobilization and*

allocation, and diverts resources away from activities that are vital for poverty eradication and economic and sustainable development” [para.13] and

- The World Summit Outcome document: *“We acknowledge that good governance and the rule of law at the national and international levels are essential for sustained economic growth, sustainable development and the eradication of poverty and hunger” [para. 11]; “We resolve (...) to make the fight against corruption a priority at all levels and welcome all actions taken in this regard at the national and international levels, including the adoption of policies that emphasize accountability, transparent public sector management and corporate responsibility and accountability, including efforts to return assets transferred through corruption, consistent with the United Nations Convention against Corruption” [para. 24.c].*

A related matter is the need for expertise in auditing and independent oversight of these institutions. Banks need indeed to have mechanisms in place to ensure sufficient oversight of projects, at the various stages, from approval to implementation phases. This should include financial and administrative, environmental and social impact analysis. It should be ensured that resources have been used appropriately, that the executing organization complied with financial contractual clauses and that internal control procedures are effective. Progress in that regard has been significant in the recent years for some banks. The Banque Gabonaise de Développement for instance launched a review of its supplier and an audit of its branches, and such efforts contributed to attracting new bilateral and multilateral support to the bank. The government of Gabon, which launched an important sector-related forest environment program (PSFE) in 2004, received the backing of the World Bank and a bilateral development agency (Agence Française de Développement), resulting in new credits by these institutions.

Management

Management and organizational efforts include the establishment and adequate composition of a board of directors and a large degree of autonomy in decision-making. The board of development banking institutions, when established, should take the management of operational risks as seriously as the control of financial risks. They should be accountable for their management on a regular basis. Best practices can be fruitfully shared in that regard with existing structures at a regional and multilateral level. Functional committees, comprised of Board members and senior executives, could be established to reinforce the oversight of the NDB’s management.

Previous inconsistencies and bureaucratic complexity had led some development banks to manage resources under short-term criteria, and they often demonstrated as a consequence a poor collection record with their borrowers. Especially at times of economic crises, those banks’ management was unable to react swiftly enough and tended simply to roll over the loans. Credit allocation in some NDBs often reflected *“poor risk management, which, combined with inadequate collection policies, kept loan recovery rates much lower than those of commercial banks. Financing based on fiscal sources and multilateral institutions, combined with a lack of budget transparency, generated a high opportunity cost for these resources”* (Titelman, 2005).

Management of risk, of loan portfolios, as well as transparency of lending policies should be high on the agenda.

Thus several measures are critical and include above all:

- Maintaining robust counterparty risk management practices;
- Increasing transparency of loan policy;
- Pursuing efforts, just as private commercial banks have, to develop accountability measures and encourage the establishment of independent audit systems.

Another management challenge lies in the need for technical expertise. The lack of technical capability and the incapacity to retain and build on knowledge is often cited amongst the main difficulties encountered by NDBs. As noted in the Monterrey Consensus, strengthened regional development banks and sub-regional financial institutions serve as a vital source of knowledge and expertise on economic growth and development for their member countries (see para. 45). The challenge is therefore twofold. First NDBs must enhance cooperation with regional and multilateral institutions. For instance, the IDB organizes an annual meeting with National development banks, which are invited to fully utilize its technical assistance facility in the areas of feasibility studies and capacity building. Similar models could be developed with other entities willing to share their experience in technical assistance. Overall strategies should address policy adjustments to be implemented, budgetary issues, cooperation and coordination among institutions, human resource requirements, and technology requirements.

3. *Measuring and Monitoring Results*

A lot of efforts and initiatives are underway in a number of agencies to address the issue of development results. A result-focused strategy requires expanding attention to circumstances and behaviors beyond the institutional boundaries of the NDBs and the projects being financed, and to look at the intended beneficiaries of development projects. Between development actors themselves it also requires, as noted in the World Bank's Comprehensive Development Framework, concerted efforts "*to disseminate information about results among stakeholders in the development process to promote accountability and to create feedback loops so that information can be used to adjust strategies and to improve projects, programs, and policies*".

Measuring results is a key element in that regard. Development assistance agencies have often focused too much on inputs and outputs, in particular disbursements, without adopting a result-oriented approach on the ground (productivity, growth, social improvements). This contributed to deteriorating the incentives to ensure that funds are used in ways that will achieve sustained development. This excessive focus on disbursement rates rather than outcomes has contributed to the under-development of financial accountability, measuring economic and social conditions, and monitoring and evaluation of public programs and policies amongst institutions in developing countries (World Bank, 2005).

The planning, implementation, and evaluation stages of project cycles ought to include result-based approaches, with adequate accountability, monitoring and evaluation mechanisms. Part of the monitoring can be done in-house through adequate desk and field monitoring, review of project implementation and review of project completion reports.

