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A private affair

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

By María José Romero

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Contents

Acronyms

ADB	Asian Development Bank
BIO	Belgian Investment Company for Developing Countries
CAO	World Bank's Compliance Advisor/Ombudsman
CDC	Commonwealth Development Corporation
CSO	Civil society organisation
DEG	Deutsche Investitions- und Entwicklungsgesellschaft mbH (German Investment Corporation)
DFI	Development Finance Institution
DOTS	Development Outcome Tracking System
EDFI	Association of European Development Finance Institutions
EIB	European Investment Bank
EITI	Extractive Industries Transparency Initiative
Eurodad	European Network on Debt and Development
FDI	Foreign Direct Investment
FMO	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (Netherlands Development Finance Company)
GIIN	Global Impact Investing Network
GNI	Gross National Income
IATI	International Aid Transparency Initiative
IEG	World Bank's Independent Evaluation Group
IF	Investment Facility
IFC	International Finance Corporation
IFI	International Finance Institution
LIC	Low-income country
LMIC	Low- and middle-income country
MIC	Middle-income country
MSME	Micro, small and medium-sized enterprises
NGO	Non-governmental organisation
ODA	Official development assistance
OECD-DAC	Organisation for Economic Co-operation and Development's Development Assistance Committee
Proparco	Promotion et Participation pour la Coopération économique (Investment and Promotion Company for Economic Cooperation, France)
SME	Small and medium-sized enterprises
WBG	World Bank Group

Executive summary

Development finance has changed substantially over the past decade. Private finance has replaced aid at the centre of global and national development initiatives, for both governments and international bodies. Development finance institutions (DFIs) have become some of the most important players in today's development arena.

DFIs are government-controlled institutions that invest billions of Euros in private sector projects in developing countries every year – often using scarce aid money to 'leverage' this finance. By 2015 the amount flowing to the private sector is expected to exceed $100 billion, which is equivalent to almost two thirds of official development assistance (ODA, or traditional 'aid').

This report covers the main findings of Eurodad's programme of research on DFIs, which has produced four major reports over two years. We have examined the way DFIs work with the private sector and explored the problems that they must tackle. We question whether they are the right institutions to hold such a dominant position in development finance and make concrete recommendations for reform.

Eurodad's principal concern is that almost all DFIs are owned and controlled by rich country governments, with little effective input or influence from developing country governments, and even less from other developing country stakeholders.

European bilateral DFIs are owned and driven by European governments and consistently fail to include recipient countries in their investment decisions. Many multilaterals also structure their governance in favour of developed countries, with recipient countries playing a weaker role. This imbalance in power structures means, among other things, that companies from wealthy nations have often received the lion's share of contracts. Investments are sometimes routed through tax havens, helping to legitimise their role in the loss of hundreds of billions of dollars to developing countries through tax dodging by multinationals.

This report finds that:

- DFIs show minimal support for companies from low-income countries. For instance, only 25% of companies supported between 2006 and 2010 by the EU's European Investment Bank (EIB) and the World Bank's International Finance Corporation (IFC) were domiciled in low-income countries.
- The financial sector has been favoured by DFIs in recent years, receiving on average more than 50% of funding that has been allocated to the private sector. This has raised serious questions in relation to what kind of development impact investments in the financial sector have, particularly after the recent financial crisis, which was driven by irresponsible investment decisions and financial deregulation.
- DFIs' selection of financial instruments is questionable. This is particularly true in the case of equity and guarantees that have not been properly assessed or monitored.

> “ Companies from wealthy nations have often received the lion’s share of (DFI) contracts and investments are sometimes routed through tax havens.

- DFIs contribute to foreign private investments flowing into developing countries by supporting foreign companies or by investing their own (foreign) capital directly in local businesses. However, positive impacts of foreign investment can be accompanied by many risks, including macroeconomic problems. These problems have had a particular impact in the experience of Asian countries during their last financial crisis.
- DFIs face serious transparency problems, especially when dealing with financial intermediaries. DFIs’ transparency to the general public is limited, which in turn constrains the ability of stakeholders to effectively exercise external control.

The next few months are a crucial time for the future of development finance as the post-2015 debate continues and goals and targets for development finance are being set. Donors are realising that existing global public resources will not be sufficient to meet the world’s development needs. Many are increasingly turning to private actors – using scarce ODA to ‘leverage’ this sector. Eurodad recognises that there is a critical role for the private sector to play in development. However, foreign-owned and controlled institutions are not going to provide the country-owned and effective strategies necessary for developing countries to harness the private sector’s power for development.

Therefore, before increasing and deepening DFI operations further, a full review from a developing country perspective should be conducted. This should be carried out, for example, by a committee of independent experts from government, civil society organisations (CSOs) and the private sector in developing countries. This review should consider carefully the many concerns Eurodad and partners have consistently raised, including that:

- DFIs should align their investment decisions to developing countries’ priorities and national development plans.
- DFIs should demonstrate clear financial and development added value.
- DFIs should comply with the guidelines of responsible finance, as outlined in Eurodad’s Responsible finance charter. You can find these guidelines at www.eurodad.org.

Introduction

The landscape of development finance has changed substantially over the last decade, particularly in terms of volume, actors, motives and instruments. After the economic and financial crisis, aid budgets were squeezed by many donors and it is becoming increasingly unlikely that most donor countries will meet the target of spending 0.7% of Gross National Income (GNI) on ODA by 2015. The largest flows to developing countries in aggregate are commercial or private, although at the same time resources also flow out of developing countries in the form of repatriated profits on foreign direct investment (FDI), repayments on loans and illicit financial flows.[1]

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

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

This report covers the main findings of Eurodad's programme of research on DFIs, which has produced four major reports over the last two years.[2]

The report is structured as follows:

- The first section presents the main features of DFIs' operations, including how they target different private sector beneficiaries, what the development implications of the financial products are, and who benefits from these institutions' investment decisions.
- The second section presents several challenges that DFIs must tackle.
- The final section makes concrete recommendations for reform.

