

# Development Finance in the BRICS Countries

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# **Development Finance in BRICS Countries**

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# Preface: Development Banking in the BRICS Countries

The world of development banking is undergoing rapid change. For decades, it was dominated by a few multilateral actors, foremost the World Bank Group as well as regional development banks. In recent years, some established banks have much expanded their scope of operation, while new actors and interests are moving in. A number of national development banks, for example from China and Brazil, have entered the international arena in a big way, often operating far outside of their respective home countries and becoming truly global actors. The BRICS group of five major emerging economies (Brazil, Russia, India, China and South Africa), during the BRICS Summit in Fortaleza, Brazil, in July 2014, formally announced the creation of the group's own New Development Bank (NDB). China, in October 2014, launched the Asian Infrastructure Investment Bank (AIIB), and in May 2015, Japan announced a massive 100 billion USD financial package for an Asia infrastructure programme within the framework of the Asian Development Bank.

The new rush into development banking is going to have substantial large-scale political, socio-economic and environmental implications. At the same time, development banking, it appears, is becoming more diverse and competitive than ever. Or is it?

The very concept of “development” means different things to different people. In fact, there have been branches of development banking directed, for example, at the support of small-scale farming or medium-scale businesses. But overall, it is the creation of infrastructure – and of large-scale infrastructure – which has been at the heart of development banking in the post-World War II era. The very rationale of development banking is to mobilise long-term, large-scale financing for projects where other – usually private – sources of finance either do not exist or are unable or unwilling to participate due to the risks of long-term engagement. In the 1980s-90s, the development debate, especially around the World Bank and its critics, had a stronger focus on (or at least, rhetoric about) issues other than growth, be it “structural adjustment” at first, or “social development” and “poverty alleviation” later on. But at least since the turn of the millennium, as the liberalised world economy rapidly expanded, with a raw material price boom on a level unknown for some decades and the arrival of China as a major actor in the global arena, the focus has turned again towards infrastructure development. In many ways, the approach to development financing has returned to its starting point.

The new focus on development finance for infrastructure development also has profound political dimensions. National development banks have begun to act internationally, projecting the influence and concepts of development of their countries of origin onto other parts of the world. Even more important, the establishment of new multilateral institutions explicitly challenges the primacy (or hegemony, as some see it) of the developed countries, especially the U.S., in the Washington-based global financial institutions. The BRICS countries' governments

designed the NDB and the currency stabilisation facility Contingent Reserve Arrangement (CRA) as a “South-South counterweight to the World Bank and International Monetary Fund (IMF), respectively. In addition, the two new infrastructure development finance facilities announced by China and Japan also serve to project the national influence and reputation of the founder states, even though in both cases, strong elements of multilateralism continue to play a role in the equation.

The new and expanding institutions of development finance reflect the considerable growth of political and economic self-confidence in these emerging economies. It remains to be seen how far they will really challenge established patterns of global development banking. The political interest to do so is clearly there; but there are obvious difficulties as well. After all, designed on whatever large scale, even the new institutions will have to mobilise finance from the global financial markets. In order to do so in a sustainable and competitive manner, they will largely have to play by the rules of these markets; otherwise, the banks would risk becoming mere sources of one-time political and financial giveaways. Furthermore, even with the increased diversity of actors, the replacement of the dollar as world reserve currency (or at least its supplementation by other currencies) continues to remain a very long haul undertaking (Chossudovsky 2015).

In the midst of major expectations of the positive political impact of the new development finance institutions for the developing world, considerations of the kind and quality of the very “development” that these banks may contribute to have largely taken a back seat.

Investment in large-scale infrastructure is necessary for economic growth; but at the same time it typically entails considerable social and ecological costs. Frequently there are manifest and severe implications, especially the displacement of local populations and the destruction of natural habitats and biodiversity. For decades, protests and social movements in affected regions and countries have pointed to these issues, and some of them have managed to stop or modify projects. For example, since the 1990s, the number of big dam projects commissioned declined in many parts of the world (Ansar 2014: figures 1, 4), at least outside China. Local resistance and international criticism appear to have made it more difficult to construct big dams in the same manner as in decades past.

Reeling from disastrous experiences in the 1980s, such as the Narmada dam projects in India and the Polonoroeste projects in Brazil, the World Bank came under pressure from its shareholders to pioneer the development of information disclosure policies as well as social and environmental safeguards and procedures that included community consultation and external monitoring of compliance. Since 1994, aggrieved parties can bring complaints to the World Bank Inspection Panel which represents an historic achievement in the creation of accountability mechanisms, despite encountering difficulties in its operations and independence. Hence, with regard to safeguards and accountability, the World Bank, as the world’s “lead” development finance institution, has provided a “gold standard” for other multilateral and bilateral institutions.<sup>1</sup> Despite criticism (especially from civil society actors) about their implementation, the World Bank standards and procedures create the reference

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<sup>1</sup> I wish to thank Nancy Alexander for providing the background information here.



baseline against which to evaluate and debate infrastructure projects; they constitute the precondition for a degree of transparency which allows public scrutiny of the work of the world's major development finance institutions.

With growing competition within the world of development financing, existing standards and safeguards could be at risk. Competition between financing institutions could contribute to weakening them; various national development banks are far less susceptible to international pressure than the World Bank. In this regard, critics view the ongoing revision of the World Bank safeguards with scepticism. From the perspective of social and ecological protection, it would be a tragedy if an increased diversity of actors and the stronger role of the Global South in the field of development finance, as desirable as it appears from the political perspective, resulted in a weakening and crowding out of safeguards and standards applied in decisions about infrastructure financing.

