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POLICY PAPER

The Role of Multilateral Development Banks in Financing the Sustainable Development Goals

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This briefing paper discusses multilateral development banks (MDBs), a leading group of development finance institutions. The goal is to inform ongoing discussions on whether Switzerland and other MDB shareholder countries should continue to support MDBs, particularly in the context of the capital increases recently agreed for the World Bank and African Development Bank. First, the brief outlines the MDB basic model, which is a powerful mechanism to channel resources to development goals. Second, the brief reviews a few of the debates about how MDBs operate and why countries support them.

Why Are MDBs Useful?

In 2015 the global community agreed on an ambitious set of Sustainable Development Goals to put our planet on an environmentally, socially and economically sustainable trajectory by 2030. While the SDGs are an impressive testament to international cooperation, they were not accompanied by a clear plan of how to finance them. The investment gap needed to achieve the SDGs is daunting: US$2.5 trillion per year (UN 2019), and an additional US$1 trillion per year for low-carbon infrastructure to slow global warming (New Climate Economy 2016). On top of this, substantial emergency lending will be needed to cope with impacts of the Covid-19 crisis (UN, 2020).

Where is this money going to come from? Fiscal space in developing countries is already maxed out, and aid budgets from wealthier countries are constrained due to fiscal and political factors. Many of the investments needed for the SDGs are either too risky or unprofitable to attract private investment, and incipient "impact investing" – private investors seeking social impact as well as financial return – cannot make up the difference.

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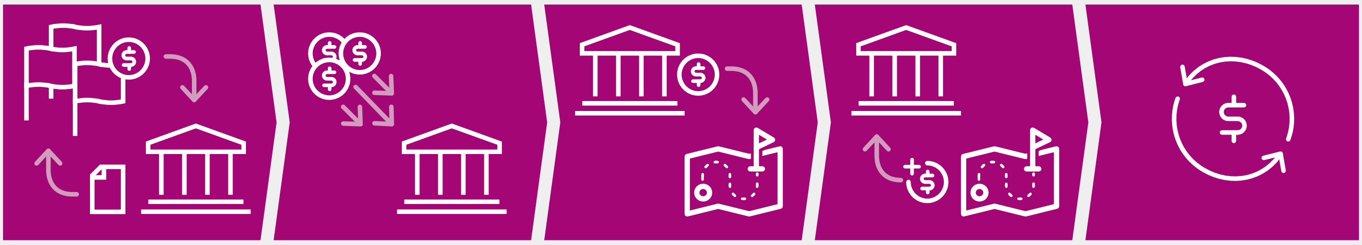
The MDB Model in Five Steps



01

A group of like-minded countries **buy shares in MDB capital**, just as private individuals buy shares in a company.

02

MDBs then **borrow money from international capital markets** to get more money to lend for development projects. Because the large MDBs are backed by wealthy countries, they are all rated "AAA" and can borrow at extremely low interest rates.

03

MDBs then **make loans for projects** in developing countries. MDBs charge a small margin above their own cost of borrowing, but this is still much less than what developing countries would have to pay when they would borrow directly from private lenders.

04

Developing country borrowers **repay their loans.** MDB income from loans (and some other investments) covers all administrative costs, including project preparation and development research.

05

Member countries do not need to contribute further resources to an MDB – it is **self-financing.** Should members decide that they would like an MDB to increase investments to achieve targets like the SDGs, they may decide to increase the share capital of an MDB.

In all the international discussions of "billions to trillions", **we often overlook one of the best-positioned set of institutions to fill the SDG investment gap: the World Bank and the major regional multilateral development banks**. The World Bank was created in 1944, the Asian, African and Inter-American Development Banks (AsDB, AfDB and IDB) were created in the 1950s and 1960s, and the European Bank for Reconstruction and Development (EBRD) was founded in 1991. More recently, the Asian Infrastructure Investment Bank (AIIB) was launched in 2016, with the backing of China, Switzerland and over 50 other countries.

To meet the challenges of the SDGs, **these banks need more capital from their shareholder governments, including Switzerland**. Member governments of the World Bank and the African Development Bank – the largest MDB in the world's most challenging development region – agreed to an increase in shareholder capital in 2018 and 2019, respectively.