1 DFI operations

What are DFIs and how do they work?

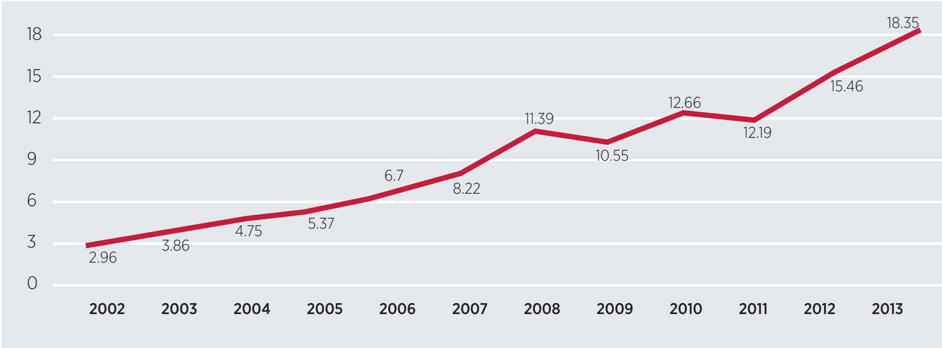
DFIs are government-controlled institutions that invest in private sector projects in developing countries. They are engaged in supporting the private sector and in mobilising additional private finance. Most DFIs are funded by donors governments' development agencies, and can raise additional funds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

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

Although DFIs have a long history in supporting cross-border private investments, the last few years have seen a sharp increase in their annual commitments as part of the increased interest in, and funding for, private sector development by most donors. At the global level, the IFC has increased by a factor of six its investment commitments since 2002 with an average annual growth rate of 15%. In 2013, with more than $18 billion in commitments, it became the biggest arm of the WBG and it is often used as a standard setter for other DFIs.

At the European level, several bilateral institutions have also boosted their financial capacity. From 2003 to 2012, the consolidated portfolio of EDFI members increased substantially: from €10 billion to €26 billion, a 160% increase. This dramatic increase is backed by two important facts. First, most DFIs have sovereign guarantees from their governments, who will bailout them – and their creditors – should that prove necessary. Second, in many cases DFIs also benefit from de facto preferred creditor treatment – meaning they will be paid even in the event of a currency crisis in the developing country where they are supporting private investment. These two facts protect DFI investments in a way that no other financial institution can compete with.

Figure 1: IFC's total commitments 2002-2013 (in billion US$)



Source: IFC, annual reports.

As the Eurodad research report *Private finance for development unravelled* shows, from 2008 to 2012 six DFIs – the ADB, DEG (Germany), the EIB, FMO (Netherlands), the IFC and Proparco (France) – committed €75 billion to the private sector operating in developing countries. However, much of this is due to the IFC, the biggest player in this field. In 2012, EDFI members' portfolios ranged from €8 million, in the case of the Portuguese SOFID, to €6.3 billion, in the case of the largest European bilateral institution, the Dutch FMO.

DFIs: dominated by rich countries

Multilateral DFIs get their capital base from member state governments, which are represented in the institutions' governing boards. Voting power is based on this capital stock, which has political implications for how the institutions approach their work and who has power in decision-making processes. In the case of the IFC, high-income countries account for 70% of voting power.[3] In the case of the ADB, they hold 60%, which includes 15.7% from Japan and 15.6% from the United States.[4]

Bilateral DFIs' ownership can vary between fully state-owned and fully privately owned. Most DFIs have mixed ownership, with shareholding divided between governments, large financial institutions and commercial banks, private companies and individual investors. In most cases, however, governments hold a majority of shares. There is no formal representation of developing countries governments' on their boards, substantially undermining the level of ownership that developing country governments have in the institutions' strategies and investment decisions.

Table 1: Private sector commitments signed by selected DFIs 2008-2012 (in billion EUR€)

Multilateral DFIs			Bilateral DFIs		
ADB	EIB ACP Investment Facility	IFC	DEG (Germany)	FMO (Netherlands)	Proparco (France)
7.25	1.69	49.97	6.03	5.95	3.91

Source: Source: DFIs' annual reports. IFC commitments cover FY 2009-FY 2013. ADB amounts refer to non-sovereign approvals.

DFIs' mandates: prioritising development or profit?

Originally, many DFIs were set up by developed countries to protect their overseas interests and to support their domestic companies in their former colonies. This legacy still continues in many cases. In some other cases, DFI mandates have shifted towards supporting the development of a private sector to kick-start the growth necessary to create better living conditions for the poor.

Overall, the mandates of today's DFIs are not homogeneous. Some have an explicit mandate to promote development by fostering the private sector and economic growth, whereas others prioritise support to an efficient private sector. Although most DFIs have the mandate to promote development, they are organised like private corporations with commercial profitability considerations, often implying a trade-off between these goals.