Here, the long-standing debate about “conditionality” reappears in modified form. “Conditionality” in the provision of World Bank loans to recipients (mostly in the form of pressure to implement certain policies, usually towards liberalisation and privatisation) has been a major bone of contention for many developing countries. Consequently, they look towards alternative sources of finance that provide them with a greater degree of independence from the pressure exerted by funders. But there is more to “conditionality” than mere blackmailing potential with regard to certain public policies; it may include protective standards as well. Talking about the removal of “conditionality” should not be allowed to result in the sidelining of social and environmental concerns, especially in countries whose national governments display only a limited degree of public accountability.

Many champions of social and environmental protection for vulnerable groups and endangered habitats feel ambivalent about the recent expansion of development banking, particularly for large-scale infrastructure development. Some question the entire development model behind large-scale infrastructure directed towards economic growth. Others focus on engagement with governments and especially the existing and newly emerging development finance institutions in order to achieve better outcomes. Non-specialist actors in the development field may wish to improve their understanding of new trends and challenges in the field of development finance and expand their engagement on this issue. As the NDB is being created by the BRICS countries, it is worthwhile to take a closer look at the practice of and experiences with development banking in each of these countries in order to understand where they are coming from and what perspective they are taking in its creation.

This volume aims to provide background information for an informed debate about development financing from the perspective of emerging economies, especially the BRICS countries. It includes five essays that address the experiences with (mostly national) development banks, showing a high degree of diversity in national policies.

In the first essay, C.P. Chandrasekhar provides an overview of the rationale and major trends in global development banking, comparing experiences and trends from emerging economies within BRICS and beyond them. The four contributions that follow look at the national national experiences in each of these countries. For Brazil, Carlos Tautz, João Roberto Lopes Pinto and

Fabricia de Andrade Ramos study the rise of the Brazilian Economic and Social Development Bank (BNDES) from a national to a global player, whose structures and policies many observers believe will influence the NDB created by the BRICS countries. Mark Grimsditch and Yu Yin look at the large “policy banks” created by China’s government

In order to promote national infrastructure expansion and China’s international engagement; in terms of sheer scale, these banks have changed the world of development finance over the last two decades. C.P. Chandrasekhar looks at the decidedly different experience of India, where large-scale development banking has lost relevance; instead, public-private partnerships have been used on a large scale for infrastructure financing, with quite mixed results. Finally, Mzukisi Qobo studies the two main development banks of South Africa, with a particular focus on identifying ways to increase civil society engagement with these banks and their policies.<sup>2</sup>

This volume emerged from a joint engagement of the Heinrich Böll Foundation (HBF) and some of its partners in the BRICS countries with a view to building civil society expertise on the emerging NDB. The idea originated from the HBF Brazil office and its partners at the Instituto Mais Democracia in Rio de Janeiro; the group met first at the Durban BRICS summit in March 2013. Draft papers were presented and discussed at the Fortaleza summit in July 2014, when the BRICS’ New Development Bank was about to take off. Our thanks go to the authors of the essays included in this volume, but also to all those who were involved in preparing and implementing the process, especially Nancy Alexander, Layla al-Zubaidi, Dawid Bartelt, Heike Löschmann, Jochen Luckscheiter, Marilene de Paula, Christina Sadeler, Shalini Yog Shah and Wang Xiaojuan from six different offices of HBF all over the world.

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<sup>2</sup> We have not been able to commission a similarly-designed study on development banking in Russia; however, C.P. Chandrasekhar’s overview essay provides some information on this issue.

# Introduction: Development Banking in Comparative Perspective

Two developments in 2014 focused attention on development banking in the global South. The first was the decision of the BRICS group of countries (Brazil, Russia, India, China and South Africa) at their Fortaleza Summit in July to establish the New Development Bank (NDB). With authorised capital of \$100 billion, and initial subscribed capital of \$50 billion, the bank's founding partners are the countries in the BRICS grouping (Brazil, Russia, India, China and South Africa). These five countries, which share the paid-up capital equally in the form of actual equity (\$10 billion) and guarantees (\$40 billion), will remain dominant in perpetuity with their aggregate shareholding never falling below 55 per cent.

The second development was the October 2014 decision of 21 Asian nations to establish an Asian Infrastructure Investment Bank (AIIB) headquartered in Beijing. With an authorised capital base of \$100 billion (of which \$50 billion will be contributed by China), the AIIB as a start-up compares well with the Asian Development Bank, with around \$160 billion of capital, and the World Bank, with around \$220 billion. This is especially significant for an institution that is expected to focus on infrastructure. Not surprisingly, many other developed and developing countries and multilateral institutions have endorsed the bank and agreed to work with it.

While expressly aimed at addressing the shortage of long-term capital for investment in crucial infrastructural areas and capital intensive industries essential for development, the decisions to create these institutions are also motivated by the disillusionment of developing countries with the governance structures, patterns of lending and the conditionalities associated with lending by the Bretton Woods institutions and the leading regional development banks.

## The Background

The confidence to create these institutions partly derives from the long experience developing countries have had with development banking at the national level. A 2009 study from the Association of Development Financing Institutions in Asia and the Pacific (Bruck 1998) estimated that there were over 550 development banks worldwide, of which 32 were in the nature of international, regional or sub-regional (as opposed to national) development banks. These were located in 185 countries, with developing countries in particular hosting an average of three or more development banks. Latin America and the Caribbean had the largest number of NDBs (152), followed by Africa (147), Asia and the Pacific (121), Europe (49) and West Asia (47).