Switzerland's share of that capital is now coming up for discussion in the Swiss Parliament, and this briefing paper lays out some of the main issues that policymakers, civil society organizations, media and the interested public may want to keep in mind in advance of a vote.

The Basic MDB Model

MDBs are cooperative banks created by governments that borrow most of their resources from private investors. MDBs lend mainly to governments to help pay for investments that will promote development. Some MDBs – like the World Bank's International Finance Corporation (IFC) and the European Bank for Reconstruction and Development – dedicate all or most of their lending to the private sector, with the aim of directly stimulating economic growth and job creation. **MDBs lend mainly to lower-middle income and middle-income developing countries. The world's poorest countries have access to interest-free loans or grants that come from special funds supported by donor countries**.

Many socially important investments – for primary schooling, maternal health or rural roads, for example – are not profitable for private investors. Nonetheless, the investments will benefit a country's long-term development. The MDBs supply low-cost financing as well as know-how in designing development projects. MDBs also closely oversee project implementation to avoid the misuse of funds and to protect against negative social and environmental impacts.

This financing is made possible through the MDB financial model. Backed by a small amount of capital from member countries, an MDB raises resources on international capital markets to lend for development. **MDBs mostly pay for themselves, and the capital investment of shareholders is maintained over time, rather than being spent like normal aid budgets**.

In financial terms, the MDB financial model has been extraordinarily successful. With a total share capital of US$46 billion, the five legacy MDBs have lent US$1.7 trillion dollars for development projects, without using up a penny of their share capital (Table 1). All administrative costs and research are paid for with income from MDB loan repayments and other investments. MDBs have also generated a further US$100 billion in retained earnings ("profit" which is kept by the MDB), which is legally owned by member countries along with their capital shares. In short, **MDB share capital not only generates large amounts of development**

finance as well as knowledge and technical assistance, but it is actually a growing financial investment for shareholders.

Table 1. Shareholder Capital, Reserves and Cumulative Operations, Legacy MDBs (US$ Billions)

	Total Paid-In Share Capital	Retained Earnings	Cumulative Financing (to end-2018)
World Bank IBRD (1944)	16.5	28.5	703.6
World Bank IFC (1956)	2.6	23.6	223.5
IDB (1959)	11.9	21.5	269.5
ADB (1966)	7.0	44.0	214.7
AfDB (1963)	6.9	3.9	138.7
EBRD (1991)	7.2	11.6	175.7
Total	**46.2**	**100.9**	**1725.7**

Source: MDB 2018 financial statements.

Note: Founding year in parenthesis. "IBRD" is the International Bank for Reconstruction and Development, the World Bank's main public sector lending window. "IFC" is the International Finance Corporation, the World Bank's private sector lending window.

Switzerland is a member of all the major MDBs as well as the new Asian Infrastructure Investment Bank. Switzerland's total share capital investment in all MDBs is US$774 million. This is a substantial amount of money, but is only about one-quarter of the nearly US$3 billion annual amount of Swiss bilateral aid funded by the government budget (Swiss Federal Department for Foreign Affairs 2020). Unlike bilateral aid, MDB share capital is not spent every year, but preserved as an asset owned by the Swiss government.

Switzerland – like all MDB member countries – has also committed "callable" capital as part of its shareholding. Callable capital is a guarantee that MDBs can call on if they ever face a serious financial crisis. Although callable capital numbers are high – US$7.9 billion for Switzerland across all MDBs – no MDB in its history has ever even come close to calling on callable capital, even in the worst years of financial crisis in past decades. Conservative financial policies, careful loan preparation and a stellar track record of loan repayment make this is a very remote possibility, even in times of global crisis.

Table 2. Swiss MDB Membership and Capital Share (US$ Billions)

	AfDB	AIIB	AsDB	EBRD	IDB	IBRD	IFC
Membership Year	1982	2016	1967	1991	1976	1992	1992
Paid-in Capital	97.3	141.3	43.1	164.1	26.8	255.5	44.1
Callable Capital	1200	565.1	818.5	622.8	776.3	3900	0

MDBs also manage a number of funds supported by donations from wealthy countries. This includes the World Bank's International Development Association (IDA) and AfDB's African Development Fund (ADF), both of which provide grants and concessional loans to poor countries. These funds should not be confused with the regular MDB windows, which do not receive donations.