ODA to the private sector: DFI funds reported as aid

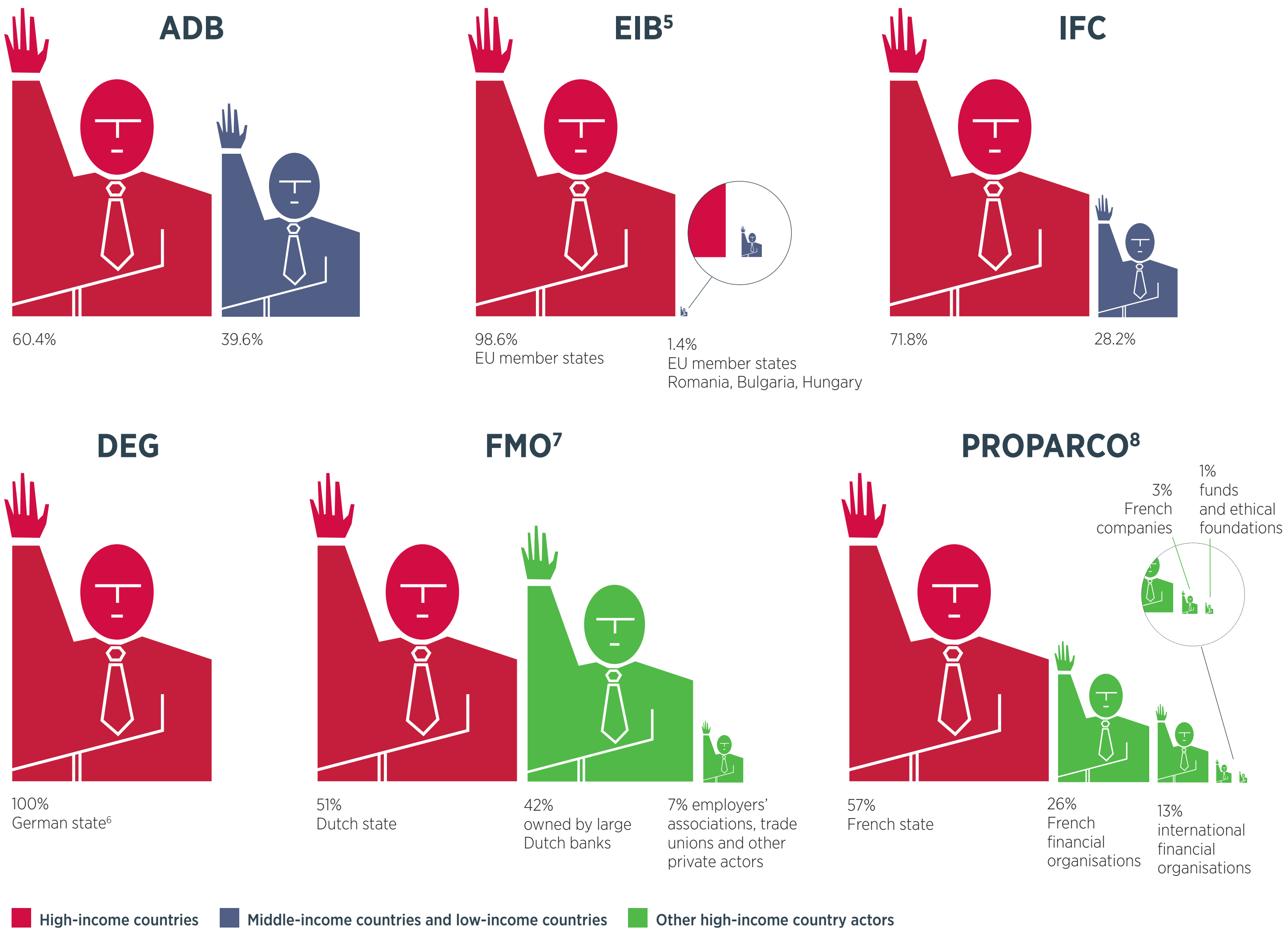
DFIs and development agencies are frequently interlinked as most DFIs receive transfers from the public sector (shareholder governments) to support their activities. These resources are aimed at private sector beneficiaries, either through direct subsidies or indirectly through the conditions under which DFIs operate, for example, their cheap cost of borrowing thanks to their state guarantees. However, each institution presents different features in this regard.

DFI funds and ODA resources are increasingly being pooled together, or 'blended'. Although the OECD Development Assistance Committee (DAC) establishes criteria for flows to be reported as ODA, the question of what proportion of DFI funds are reported as ODA is currently impossible to answer due to the lack of harmonised reporting practices and poor data. Public resources that are intended to be reported as ODA are used by DFIs in the following manner:

- technical assistance funds channelled through DFIs;
- capital subscriptions to DFIs;
- interest rate subsidies;
- guarantees.

Moreover, owing to a major flaw in the reporting system for ODA, highlighted by Eurodad's report *A matter of high interest*,[9] market-rate loans can meet the 'concessionality' criteria and be counted as ODA, leading to inflated ODA figures and incentives for loan-based over grant-based aid.

Figure 2: Ownership and shareholding voting power by country income groups of selected institutions



Source: DFI website and WB country and lending groups database

How DFIs target different private sector beneficiaries

DFIs use different financing products to target private sector actors operating in developing countries. Usually, a distinction is made between loans and equity instruments, but other more complex financial instruments are also part of DFI financial products. Here we present the instruments most commonly used by DFIs.

Direct loans

The DFI lends to a company to undertake a specific project. The IFC, for example, generally lends up to 25% of the total cost of a project. A distinction is made between senior and junior loans. Senior loans are the first to be paid back in case of default, making them more secure for the lender. Junior loans are the last to be paid back, making them more risky.

Guarantees

A guarantee is defined as a legally binding agreement under which the guarantor agrees to pay the lender part or the entire amount due on a loan, equity or other instrument if the borrower defaults. Guarantees generally do not involve an actual transfer of funds, unless the borrower defaults. Guarantees mainly serve to reduce the risk of investments.
The IFC reports trade finance as guarantees, although it is normally regarded as a specific form of short-term finance.

Hybrid instruments
'quasi-equity' and mezzanine finance

Hybrid instruments combine the characteristics of loans and equity. These are usually subordinated or junior loans, which have fixed repayment conditions but are to be paid after all senior loans, or preferred equity, which require less rigid repayment conditions, but are to be paid before common equity holders. As they are riskier than senior loans these entail higher returns. In the case of convertible debt, they can be converted into equity stakes if there is a problem with loan repayments.