As is to be expected, these banks varied significantly in terms of their size and scope of operations. A sample of 90 DFIs studied by Luna-Martinez and Vicente (2012) in 2009, which defined a DFI as an institution with “at least 30 per cent state-owned equity” and “an explicit

legal mandate to reach socioeconomic goals in a region, sector or particular market segment”, found that 74 per cent of these institutions were entirely government-owned and controlled and a further 21 per cent had less than 50 per cent of private equity ownership.

There were other similarities among these institutions. For example, most of them depended by and large on sources of finance other than the conventional demand and time deposits mobilised by commercial banks from their clients. Nearly 90 per cent of those surveyed borrowed resources from other financial institutions or issued debt instruments in domestic markets and 64 per cent had the benefit of government guarantees for debt issued by them. More importantly, 40 per cent of them received budgetary transfers from the government. This backing allowed around half of these development banks to offer credit at subsidised interest rates, and two-thirds of those institutions reported financing those subsidies with the transfers they received from government.<sup>1</sup> This helped more than half of them (53 per cent) to fulfil their specific policy mandates, which required them to “support the agriculture sector (13 per cent of all DBs), SMEs through their lending, guarantee or advisory services (12 per cent), export and import activities (9 per cent), housing (6 per cent), infrastructure projects (4 per cent), local governments (3 per cent), and other sectors (6 per cent).” (Luna-Martinez and Vicente 2012). Such requirements meant that they could not finance their activities only with finance from the market.

## Cross-Country Variations

Development banking in different countries evolved in response to similar needs. Principal among these was the need to mobilise the large volumes of long-term capital required to finance the effort at industrial take-off in late industrialising countries. However, the experience with development finance institutions (DFI) has varied considerably from country to country, and these differences are of many kinds.

First, while more than half of these DFIs are small, with assets less than \$10 billion, about 5 per cent are mega-banks with assets greater than \$100 billion, including institutions like China Development Bank and the BNDES of Brazil, both of which are bigger than the World Bank.

Second, there are differences in ownership structure, influenced in part by the relationship between the state and private capital. In most countries these banks are wholly or dominantly publicly owned. This is, for example, true of the Korea Development Bank in South Korea and the many development banks in Thailand (the Small Industrial Finance Corporation and its successor the Small and Medium Enterprise Development Bank, the Small Industry Credit Guarantee Corporation and the Bank for Agriculture and Agricultural Cooperatives). The norm seems to be that development finance institutions are publicly owned and serve as direct instruments of industrial policy. However, there are exceptions. In Turkey, for example, while the State Investment Bank focuses on lending to state enterprises, the Industrial Development Bank (IDB) established in 1950 (with support from the World Bank and the Central Bank of Turkey) and the Industrial Investment and Credit Bank founded in 1963, are private institutions, substantially owned by private commercial banks. However, even in these cases the government had an important role in influencing the functioning of the bank. The IDB

<sup>1</sup> Eighteen per cent of the institutions that received transfers declared that if transfers were withdrawn, they would not be able to operate.

relies on the government (besides the World Bank) for its funds and reportedly consults regularly with the State Planning organisation (Fry 1972).

Third, there were considerable differences in the way in which funds were mobilised. In many countries, the DFIs were provided resources either directly from the government's budget or the central bank, whereas in others the main sources of funding were bonds issued either to the banking system or in the "open market".

Fourth, the way in which resources were mobilised influenced the activities of the DFIs, both in terms of the kinds of projects they funded and the interest rates they charged on their loans. The greater the reliance on market sources of finance, the less the ability of these institutions to keep in mind larger social and developmental benefits, as opposed to pure commercial considerations, when funding projects. But there are interesting exceptions, where government guarantees played a role. Thus, an interesting feature of industrial finance in Korea was the guarantee system, created largely to privilege borrowing abroad over attracting foreign investment, to keep Japanese capital at bay. Firms wishing to borrow from abroad obtained approval from the Economic Planning Board, which was ratified by the National Assembly. Once that was done the central bank, Bank of Korea, (or later the Korea Exchange Bank) issued a guarantee to the foreign lender and the Korea Development Bank (KDB) issued one to the Bank of Korea. So, while the borrower was committed to repay the loan and carry the exchange risk, that commitment was underwritten by the KDB and BOK, which, by guaranteeing against default, were ensuring access to foreign borrowing.

Fifth, development banks can be broadly separated into two categories. One consists of institutions focused on long-term lending to large industry and infrastructure, and the other of institutions established to realise specific policy mandates, such as supporting the agricultural sector, promoting SMEs, financing local governments or driving export and import activities through their lending, guarantee or advisory services. While some countries promoted both kinds of institutions, others relied largely on developments of the latter kind. In Thailand, for example, most DFIs were specialised financial institutions (SFIs), owned by the government and geared largely to extending credit to sections excluded from access to commercial bank advances. While some of these institutions were deposit-taking institutions (Government Housing Bank, Bank for Agriculture and Agricultural Cooperatives and Government Savings Bank), the others relied on the issuance of debt.

Sixth, DFI behaviour has varied across nations in terms of the degree to which they have provided non-financial assistance to private corporations and to which they have involved themselves in decision-making and board functioning at the firm level.