Yet while the impact of projects may in theory be measured through a simple cost-benefit analysis (CBA), it is often difficult to do so in reality. Capturing the diffuse benefits of structural, institutional, educational change brought by development projects is a technically complex task. Economic spillovers or clustering effects in particular may be significant and yet hard to assess. Benchmarking NDBs could help establishing a measuring of results through comparisons to similar development banks for which statistical tools are readily available. One might indeed highlight best practices in that regard, such as for the assessment of performing vs. nonperforming loans, of staffing needs and of customer service. Such methods, relatively sensitive to enforce, were used to reform and modernize certain NDBs, such as for instance for Pakistan's agricultural development bank. This constitutes only an indirect way to measure banks' efficiency for economic development. The need for concerted support for statistical, monitoring and evaluation capacity building in NDBS is thus crucial. In this regard, efforts should include donors and regional and multilateral development banks.

Index of Stakeholders

A

Ad Hoc Expert Group Meeting · 3
ADB · 13, 15, 16, 21, 31, 39
AFD · 15, 20, 24, 25, 34, 39, 40
Afreximbank · 7
Agence Française de Développement · 34
Andhra Pradesh Industrial Development Corporation · 22
Andra Pradesh Development Bank · 8
Austria · 6

B

BAAC · 16, 23
BANADESA · 22
Banco de Avio · 4
Banco de Comercio Exterior de Colombia S.A. · 6
Banco del Desarrollo · 25, 33
BancoEstado · 8, 24, 25
Bancolombia · 24
Bank of Uganda · 23
Banque agricole et commerciale du Burkina · 8
Banque gabonaise de développement · 4, 34
Banque Régionale de Solidarité · 8
Banrural · 22
Blue Book · 21
BNDA · 7, 22, 23, 24, 27
BNDES · 5, 7, 8, 15, 17, 18, 19, 21, 30, 33
Botswana · 4, 16, 19
Botswana Development Corporation · 4, 19
Brazil · 5, 15, 17, 19, 21, 30, 33, 39
Burkina · 8, 23

C

CAF · 8, 30
Canada · 25
Caribbean Development bank · 8
Caricom · 8
Chile · 8, 24, 25, 30, 33, 40, 41
China · 14
China Development bank · 14
COFIDE · 6
Colombia · 6
Commonwealth Development Corporation · 6
Compagnie Malienne pour le Développement · 18
CORFO · 25
Council of Europe Development Bank · 8
Crédit Municipal · 16

D

DBSA · 5, 7, 18, 23, 30

DEG · 6
Denmark · 16
Development Bank of Kenya · 6

E

ECLAC · 14
Egypt · 7, 24, 39
EIB · 23
EKN · 15
Eksportfinans ASA · 6
Eximbank of the United States · 6

F

Finance Corporation for Municipal Enterprises · 16
FINFRA · 14
FMO · 6
Fonplata · 30
France · 3, 15, 16, 18, 25, 33

G

Gabon · 8, 34
Germany · 3, 6, 15, 22, 33
GIEK · 15
Guatemala · 22

H

Honduras · 22

I

IADB · 8, 18, 30
IDBI · 26
IFC · 6, 18, 20, 21, 39
India · 8, 14, 22, 23, 25, 26, 31
Industrial Bank of Korea · 12
Industrial Development Corporation · 31
International Monetary Fund · 3
Islamic Development Bank · 31
Islamic Rating Agency · 31
Italy · 3

J

Japan · 15, 16, 25, 39
JBIC · 8, 14, 25

K

KfW · 6, 22
KommuneKredit · 16
Korea · 12, 15
Korea Development Bank · 12

L

Laos · 15
Lesotho · 26, 29, 31
LNDC · 31

M

Malaysia · 27
Mali · 7, 18, 22, 23, 24, 39
Merchant Banks · 3, 4
Mexico · 1, 4, 14, 18, 19, 24, 25, 30, 33
MIGA · 20, 21
Monterrey Consensus · 1, 2, 3, 13, 33, 35, 41
Morocco · 23

N

NABARD · 14, 23
Nafin · 4
NAFIN · 19, 25, 26, 33
National Bank for Development · 7, 24, 39
National Development Bank of Botswana · 16
National Development Bank of Sri Lanka · 19
Netherlands · 6, 39
New Rules for Global Finance Coalition · 1, 41
Nicaragua · 7, 33
North American Development Bank · 29
Norway · 6, 15

O

Oesterreichische Kontrollbank AG · 6
Overseas Private Investment Corporation · 20

P

Pakistan · 31, 36
Peru · 6

Philippines · 21, 31
Private Export Funding Corp · 6
Proparco · 15, 18, 25

R

Rio Group · 30

S

SERCOTEC · 25
SIDBI · 25
Société générale · 18
South Africa · 18, 23, 30, 31, 33
Spain · 33
Sri Lanka · 19
Standard & Poor · 32, 41
Sweden · 15, 18

T

Tanzania Investment Bank · 33
Thailand · 16, 23
Tunisia · 23

U

Uganda · 23, 24
UNCDF · 26
UNCTAD · 26
United Kingdom · 3
United Nations Development Programme · 3
United States · 4, 6, 20, 21, 26

W

WEF · 30, 41
WESS · 12, 13, 16, 32
West African Economic and Monetary Union · 20
World Bank · 3, 4, 5, 13, 16, 20, 24, 34, 35, 39, 41
World Economic and Social Survey · 12, 41
World Panel on Financing Water Infrastructure · 29, 41
World Summit Outcome · 34

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