Direct equity investments

DFIs acquire equity stakes – stocks and shares – in private sector companies. These may be publicly listed in the stock market, or may be privately owned. This means the DFI owns a portion of the company, which may earn it dividends. In general these are non-voting shares, which restrict DFIs' management role in the company. They are mostly bought for a limited period of time and then sold, often through stock market flotation of the company if it was a private company. The IFC generally invests between 5% and 20% of a company's equity.

Private equity

Most DFIs invest in private equity funds, which borrow money to buy companies in developing countries. The fund aims to make money by selling on the company at a later date at a higher price, paying off the money borrowed to buy the company and also making a large profit. Private equity firms have been criticised when their strategy involves asset-stripping of the companies they buy, or ruthlessly driving down costs through, for example sacking workers. DFIs normally invest as a 'limited partner', which means that they contribute a limited stake but do not run the fund.

Loans to financial intermediaries

Most DFIs provide loans to financial intermediaries, which are loans to banks or other financial sector entities that then on-lend to their clients. Unlike direct loans, DFIs do not generally require the intermediary to contribute with additional capital.

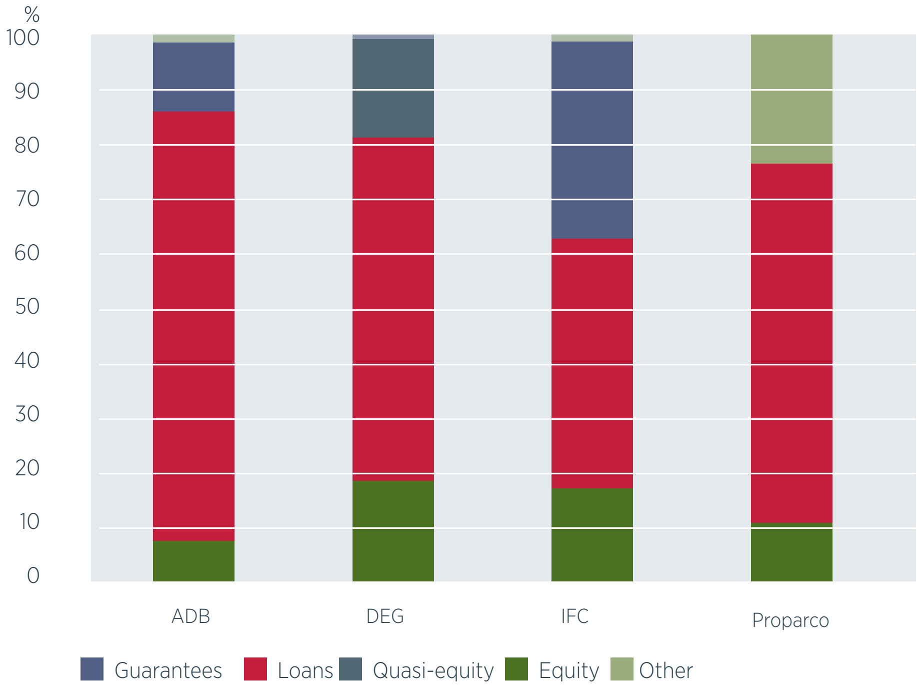
Syndicated loans

Most DFIs issue loans in which they act as a broker between borrowers and commercial lenders. Generally, the DFI acts as the sole 'lender of record'. This decreases the risk for commercial lenders who benefit from the preferred creditor status of the DFI, meaning that they are more likely to be repaid, even in the event of a foreign exchange crisis. The borrower signs a single loan agreement with the DFI and the DFI signs a participation agreement with the other lenders. The DFI portion of the loan is known as the 'A loan', and the other participants' syndicated loans are known as 'B loans'.

Grants

Transfers made in cash, goods or services for which no repayment is required. The most common type used by DFIs and reported as ODA are not really 'grants' in the normal sense of the word (which implies a cash donation), but advisory services and technical assistance. Some DFIs also use grants to soften the conditions of the loans (concessional loans, i.e. loans under market conditions). For example the concept of 'blended finance' involves a grant combined with a loan or equity.

Figure 3: Selected DFIs' usage of financial instruments, 2008-2012 (% of total new commitments)



> On average over 50% of public finance flowing from DFIs to the private sector goes to the financial sector.

Eurodad research report *Private finance for development unravelled* shows that between 2008 and 2012, four institutions alone – ADB, DEG, the IFC and Proparco – committed an estimated €67 billion to the private sector. Of these resources:

- more than half (€34 billion) were loans;
- 16% were equity;
- 29% were guarantees, mainly from the IFC and ADB (see Figure 3);
- very small amounts were quasi-equity instruments, but the real figures may be much higher as quasi-equity is often reported as either debt or equity instruments and more detailed data is often unavailable.

However, aggregated figures on the use of financial products mask a diversity among various institutions, mainly at multilateral level, as Figure 3 shows.

Development implications of financial instruments

There is little theoretical or empirical evidence available to support any particular instrument, from a development perspective. Each instrument entails possible benefits for the DFI client – private sector companies – and potential problems for the receiving country, particularly in terms of assessing financial leverage, transparency, accountability and macroeconomic impacts (see Table 2).[10]

It is often more important to focus on the overall impacts of DFI operations, as they contribute to the promotion of foreign direct (private) investment (FDI) flowing to developing countries. FDI can have an impact on the macroeconomic situation and the size and structure of the financial system in receiving countries, and the implicit and explicit subsidies and support DFIs provide inevitably can favour foreign over national investors.

Private capital flows can significantly increase receiving countries' exposure to macroeconomic risk, financial instability and volatility. For example, the devastating Asian financial crisis at the end of the last century was precipitated by huge reversals of capital – mostly equity investments – as foreign investors panicked and withdrew their money rapidly.

Who gets investment from DFIs?