Finally, there are major differences with regard to how the reliance on DFIs has shifted with changes in the policy regime. In India, specialised development banking has been almost given up after liberalisation. In Indonesia, the Indonesian Development Bank, created through the transformation of the State Industrial Bank originally established in 1951, was merged with three other banks in 1999. But in Brazil, China and elsewhere the importance of development banks has increased since the 1990s.

This book is an attempt to examine the national development banking experience in the BRICS countries in particular, in order to assess the role they play in promoting sustainable and equitable development, since that may in turn influence the functioning of regional institutions in which these countries play an important role. This could provide a frame for civil society interventions that help improve the functioning of cooperatively established alternatives to traditional multilateral development banking institutions dominated by the developed countries, and align such functioning with development objectives that are in keeping with the needs of poorer developing countries and their most deprived sections.

## The Entry of the BRICS

The establishment of the development banking infrastructure in the BRICS countries began in the 1940s. The Industrial Development Corporation (IDC) was established in South Africa in 1940, the Industrial Finance Corporation of India (IFCI) in 1948 and the BNDES in Brazil in 1952. It was in China and Russia that the creation of development banks occurred slightly later. In China, the China Development Bank and two other “policy banks” (the China Eximbank and the Agricultural Development Bank of China) were established starting in 1994. In the years prior to 1993, it was difficult to separate development banking from “normal” or commercial banking in China. Long-term investments were financed either directly from the state budget or through directing credit to the enterprise sector. In fact, till the 1980s, the only bank of relevance was the People’s Bank of China (PBoC), which, through its head office, branches across the country, and subsidiary units such as the Bank of China, undertook all kinds of financial activities.

In Russia too, it was in the aftermath of the transition to a market economy that some development banks were created out of pre-existing institutions and some new ones established, especially in the mid-2000s (Maidan 2012). There are currently a number of development bank-type financial institutions, the most important among which is The Bank for Development and Foreign Economic Affairs (Vnesheconombank or VEB), which was mandated in 2006. The development bank was formed by pooling the assets of the erstwhile Vnesheconombank of the USSR, federally-owned shares of the Russian Development Bank and Roseximbank as well as assets transferred by the Russian Government

There are other specialised development finance institutions such as the Russian Venture Company, which is a state-owned venture capital company, also created in 2006 to boost innovation, the Russian Direct Investment Fund (RDIF) established in 2011 to act as a catalyst for foreign direct investment by investing in joint ventures, and the Russian Corporation for Nanotechnologies established in 2007.

In terms of the number of institutions, the evolution of development banking took very different trajectories in Brazil, Russia and South Africa on the one hand, and India on the other.

In South Africa, the two main development financing institutions, the Industrial Development Corporation (IDC) and the Development Bank of South Africa (DBSA) were created under apartheid, with the former focused on supporting Afrikaner industrialists and the latter established in 1983 to “perform a broad economic development function within the homeland constitutional dispensation”. And in Russia, while there are a number of institutions, the

Vnesheconombank is the largest with the mandate to provide long-term finance for infrastructure, big industry, small businesses, exports and projects related to environmental protection. These institutions were created to support the transition to a private sector dominated economy. In Brazil, a single institution, BNDES, performs most of the crucial development banking functions, making it one of the biggest development banks in developing countries. Besides BNDES, there are three important regional development banks in Brazil, whose size and role are much less significant. These are the Minas Gerais Development Bank (BDMG), the Extreme South of Brazil Development Bank (BRDE), and the North-eastern Brazil Bank (BNB).

India, on the other hand, had over time established a large number of development and policy banks. By the end of the 1980s, the industrial development banking infrastructure in India consisted of three all-India development banks (Industrial Finance Corporation of India [IFCI, established in 1958], the Industrial Credit and Investment Corporation of India [ICICI, 1955] and the apex Industrial Development Bank of India [IDBI, 1964]), and 18 State Financial Corporations. In 1990, the government established the Small Industries Development Bank of India (SIDBI) as an all-India financial institution for the financing of micro, small and medium enterprises.

While the DFIs in Brazil, India and Russia were and are quite visibly instruments of a state-led industrialisation strategy, the South African apartheid state was not as much of a developmental agent. It was only after apartheid that the South African state used DFIs to promote growth through infrastructural development within the country and in southern Africa as a whole. The DBSA in particular has paid much attention to supporting infrastructural development in the municipalities, while IDC has focused on industrial development with some attention to the black economic empowerment agenda. The CDB in China, on the other hand, was an agent that was created to facilitate the transition to a high growth, “socialist market economy”.

## Ownership and Financing

Till the 1990s, the development banks in all of these countries were state-owned, with a few exceptions such as the ICICI in India. Public ownership implies that: (i) these institutions can be backed with financial support from the state at low, subsidised interest rates; (ii) that profitability need not be the criterion on which the performance of these institutions can be judged, with focus instead on social returns such as the expansion of sectors with positive economy-wide external effects (like infrastructure) and the delivery of credit to sections like small farmers and small and medium enterprises neglected by the private financial sector; and (iii) the motivations of managers can be aligned with those of the government and incentives of managers rendered compatible with the shareholding state.