Why contribute to MDBs when we have our own bilateral agencies like SDC and SECO?

Switzerland – like other bilateral donors – has its own development cooperation programs, and many Swiss might wonder why the country should also contribute to MDBs. The answer is that **bilateral aid programs and multilateral agencies each have different roles and advantages**.

Switzerland's development aid – like all bilateral aid – focuses on the country's national priorities and the particular strengths Switzerland can bring to bear from its own experiences. Switzerland must focus on a sub-set of countries and in a few sec-

tors where it believes its cooperation can be most effective, as defined every four years in the Swiss parliament.

MDBs can take a much broader approach, due to the size of the institutions and scale of operations. Each MDB has specialists and experience in a wide variety of sectors and close relationships with many countries developed over decades. MDBs can address regional or global issues like disaster relief and climate change, and to take on investments that are not feasible for Switzerland to undertake alone such as major infrastructure projects or reforming a country's education system. MDB operations generate a much larger set of "public goods" that benefits all countries, including Switzerland, in a way that bilateral aid cannot. Switzerland's bilateral aid also benefits from engagement with MDBs by leveraging on their expertise and experience as well as channeling a portion of its aid budget through MDB programs.

MDBs have a degree of international legitimacy that even a well-respected country like Switzerland cannot match. Their activities do not obey the interests of a single country, but rather express the collective view of what is best for global development. Of course, politics does play a role at MDBs, and large shareholders like the U.S. unquestionably have a strong influence on MDB policy. But day-to-day MDB lending activities can focus more on development needs rather than the interests of individual member countries.

Does Switzerland Have a Meaningful Voice in the MDBs?

Switzerland's voting power ranges from 2.3% at EBRD to 0.47% at IDB. Although this is small, it is not unusual in light of the high number of member countries, and Switzerland is able to make its voice heard. Daily business at all the MDBs – including loan approvals and many policy decisions – are decided at the Board of Directors (BoD). Most countries are grouped together into "constituencies", which elect a representative to physically sit at the BoD. Switzerland has one of the largest voting shares within its constituencies at the World Bank, European Bank for Reconstruction and Development and African Development Bank, and is thus often (but not always) assumes the directorship, meaning Switzerland's executive director sits at the BoD.

Table 3. Swiss Voting Power at MDBs (2018)

	AfDB	AIIB	AsDB	EBRD	IBRD	IDB	IFC
Voting Power	1.48%	0.84%	0.76%	2.30%	1.47%	0.47%	1.66%
# Members	81	76	68	69	189	48	185

Switzerland has several characteristics that give its views greater credibility within MDB governance beyond its pure voting power. The fact that it is a AAA-rated country means that its backing helps the MDBs themselves achieve their AAA rating, and thus improves their financial strength and development impact. As a result, MDB management and other shareholders value Switzerland's membership and will work to keep it. As well, the country's reputation for political neutrality, excellent public administration and long-term view of its own economic development and environmental protection give Switzerland further credibility in expressing views within MDB governance.

Why can't private investors contribute share capital to MDBs, instead of governments?

With the rapid rise of "impact" or "socially-aware" investing, why not just get private investors to contribute capital to the MDBs? In reality, **taking on private shareholders would risk undermining the developmental impact and international legitimacy of the MDBs**. MDBs already have to strike a delicate balance between maintaining the confidence of bond investors and focusing on development. Bond markets and ratings agencies worry about how well an MDB performs in financial rather than developmental terms, and MDBs have to manage their operations to take these concerns into account (Humphrey 2017). That is the trade-off of the MDB financial model.

Bringing investors into the MDB capital structure would push MDBs even further toward investor rather than developmental priorities. Investors would only want to become shareholders if they were paid a dividend, unlike member countries. Generating dividends means that MDBs would have to increase their loan pricing, which would impact debt levels in developing countries. Investors would also push MDBs to invest in more "bankable" projects, and away from projects with social rather than financial benefits. In short, **taking on investor shareholders would run the risk of turning MDBs into just another profit-seeking bank**.

Don't MDBs force neoliberal, free market policies on developing countries against their will?