DFIs favour middle-income countries and companies in OECD countries – some in tax havens

DFIs cover all regions with their operations, but middle-income countries receive the vast majority of DFI loans and investments. Although some DFIs have strategic priorities in terms of regional targets and even specific targets relating to low-income countries (LICs) and lower middle-income countries (LMICs),[11] in practice DFIs show minimum support for companies in LICs and the majority of DFI investment goes to middle-income countries (MICs). The case for DFI investment in MICs is much harder to justify as they have much better developed financial sectors, and attract significant foreign capital already.

Moreover, DFIs invest mostly in companies based in rich countries and some in tax havens, which casts doubt on the development impact of these investments.

Research by the Bretton Woods Project on IFC investments in the financial sector during the period FY2010-FY2013[12] revealed that:

- 35% of financial intermediary projects went to upper middle-income countries, specifically to countries such as Russia, Brazil, China and Turkey.
- Global scale clients represented over 17% of the total.
- Low-income countries received only 5.5% of IFC financial intermediary financing.

Eurodad research for our *Private profit for public good?*[13] report showed that only 25% of all companies supported by the EIB and IFC during the period 2006-2010 were domiciled in low-income countries. Almost half of the funds distributed by DFIs during the same period supported companies based in Organisation for Economic Co-operation and Development (OECD) countries and some in tax havens. Also, close to 40% of the companies are big companies listed in some of the world's largest stock exchanges.

This investment pattern focuses on 'low hanging fruit' and casts doubt on whether

Table 2: Benefits and problems with main instruments

Financial product	Possible private company benefits	Potential problems for developing country
Loans	• Clear cost of finance. • More stable than equity in relation to changes in ownership. • Company and other investors benefit from DFI 'stamp of approval'. • If blended loan, cheaper financing/ additional technical assistance.	• Potential debt impacts (private and/or public) – if the loan goes sour, the state often has to step in and take on the liability for the loan. Lack of transparency, particularly of financial intermediary loans, increases uncertainty. • If the loans are large and made in foreign currency, this may affect the exchange rate of the country, damaging the economy through making exports more expensive (known as a 'Dutch disease'). • Cheaper loans and guarantees may offer foreign companies an advantage over domestic companies. • Unclear alignment with partner country development objectives, and little input into strategic decisions on where directed. • If blended loan, opportunity costs as it diverts ODA from grants. • Little influence over monitoring and evaluation. • Challenging to reach small and medium-sized enterprises (SMEs) or informal companies.
Hybrid instruments	• Combine pros and cons of debt and equity.	• Combine pros and cons of debt and equity.
Equity	• Increased debt-free financing. • Increased creditworthiness. • May bring technical expertise or advice (though DFIs tend to take a back seat role).	• Foreign equity investments are the most volatile and pro-cyclical financing source for developing countries – with significant potential to trigger crises. • Unclear effect on actual company in terms of improving practices and impacts, as DFI ownership stake does not usually mean strong influence over company. • Challenging to reach SMEs or informal companies.
Private equity	• Easy for accessing various investors. • Increased creditworthiness and access to risk capital (DFI 'stamp of approval').	• Additionality very difficult to assess. • Confidentiality constraints hamper transparency and accountability. • Risk of negative impacts.

> “ DFIs are giving the green light to (the use of tax havens), and are therefore helping to legitimise the potentially harmful use of such jurisdictions.

DFIs are succeeding in supporting the most credit-constrained companies in the world's poorest countries. This market-driven pattern questions DFIs' added value as development institutions, as companies operating on a global scale and from high-income countries should be able to access credit or capital markets on commercial terms. Even more worryingly, this approach challenges the poverty and development focus of DFIs, with concerns also raised by the World Bank's own Independent Evaluation Group (IEG).[14]

The issue of routing DFI investments through offshore financial centres or 'tax havens' is itself extremely worrying. Currently, there is an overwhelming recognition that tax havens play a key role in international tax dodging by both companies and individuals and are costing the developing world billions of dollars every year. At the global level, trillions of dollars have been channelled through tax havens to avoid and evade taxes. A conservative estimate by the Tax Justice Network shows that between $21 and $32 trillion at least had been invested through 'offshore' secrecy jurisdictions as of 2010.[15] By channelling investments through offshore financial centres, DFIs are giving the green light to their use, and are therefore helping to legitimise the potentially harmful use of such jurisdictions. Although reliable figures on the amount of money routed through tax havens for tax avoiding purposes are not easily available, due to lack of consistent reporting and inadequate information about the real owners of companies, previous research by CSOs and academics[16] has exposed DFI practices extensively. Not addressing illicit finance in an effective way could undermine and counter the development results that DFIs set out to achieve.

What sectors? A focus on the financial sector

On average over 50% of public finance flowing from DFIs to the private sector goes to the financial sector, both in the form of loans and equity. Though multilateral and bilateral DFIs invest in a wide variety of sectors, including infrastructure and agribusiness, they are increasingly focusing on the financial sector and concentrating on commercial banking. This is either to support financial institutions directly or to use them as an intermediary that is set to lend to other companies. Serious questions have been raised in relation to what kind of development impact investments in the financial sector have, particularly after the recent financial crisis (which was driven by irresponsible investment decisions and financial deregulation), and what the real impact of these investments on the ground are. There is also a high opportunity cost associated with these investments, as the money invested in the financial sector is not available to invest in other kinds of projects.