The role of the state in financially backing national development banks is visible in the case of the Brazil, China, India, and Russia. But the picture in South Africa is mixed. The National Treasury provides the financing for the infrastructural support operations of DBSA, with the bank raising additional funds from capital markets and international organisations. The IDC, on the other hand, is a self-financing DFI and pays corporate tax according to the Companies Act, 2008. Its funds are drawn from borrowings, mature investments and its retained earnings. In India, besides the government that allocated budgetary resources, the central bank played an



important role. An Industrial Finance Department was established in 1957 within the Reserve Bank of India (RBI) and the central bank began administering a credit guarantee scheme for small-scale industries from July 1960. Subsequently, with a view to supporting various term-financing institutions, the RBI set up the National Industrial Credit (Long-Term Operations) Fund from the year 1964-65.

Much of the funding for Russia's development banks, especially VEB, comes from the Russian Federation and Ministry of Finance, in the form of equity, and from traditional bank lending as well as bond finance in domestic and foreign markets.

The sources of finance for the BNDES have been unusual. Besides bond issues, resources from multilateral organisations, transfers from the treasury, and deposits from the government of funds from privatisation, the institution benefited from resources garnered through a special cess. In the early 1970s, the Brazilian government instituted the Social Integration Programme (PIS) and the Public Employment Savings Programme (PASEP) which were to be financed with payroll taxes imposed on company profits. Under President Ernesto Geisel (1974-1979), the administration of these funds was transferred to BNDES. Subsequently, under the 1988 Constitution changes were made in the management of PIS-PASEP, which led to the creation of a Workers Assistance Fund, 40 per cent of accruals to which had to be mandatorily routed to BNDES for investments in employment generating projects. In addition, the government has used various measures such as special taxes and cesses, levies on insurance and investment companies and the reallocation of pension fund capital to direct resources to the industrial financing activities of the BNDES (Baer & Villela 1980). In 2007, 10 per cent of BNDES' funds reportedly came from the government's investment in its equity, and 75 per cent from obligatory investments of FAT (Workers' Support Fund) resources and special programmes such as the Accelerated Growth Programme (PAG) and the Sustainable Investment Programme (PSA).

## Aspects of Functioning

As a consequence of this, the Brazilian Federal government has been, through BNDES, an important source of long-term credit to the country's corporate sector. Implicit in that process has been the delivery of a subsidy to the private sector through BNDES. The rate of interest at which the government borrows from the market, which is the benchmark SELIC (Sistema Especial de Liquidação e Custódia or Special System for Settlement and Custody) rate set by the central bank, is higher than the TJLP (Taxa de Juros de Longo Prazo or Long Term Interest Rate), which is the rate at which it lends to the BNDES. This amounts to subsidised lending to the BNDES at the cost of the tax payer. To the extent that BNDES offers credit to its borrowers at a rate lower than the SELIC, there is a transfer to the latter as well. The BNDES does indeed lend at rates close to the TJLP. According to one study (Lazzarini et al. 2011), if the BNDES had been obtaining funds at the SELIC rate, then its net interest margin would have been negative for many years. Clearly, the federal government is using BNDES as a means to make implicit transfers to firms it supports.

Thus, using public resources the development banks in these countries have advanced substantial funds for capital formation in the private sector. The first phase of the BNDES's activities stretched to the mid-1960s, during which period (besides investments in developing a new capital at Brasília) the focus of its activity was the financing of public sector projects in infrastructural sectors like transport and power. During these years between 80 and 90 per cent of its financing was directed at the public sector.



A transition occurred in the mid-1960s involving two major changes. First, there was a significant step up in BNDES financing. In 1965, BNDES outlays rose from 3 per cent of capital formation to 6.6 per cent and continued at that enhanced level. Second, more of the institution's financing now went to the private sector, with the public sector's share falling to 44 per cent during 1967-71 and between 20 and 30 per cent subsequently. This shift in favour of the private sector was accompanied by a change in the sectoral composition of BNDES funding, which was now directed also to sectors such as nonferrous metals, chemicals, petrochemicals, paper, machinery, and other industries.

In Russia, the VEB's loan portfolio rose seven fold in the short period from 2007 to 2012, from about RUB 100bn (about US\$4.05bn) to around RUB 720bn (US\$20.7bn) in 2012. As compared to this RDIF has, since 2011, invested \$1.3 billion as equity to projects in which foreign investors contributed \$6 billion (Barone and Spratt 2015).

In South Africa, DBSA allocated 61 per cent of lending to South African projects, with 44.4 per cent of that going to energy projects, 25.7 per cent to entrepreneurial and manufacturing activities, and 11.6 per cent to communication infrastructure. As much as 70 per cent of the funding is allocated to projects in the public sector, which is different from the experience of some of the other countries covered in this volume. The fact that close to two-fifths of the financing is diverted to external projects reflects the importance that South Africa gives to improving conditions among neighbours in the region. This does seem to reflect more than the financing of the country's "going out" strategy seen in Brazil and China.

## Social and Economic Impact

The question that arises is whether this focus on state-backed development financing has made much difference in terms of concern for sustainability and the rights of affected populations. With state control and influence over financing, projects that are supported can be chosen to privilege promoters, locations and technologies that would help ensure reduced concentration of economic power, greater regional dispersion of economic activity and the realisation of larger goals such as employment generation, foreign exchange saving and adherence to social and environmental standards. That some of these objectives were indeed kept in mind (however, inadequately) cannot be denied.

In fact, the assessment of the South African experience included in this volume suggests that while the development strategy being adopted by South Africa remains unclear and engagement with civil society organisations is minimal, for reputational reasons South African DFIs comply with international standards and best practices, and often apply rigorous standards in assessing social and environmental impacts of projects that they finance. Further, the development of a "green economy" in South Africa is one of the priority areas for the IDC, with funds being allocated to renewable energy and pollution management projects.