There's no question that during the 1980s and into the 1990s, the World Bank and International Monetary Fund used "structural adjustment programs" to push countries into policies they didn't always want to follow, but had to so they could access badly needed loans. The development world has changed radically since those times. As recognized by the Paris Declaration on Aid Effectiveness (2005) and the Accra Agenda for Action (2008) emphasize, forcing countries to adopt policies is not a good approach, both ethically and practically. Developing countries themselves are much more assertive – open to hearing advice from experienced MDB staff, but strongly defending their right to design and implement their own policies.

Nowadays the World Bank and regional MDBs are much more careful about how they try to influence government policies, and are more open to different approaches that do not always follow the neoliberal "Washington Consensus" policies of previous years. The economic development and poverty reduction achieved by China over the last 30 years, for example, has made MDB staffers more humble about dictating "best practice" policies. But much depends on the countries. When a government has a clear plan, MDBs can be a useful tool for financing and technical assistance. But when a government is disorganized or poorly led, or badly in need of loans due to a crisis, MDBs can still slip into bad habits of dictating policies or development agendas. **Shareholders like Switzerland need to closely examine projects to ensure real borrower country ownership**.

Are MDBs doing enough to reduce climate change and safeguard the environment and vulnerable people?

The short answer is that MDBs are doing a lot, but could be doing a lot more. On **climate change and sustainability**, the MDBs to which Switzerland is a member have all signed an agreement committing themselves to bring their operations in alignment with the Paris Climate Accord. Under a strict interpretation of the agreement, that should mean not supporting any fossil fuel-based projects (Bhattacharya et al. 2019), and instead focus on renewable energy and public transport systems.

MDBs have not been willing to go that far, arguing that achieving the SDGs by 2030 requires making compromises. Many civil society organizations (CSO), on the other hand, believe that the MDBs are best positioned to help lead the global transition to a more sustainable climate path, starting right now. There are some signs of movement by the MDBs in recent years. The African Development Bank committed in the fall of 2019 to phasing out coal projects, and the European Investment Bank a month later announced it would exit fossil fuel support entirely by 2021. The International Finance Corporation has also proposed a coal phase-out, although it has not yet been approved.

Safeguards focus on ensuring that MDB projects do not damage the environment or harm vulnerable social groups (Morgado and Taskin 2019). This has been a constant battle at MDBs in recent years, particularly for infrastructure projects and extractive industries. CSOs and non-borrower shareholders like Switzerland have pushed to impose strict rules that countries must follow on MDB projects, including consultations with affected groups, environmental assessments and much more. Borrowers, on the other hand, complain that safeguards are expensive, slow down project implementation and are an infringement on their national sovereignty.

As of 2018, the World Bank introduced a new set of safeguard policies after a long series of public consultations. The new policy is not significantly "looser," but does find ways to make more use of a country's own laws and regulations when possible. The new Asian Infrastructure Investment Bank has a set of safeguards very similar to the World Bank, as do the other legacy MDBs. The key is how the MDBs can help strengthen developing country capacity to manage environmental and social issues on their own, and it remains an open question as to whether safeguards are the best way to do that.

Just as important as safeguards are systems for MDBs to monitor project implementation over time and mechanisms to address complaints from project-affected people. While all MDBs have these, their effectiveness and organizational independence from MDB management vary considerably.

Conclusion

This briefing paper has argued that the MDBs are a valuable set of institutions that deserve continued support by Switzerland and other shareholders. They are able to promote global development goals in ways that bilateral aid agencies cannot, and they do so using a powerful financial mechanism able to leverage large amounts of investor resources with only minimal contributions from shareholder countries.

MDBs are far from perfect, and shareholders must keep close track of their activities to avoid bureaucratic bloating and ensure that projects have strong developmental impact. The impulse of

MDB staff to impose policies and ideas on borrowers should be kept in check to strength country ownership of their own development agenda. It is also essential to push MDBs towards greater support for global climate goals and protecting against negative social and environmental impacts of development projects.

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Photos:

p. 1: Cambodian farmers. Photo: Chor Sokunthea / World Bank
p. 3: Temporary wooden bridge, Myanmar. Photo: Asian Development Bank
p. 4: Wind farm in the People's Republic of China. Photo: Asian Development Bank

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