A recent evaluation by the World Bank's IEG[17] reviewed 166 IFC investment projects that target SMEs through financial intermediaries, finding that only 20% of the projects define SMEs and have provisions mentioning SMEs as beneficiaries. DFIs claim the rationale for favouring the financial sector is rooted in the need to address access to finance problems of micro, small and medium-sized enterprises (MSMEs). As DFIs have no public banking facilities, they engage with MSMEs through intermediaries, which also implies lower transaction costs for them. However, lack of transparency in the reporting of this sector and of adequate monitoring and evaluation mechanisms mean it is unclear whether DFIs have been successful in achieving their intended targets, as the IEG report shows. In addition, DFIs' definition of MSMEs is highly controversial, as a loan of up to $2 million to its client still counts as an MSME loan.[18]

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

Investments in five-star hotels owned by multinational chains

In Ghana and Jamaica, for example, the IFC invested in Mövenpick ($26 million)[19] and Marriot ($53 million) respectively,[20] two multinational hotel corporations. These investments were justified by their potential to create jobs, but several actors have raised concerns in relation to their questionable development impact or need for public subsidy. These include impacts in crowding out other sources of funds and even "entering into direct competition with the people [the IFC] claims it wants to lift out of poverty" (see endnote 19). Bilateral DFIs also show the same type of investment pattern. The UK's CDC, formerly the Commonwealth Development Corporation, has been financing builders of gated communities, shopping centres and luxury property in poor countries such as Kenya, El Salvador and Mauritius, among others.[21] Belgium's BIO has invested in fitness centres in Colombia[22] and Sweden's Swedfund in Radisson Blu Hotel in Addis Ababa, Ethiopia.[23]

Investments through financial intermediaries harmful to local communities

The IFC's investment model through financial intermediaries has a serious basic flaw: if the financial intermediaries harm local communities' human rights, social development or environmental sustainability, there is little that can be done, and often little information available due to the inherent lack of transparency of the IFC's model. The World Bank's Compliance Advisor/ Ombudsman (CAO) argued in an audit report that the IFC "*knows very little about potential environmental or social impacts of its financial markets lending*" and cannot even claim that it meets a 'do no harm' requirement.[24]

In **Honduras**, IFC's direct investment in Dinant Corporation, a palm oil and food company, triggered a formal complaint from local communities about human rights abuses. As a result of a CAO investigation of this direct investment, it came to light that the IFC also has a relationship with Dinant through a 2011 investment in the country's third largest bank, FICOHSA. A January 2014 CAO audit report[25] found that the IFC violated nearly all its performance standards by investing in Dinant, which has repeatedly been accused of involvement in the killing, kidnapping and forcible eviction of peasant farmers who lay claim to their land. At the same time, IFC's investment in FICOHSA is currently subject to an investigation by the CAO and the audit report is due to be published in (boreal) summer 2014.[26]

In **Cambodia**, the IFC has been instrumental in alleged 'land grabbing' following the acquisition of vast amounts of land by IFC-backed Vietnamese companies for producing rubber. In 2002, the IFC invested in the private equity fund Dragon Capital Group, which subsequently lent money to two of Vietnam's largest companies, Hoang Anh Gia Lai (HAGL) and the Vietnam Rubber Group. These companies acquired more than 200,000 hectares of land through a series of obscure deals with the Laos and Cambodian governments.[27] In February 2014, local members of 17 villages and five Cambodian non-governmental organisations (NGOs) filed a complaint to the CAO, raising environmental and social concerns and claiming that these acquisitions have been harmful to their standard of living and the environment. The CAO is currently facilitating a voluntary dispute resolution process between both parties.[28]

Lessons learned?

Following pressure from civil society groups, the IFC recently presented its *Lessons learned* document[29] in April 2014. The document, which could be seen as a mea culpa following recent failures, including Dinant Corporation in Honduras. It claims that there is a "*concerted effort to improve procedures, guidance for staff, clients and training*", which is a positive starting point. Other positive elements included are the acknowledgment of the need to improve in several areas including spotting and managing risk; improved consultation with communities as a way to avoid conflict; increased attention to legacy issues, country context and security/ conflict context, and the intention to introduce a number of new tools and mechanisms, including the Guidance Note on Land, risk screening of agribusiness and forestry investments and the creation of a 'High Risk' list.

However, civil society groups remain concerned about the number of fundamental omissions, such as institutional culture and incentives to elevate the emphasis on environmental and social due diligence, mis-categorisation of risk, which has implications for due diligence and supervision, and the need to prioritise human rights, among other issues. In June 2014, civil society groups sent a letter to the IFC and the Bank's board, calling for a *"a public commitment to a time bound plan for the lessons learned exercise"*, in order to produce the necessary changes to avoid future harm to communities and the environment. Groups also urged the IFC to demonstrate real commitments to ensure that these lessons are not only learned, but also influence future decision-making processes.[30]

2 Challenges for DFI operations

> Ownership by developing countries is a key principle for development effectiveness and it often determines the success of any development intervention.

No clear development outcomes

DFIs face important challenges demonstrating causal effects on poverty reduction in developing countries, including impacts on reducing inequality, on women's right and on marginalised groups. This is partially due to the nature of investing in the private sector, where social outputs are not normally the objective of the private sector partner, and are difficult to measure. DFIs have developed different systems for assessing the impact of their operations, among them the IFC's Development Outcome Tracking System (DOTS), the DEG's Corporate Policy Project Rating (GPR) and the EIB's Results Measurement framework (ReM). However, despite recent efforts to try and harmonise practices and systems, it is still very difficult to compare 'development impact' on the basis of the available data.

Some evaluation reports have cast doubt on the real impacts of DFI operations and challenged the way DFIs decide their investment strategies. In the case of the IFC, an IEG evaluation report from 2011[31] on the IFC's poverty focus and its effectiveness for greater poverty impact, states that "*IFC's interventions are designed to contribute to growth, although it has been challenging for the Corporation to integrate distributional aspects in projects*". Worryingly, "*fewer than half the projects reviewed for this evaluation included evidence of poverty and distributional aspects in project design*". In addition, a recent evaluation of FMO is not conclusive about whether development outcomes are actually driving investment decisions. It found that, in 50% of the sample, the expected development impact was more positive than the actual results. It also mentions that "*there is very little information or analysis available (...) to demonstrate development impact or additionality comprehensively*".[32]

Existing responsible finance standards are insufficient. Most DFI are signatories to international investment agreements such as the equator principles or other responsible financing frameworks. The IFC Performance Standards have become globally recognised as a benchmark for environmental and social risk management. They were revised in 2012 following a multi-year consultation process. Although these revised standards included key changes, such as the categorisation of financial intermediaries' projects according to risk, a requirement for free prior and informed consent from indigenous peoples in certain situations and protection for migrant workers, among others, they have been criticised for being too weak on human rights due diligence to ensure that communities affected by the IFC's activities are protected. There has also been criticism of its lack of independent verification or adequate disclosure of its monitoring and supervision reports.