Globally, one impact of project financing that has received attention in recent times is the environmental fallout of the projects that are funded. The Finance Initiative of the United Nations Environmental Programme, with its set of Principles of Responsible Investment and Global

Reporting Initiative, and the Equator principles framed in 2003 by ten leading banks together with the International Finance Corporation are indicative of this tendency. Some countries like India have begun adopting such initiatives, though concern at the ground level for the environmental consequences of large projects are still far from adequate. Even to the extent that large projects funded by Development Finance Institutions and the banks have been conscious of environmental impacts and attempted to follow national guidelines or international best practices, this has largely been the result of pressure from civil society, the judiciary and the government.

In India, there have been a number of projects funded by the DFIs that have been extremely controversial from an environment point of view. In Brazil, despite civil society pressure (as through the BNDES Platform document), the environmental record of the projects financed by the institution has been found wanting. Moreover, BNDES's record even with regard to transparency and information disclosure has been poor, making it difficult for civil society activists to sharpen the debate. Governmental pressure and pressure from the World Bank have been only marginally effective, and largely inadequate. It was only as late as 2008 that the Brazilian government got BNDES to sign a "Green Protocol" that committed it to adopt environmental and social criteria when deciding on loans to its clients. This process was strengthened by a \$1.3 billion loan from the IBRD in 2009, which was to help improve the effectiveness of environmental and sustainable development principles adopted by BNDES in key sectors. However there is still no clarity on contractual mechanisms and monitoring and control procedures to ensure that borrowing enterprises address and mitigate expected and unexpected adverse socio-environmental impacts.

Matters have got worse recently also for structural reasons. In both Brazil and India, a change has occurred in the structure and activity of development banking in the years since the 1980s, when the liberalisation wave swept across countries. In Brazil, as noted earlier, the BNDES increasingly turned to subsidising credit to the private sector, especially large private firms. There is also evidence of concentration in BNDES lending. It also holds large chunks of equity in private companies. The bank has also supported Brazilian firms to target foreign markets or go global, by financing the modernisation of potential export sectors such as textiles, footwear and apparel. These changes have been associated with other policies that implied a greater role for the market.

Recent South African developments provide a contrasting experience. Losses resulting from poor investment decisions have resulted in a rethink on financial grounds, as opposed to development considerations, of lending to the private sector. Further, lending abroad has also, for reasons of reputation and influence, been focused on infrastructure with substantial coordination with governments.

The impact of liberalisation in India has been completely different. It led to the decline of development banking and the demise of the major development finance institutions in India. In 1993, the IFCI Act was amended to convert the IFCI, established as a statutory corporation, into a public limited company. The stated intention was to do away with the institution's dependence on funding from the central banks and the government and require it to access capital from the open market. Since this would involve borrowing at market rates, the role played by the IFCI has been substantially transformed. In the case of the ICICI, which was

in 2002, through a reverse merger, integrated with ICICI Bank, to create what was essentially a pure commercial bank. Similar moves were undertaken to transform the Industrial Development Bank of India (IDBI). In 2003 the IDBI Act was repealed and a company in the name of IDBI Ltd was set, which in turn set up IDBI Bank as a subsidiary. Subsequently IDBI was merged with IDBI bank. That marked the end of industrial development banking in India. The focus now is on targeted policy lending. By 2012, there were only two all-India development banking institutions: the National Bank for Agricultural and Rural Development (established in 1982) and the SIDBI.

In the case of China, the fact that the China Development Bank (CDB) was established as part of the transition to a more market-dependent and market-friendly development phase has implications for environmental and social outcomes with respect to which the country's record has come under much criticism. After a lack-lustre initial innings, CDB registered a dramatic expansion of its asset base. That process was accelerated in 2008-09, when CDB became a leading vehicle to finance the government's gigantic stimulus package adopted in response to the global financial crisis. By 2011, the assets of CDB were estimated at \$991 billion, as compared with \$545 billion for the World Bank group (consisting of IBRD, IDA and IFC), \$306 for BNDES (2010) and \$132 billion for the Korea Development Bank (Sanderson and Forsythe 2013).

The CDB has expanded through forays into four areas. The first is lending to the state-owned enterprises replacing the government and the commercial banks. The second is lending to the Local Government Financing Vehicles (LGFVs) to finance the huge infrastructural investments being undertaken by the provincial governments. According to one estimate, as much as one-half of CDB's loan book could consist of lending to local governments, and the bank may account for as much as one-third of all LGFV loans, making it a bigger lender than all of the four commercial banks put together. The third, is financing China's "going out" policy or spread abroad, partly as manufacturing investor in low cost locations in Africa and Latin America but more importantly as acquirer of mineral and oil resources across the globe. Finally, CDB invests in China's wind, solar and telecommunications companies, with Huawei Technologies being the largest beneficiary. The first three of these are areas in which the social and environmental impacts both within China and in poor developing countries have been known to be adverse.

In Russia and Turkey, development banks have committed themselves to creating a cleaner environment. The Industrial Bank of Turkey claims that as a sustainable development bank it "is keen on the protection of the environment and climate. During the course of the last decade, in addition to the subsectors of the industry, renewable energy and energy efficiency projects have been actively promoted" (International Development Finance Club 2015). The Russian VEB's Board has committed itself to a corporate social responsibility (CSR) strategy, which makes CSR an integral part of all the bank's activities rather than a separate business line and makes the organisation responsible for the social and environmental fallout of its investment decisions (Barone and Sopratt 2015). To what extent these commitments would be reflected in actual practice is yet to be seen.