The implementation of safeguards and standards has often been developed with direct operations in mind, while recent increases in intermediary investment pose specific challenges to standards, monitoring and evaluation. Intermediary lending, as well as dealing with suppliers and subcontractors within global value chains, present particular challenges to due diligence procedures.

Moreover, important challenges remain with the implementation of the standards that are in place.

Little developing country ownership over DFIs and their strategies

Ownership by developing countries is a key principle for development effectiveness, recognised by various international commitments made by the donor community, and it often determines the success of any development intervention. However, due to the nature of DFIs' shareholding and/or their voting power structures, DFIs are driven by developed countries. Recipient countries are either not represented, or are only very weakly represented in DFIs' governance structures. In addition, DFIs are not conducive to the meaningful participation of governments and citizens from developing countries, to whom they ought to be accountable. Although some European bilateral DFIs have regional representatives in the field, these offices have very limited resources, cover a group of countries and/or regions and are mainly focused on managing the first phase of the project pipeline.

DFIs' governance structures and practices mean that their operations are unlikely to be aligned with national development strategies and priorities. Development plans, defined at national level through a democratic and inclusive process, have the potential to direct and influence foreign private investments in a way that ensures sufficient investment in key areas with a particular focus on increasing productivity, employment and sustainable poverty-reducing growth. Given the high risks of external capital and the overarching need for stability in the financial sector, failures in driving investment strategies by local needs and priorities run the risk of doing more harm than good.

In practice, a more effective way for DFIs to operate could be to channel their resources to national or regional publicly-owned institutions for them to support private sector actors at the national and regional level, in line with development strategies. This could also increase corporate, environmental, social and governance standards, as well as the risk management and supervision capabilities of these institutions. As national development banks have a proven track record as countercyclical investors and huge potential to mobilise domestic savings,[33] they should be considered as the natural partner for (northern) DFIs.

Therefore, there is a need for a strategic reflection coming from developing country stakeholders on the role and structure of a financial sector that is conducive for sustainable development, and what the role of DFIs could be to support this. This reflection might find that low-income countries, for instance, are better served by a large number of small banks working in local areas and sectors they understand well. It could also look at which financial services are actually most important for poor people and how to deliver these.[34]

Seriously inadequate transparency and poor accountability

Based on a narrow understanding of DFI mandates, DFI staff often regard their fund managers and private sector clients as their main stakeholders, since they are mainly accountable to them in practice - without clients there is no 'business'. As development actors, however, DFIs should be accountable to a variety of actors and provide meaningful information that enables public scrutiny and mechanisms for the participation of affected communities. As most DFIs are at least partly owned by donor governments, consultations with donor governments are formally expected, while parliamentary scrutiny is rarer. Dialogues with CSOs, both in donor and beneficiary countries, and governments and parliaments of beneficiary countries, are also unusual. As DFIs often claim, at the project level, stakeholder consultations are required by the IFC Performance Standards, including the establishment of grievance mechanisms both at the level of project-affected stakeholders, as well as the personnel of the investee companies. However, questions often arise in terms of proper implementation of what is written on paper.

While the IFC and other multilateral DFIs have already put in place independent redress mechanisms, European bilateral DFIs rarely have such mechanisms, or are in the process of developing them. In January 2014, the Dutch FMO and German DEG established an independent complaints mechanism, which in the case of the former involved consultation with CSOs. It remains to be seen how these mechanisms will impact on the investments of these institutions.[35]

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

In general, multilateral DFIs seem to do a better job of disclosing information, but they still remain unacceptably opaque. The IFC discloses all commercially non-sensitive information, which means financial information on the project level and non-financial information regarding contractual relationships are not disclosed, but periodic updates that include development and risk ratings of projects are available. At the European bilateral level, the Dutch FMO recently adopted a disclosure policy that could be seen as the most advanced for bilateral DFIs. However, it is still below IFC practices in this regard. Although the German DEG has signed the Extractive Industries Transparency Initiative (EITI) and the Corporate Governance Development Framework, it is the institution with by far the least formalised and least comprehensive policy in terms of transparency and disclosure of information, which is justified by legal adherence to the German Banking Secrecy Law.

Providing additional finance or crowding out others?

Since DFIs focus so heavily on countries and sectors where private capital is relatively abundant, and focus so little on the poorest countries or under-served areas and sectors, this suggests that there is a serious risk that they are not providing new finance for the private sector, but are simply crowding out other possible financiers. In other words, by providing more favourable loans and investments than domestic banks or financial institutions, they may be damaging the domestic financial sector. In addition, it is not clear whether the private finance that DFIs co-invest with was brought in by the DFIs' involvement, or whether it would have happened anyway.

Assessing financial 'additionality' – whether DFIs finance projects that would not get financing from other sources – is difficult, but unfortunately DFIs simply do not take this issue seriously enough. Instead they frequently quote 'leverage ratios' that assume that all of their financing is new and additional, and that all co-financiers would not have made any investments without the DFI's involvement. In fact, higher leverage ratios might also imply that the project is more likely to have been funded without any public sector involvement. This position is clearly completely inadequate: DFIs should make a serious effort, involving independent experts, to produce reliable and robust assessments of these issues.

Macroeconomic risks

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

In addition there is a risk associated with external, private borrowing potentially leading to unsustainable and damaging debt situations. Recent experience of the financial crisis in many countries shows how private debt may end up as public debt through explicit or implicit government guarantees, which are known as contingent liabilities. In many developing countries, this institutional framework is weak so that actual magnitudes of private debt and related risks are not known to regulators and policy-makers.

There are also a number of additional reasons why a more cautious approach to foreign investment is needed in international discussions about financing for development:

- A focus on natural resources – foreign investment often goes to specific countries, particularly major exporters

> “ Currently, transparency standards are not consistent with development effectiveness principles...

of natural resources. This is highly problematic, as the resource extraction sector has a low decent job creation potential, can have huge social, environmental and human rights impacts, and increases problems of macroeconomic management.

- Resources flowing out: profit repatriation and tax evasion – foreign investment is often associated with profit repatriation and outward withdrawal of equity capital. Illicit financial flows due to trade mispricing and other tax minimisation tactics contribute to a draining of domestic resources mobilisation in receiving countries. For instance, repatriated profits on foreign direct investment accounted for $420 billion in 2011,[36] while illicit financial flows accounted for $946.7 billion in the same year.[37] In addition, figures greatly overstate the real net financial private flows to developing countries. Outflows of profits made on FDI were equivalent to almost 90% of new FDI in 2011.

- Preferential conditions for foreign investors – foreign companies often put pressure on national governments to introduce favourable conditions – tax exemptions, tax stability agreements and lighter regulations. In some cases, threats of leaving the country are also used in order to get secure profits. This can have a negative impact in terms of competition with national private sector actors.

> “Foreign investment should not be seen as an end in itself, as positive impacts are often accompanied by many risks and problems, including macroeconomic problems.

Conclusion and recommendations

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

Instead democratic ownership of any development intervention should be seen as the starting point, on the basis of national strategies and institutions of the recipient country. It will be more sustainable in the long run to help build national or regionally owned institutions than to expect donor-owned institutions headquartered hundreds or thousands of miles away to do the job. This also gets past the very real problem of DFIs having a tension between their development objectives and their desire to support firms from their home countries.

However, there is very little information about what developing country governments and stakeholders at the national level think of DFIs or what they expect from them. Before increasing and deepening DFI operations further, a full review from a developing country perspective should be conducted, for example by a committee of independent experts from government, CSOs and the private sector in developing countries. Issues that this review should consider include:

Making development outcomes the overriding criteria for DFI project selection and evaluation

To ensure this, DFIs should:

- Mainstream development objectives into all investments, with clear outcome indicators and effective monitoring of projects from the project selection phase to its completion.
- Require that the development outcome of all projects should be disclosed at project – not aggregated – level. This is crucial to improving accountability to external stakeholders and affected communities.
- Establish policies that ensure all contracts comply with high responsible investment standards, such as those outlined in Eurodad’s Reponsible Finance Charter.[38]

Aligning to developing countries’ investment priorities to respect country ownership

To ensure this, DFIs should:

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

Targeting the neediest populations, and the poorest developing countries using appropriate instruments

To ensure this, they could:

- Support ‘frontier’ sectors, such as climate change and agricultural systems designed to support food sovereignty. Priorities should be country-specific and country-driven and the focus should be on supporting sectors that are underdeveloped and underserved, as they are considered too high risk for most investors.
- Research efforts should be directed at identifying best practices in relation to financial products/instruments with a focus on development impact and not crowding out other sources of private finance. In the case of guarantees, development

additionality and moral hazard issues should be carefully considered.

- Target domestic enterprises owned and domiciled within developing countries. This will support the development of competitive and locally owned industry, and stimulate domestic resource mobilisation. To this effect, DFIs could ensure that at least 50% of companies receiving financing are domiciled within the developing country where they are active; set targets, for all investments, for local content requirements, and knowledge and technology transfer; provide obligatory explanations when they invest in companies not based in partner countries.

Setting high standards for transparency and accountability

- DFIs should make special efforts to ensure affected people can actually access information about projects that affect their lives, which includes, for example, translating key documents into local languages, and ensuring effective consultation processes, respecting the internationally agreed principle of free prior and informed consent. Access to information is a right, and withholding information must be carefully justified. All information, including social, environmental and governance standards, contracts, subcontracts, investment and partnership agreements, should be available to the public and, in particular, affected communities, with a limited regime of exceptions.

- All DFIs should set up independent complaints mechanisms with a mandate to carry out independent investigations of financed projects. These should be available at the onset of a project to allow affected communities and other stakeholders to raise legitimate complaints and to force the implementing DFI to follow up and make changes based on findings.

Improving transparency of financial intermediary investments and reviewing their use

- Understand the limitations of financial intermediaries and investment instruments by undertaking further research on their leverage potential and impact in developing countries. The use of financial intermediaries should be looked at as just one of the many potential options. Research efforts should be directed at identifying best practices and assessing the strengths and weaknesses of different kinds of financial intermediaries.

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

- Ensure that the investing company is domiciled in the country of investment, or in cases where the company is not domiciled in the country of investment, the reason should be clearly stated, including details of how all other possible options were ruled out. In instances where there is suspicion of tax dodging, the burden of proof must lie with the company.

- Require all companies and financial institutions involved in the transaction to disclose reliable annual information related to sales, employees, profits made and taxes paid in the country.

- Require all companies and financial institutions involved in the transaction to disclose information regarding beneficial ownership of any legal structure directly or indirectly related to the company, including trusts, foundations and bank accounts.

- Implement effective systems to ensure adherence to international social, environmental and human rights standards. These systems must ensure that sub-projects are also covered and effective monitoring takes place, instead of relying on self-reporting.

- Scale up investments in renewable energy, especially community-based renewable energy projects, and phase out funding of fossil fuel projects as quickly as possible. Donor governments should adopt policies to prohibit the use of their contributions to finance fossil fuel projects.

- Declare a moratorium on supporting carbon market projects and undertake a thorough and independent review of carbon market impacts.

Endnotes

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

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