## Implications for Southern Institutions

These developments raise questions regarding the claim that new Southern institutions such as the NDB and the AIIB can be pressured into bettering or substantially improving upon the

record of existing multilateral institutions with respect to the social, environmental and human rights impacts of developmental lending. The government of one country involved in these institutions as an important player, which is amenable to democratic, civil society pressure because of its Right to Information Act, its activist judiciary and parliamentary democracy, is India. India is a large player within the BRICS and holds the first Presidency of the NDB. It will also be the second largest shareholder in the AIIB. But here too the prognosis is not good. The Indian government is also seen as turning its back on social and environmental goals. The recently elected National Democratic Alliance government has in the face of opposition in Parliament, resorted to the executive “ordinance” route to simplify land acquisition procedures (that could result in displacement without adequate compensation and resettlement) and dilute environmental norms.

In the final analysis, development banks are instruments of state capitalist development. Such specialised institutions are needed because of the shortfalls in the availability of long-term finance for capital-intensive projects in market economies, resulting from the maturity and liquidity mismatches involved. In non-market economies, allocations for such investments can be made through the budget and financed with taxes or the surpluses generated by state-owned enterprises. If the instruments are state capitalist, they are unlikely to serve objectives that sacrifice private profit to deliver social benefit. So the best that can be expected of the NDB is that it would serve better the interests of capitalist development in the less developed countries (with some concern for sustainability and inclusiveness) than would multilateral banks that are dominated by the developed countries.

Whether even this difference would be material depends on three factors. The first is the degree to which the emergence of the NDB alters the global financial architecture and perhaps, therefore, the behaviour of the institutions currently populating it. The second is the degree to which the NDB can differ in its lending practices from the institutions that currently dominate the global development-banking infrastructure. And, the third is the degree to which a development bank set up as a tool of state-guided development by governments in countries pursuing market-friendly, neoliberal development trajectories can indeed contribute to furthering goals of more equitable and sustainable development.

## The Multilateral Climate

Meanwhile, seeing the BRICS, and China in particular, “exploiting” the development and infrastructure financing platform for a foray in economic diplomacy, the G20 countries as a group are looking to play a role. At their meeting in Brisbane in September 2014 the group decided to launch a Global Infrastructure Initiative centred on a Global Infrastructure Hub in Sydney that will share information and match investors with needed projects. This is merely an attempt to strengthen the existing multilateral development finance network with a dose of coordination. Not surprisingly the leading MDBs—the African Development Bank, Asian Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, the Inter-American Development Bank, the Islamic Development Bank, the World Bank and the IMF—issued a statement which said: “We stand ready to bring our experiences and skills to the G20’s work on infrastructure and to support a proposed new global infrastructure hub.” (AFP 2014).

What is more, faced with the “threat” from the NDB and AIIB, the World Bank has decided to step up its presence in the infrastructure area by presenting itself as a body that can coordinate investments in developing countries in infrastructure. The required level of such investments is estimated at \$1-1.5 trillion a year for the next 20 years. Since governments are not in a position to provide resources of that magnitude either directly, through the World Bank or through the new Southern institutions being created, the Bank has set up a Global Infrastructure Facility (GIF), which it defines as “a global open platform that will facilitate the preparation and structuring of complex infrastructure PPPs to mobilise private sector and institutional investor capital.” This may just be wishful thinking on the part of an institution that has thus far delivered a maximum of \$24 billion a year (in 2014) for the purpose. But even if the GIF proves successful it is unlikely to contribute much to advancing a holistic development agenda. Despite protestations to the contrary, the World Bank’s record on social and environmental standards has not been positive.

In fact, there is much concern being expressed about a likely World Bank decision to harmonise downwards the safeguards provisions it imposes on lending to projects in developing countries. Though implementation and monitoring are seen as poor, the World Bank’s existing safeguard policy was found to be working in a 2010 evaluation by the bank’s Independent Evaluation Group (IEG 2010). Yet, a revised Environment and Social Policy (ESP) draft document that was leaked in July 2014 seeks to dilute safeguards and reverse a thirty-year strengthening effort. According to the Washington-based Bank Information Center (McElhinny 2014): “Dilutions include the broadly expanded but weakly regulated deferral of Bank safeguard responsibility through multiple opt out clauses – each of which is unaccompanied by clear thresholds; unlimited flexibility to defer appraisal and adopt open-ended compliance timeframes; absence of explicit minimum procedural requirements – particularly for consultation and disclosure; an ‘opt out’ clause for the Indigenous Peoples Policy; (and) the lack of similar disclosure and assessment requirements for substantial risk subprojects.” The Center holds that under the new “light touch rules” employment safeguards, biodiversity protection rules, constraints on logging, and consultations with local populations are all bound to be adversely affected.

One reason for the retreat is objections from developing country borrowers. That suggests that safeguards are best strengthened at the national level, leading to a regional or multilateral consensus. This requires strengthening the respect for social, environmental and human rights benchmarks through state policy and the role of development finance institutions at the national level. Unfortunately, as the country studies in this volume suggest, that goal is far from being realised and is in fact in danger of being reversed even to the extent so far achieved.

Hence, it may be too much to expect the NDB to self-consciously adhere to sustainable development norms that its market-dependent financing pattern does not permit and the governments backing the organisation do not respect. The fact that these institutions introduce more plurality into the international financial and monetary landscape does not guarantee significant difference. This is where civil society organisations and other democratic forces have an important role to play. A first effort of democratic forces in the BRICS countries and elsewhere should be to monitor the lending by the new multilateral institutions their governments have helped establish and pressure the governments involved to act in ways that differentiate the NDB and AIIB from the currently dominant global institutions in terms of funding patterns, rules forced to show greater respect for norms of sustainable and inclusive development than the

and terms. Positive results may not be easy to come by. But if, in the end, these institutions are forced to show greater respect for norms of sustainable and inclusive development than the Bretton Woods institutions do, that would be a major advance.

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CARLOS TAUTZ, JOÃO ROBERTO LOPES PINTO AND FABRICIA DE ANDRADE RAMOS

# Brazil's National Bank for Social and Economic Development BNDES: A Critical Analysis



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## Setting the Context

The industrialised world's 8<sup>th</sup> economy, Brazil's development system is certainly complex. It comprises a number of big private as well as state-owned companies (such as oil giant Petrobras, electric conglomerate Eletrobras and nuclear holding Eletrobras), official development agencies (both at the national and regional levels) and a public banking system that focuses on supporting economic infrastructure (BNDES), housing and sanitation (savings bank CEF) and agricultural finance complex Bank of Brasil/BB.

However, when it comes to banking for long-term infrastructure projects, both for state-owned as well as for private companies, we concentrate our attention on a specific institution that contributes to concept the country's industrial policies, and, during the 1990s, spearheaded a huge privatisation plan that reshaped the country's pattern of accumulation. Since 2001, it has increasingly widened the horizon of financial support to different Brazilian and foreign economic agents and played a growing role in funding roads, hydroelectric plants, subway lines, private industrial complexes, etc. not only in Brazil but throughout Latin America, as well as increasingly lending support to Brazilian conglomerates in sub-Saharan Africa.

### *BNDES' specific weight*

The Brazilian Economic and Social Development Bank or BNDES is the country's main financing agency for long-term investment policies in the field of economic infrastructure for both state programs and private ventures. It is owned exclusively by Brazil's federal government, which controls all of the bank's shares. BNDES alone is responsible for about 20 per cent of Brazil's total investment capacity. In the last decade and a half, as a result of the policies adopted by the Brazilian government, BNDES has continuously increased the volume of disbursements, with a total of US\$ 90 billion released in 2013.

In fact, since its foundation in 1952, the BNDES has stimulated the expansion of industry, exports and infrastructure, and has invested in technological innovation and in modernising the public administration.

Historically, however, the bank has assumed more roles than just extending financial support, contributing effectively – through its technical and bureaucratic staff and qualified access to information on economic factors and agents – to shape Brazilian development. Until the 1990s, the bank sponsored the state’s strategy of import substitution, in which it developed the country’s basic industry and infrastructure. This model, however, required too much state intervention and public efforts, and was criticised strongly at the end of the eighties.

At that point, both the Brazilian government and the bank changed positions radically, and began a strong process of privatisation focused on the “competitive insertion” of Brazil into the global economy. It is interesting to note that this expansion of Brazilian corporate groups (also called “national champions”) is articulated alongside diplomatic efforts to broaden Brazilian influence in the international scenario and is part of a wider strategy that aims to lead Brazil towards a permanent seat at UN’s Security Council.

### *The 1990s Privatisation Process*

Privatisation in the 1990s was undertaken by groups of SOEs and with facilitated credit from the BNDES to stimulate these conglomerates in the sectors of civil construction, agricultures, mining and extracting businesses, and energy production, among others. Today, BNDES continues to contribute in this process that is now less focused on the privatisation of state enterprises and more focused on the formation of “national champions”, i.e., strengthening the big private conglomerates in the commodities sector so they can compete with leading global enterprises. Officially, however, BNDES’ objective is to offer varying schemes of financial support to Brazilian private enterprises of all types and sizes, including those in the public sector, and to promote its three declared principles – innovation, local development and socio-environmental development – in all economic sectors.

The BNDES’ importance as an economic actor is significant not only within Brazil, but also on the international stage. Compared to the annual disbursements of other development banks like the Inter-American Development Bank (IDB) and the World Bank’s International Bank for Reconstruction and Development (IBRD), BNDES has accounted for at least twice the amount of expenditure of both banks together since 2007. The media has pointed to the bank’s growth and compared its disbursements in 2010: while BNDES invested R\$168.4 billion (US\$81 billion), IBRD invested R\$45.4 billion (US\$22 billion) in 43 countries and IDB, R\$17.5 billion (US\$8 billion) in 26 countries<sup>1</sup>. Meanwhile, scholars point to a longer period in which the BNDES had already surpassed the international banks, disbursing US\$33 billion in 2007, US\$50 billion in 2008 and US\$68 billion in 2009, while both the IDB and the IBRD combined invested US\$18 billion in each of the first two referenced years and US\$30 billion in the last<sup>2</sup>.

It is important to note that both the IDB and the IBRD have, in recent decades, declined in importance Brazil’s general development strategy and now maintain a low profile role. They

<sup>1</sup> O Globo. “O gigantismo do BNDES”. Viewed 10/10/2012. <http://oglobo.globo.com/infograficos/gigantismo-bndes/>.

<sup>2</sup> LOPES, João Roberto (org.) “Introdução”. *Ambientalização dos Bancos e Financeirização da Natureza*. Rede Brasil sobre Instituições Financeiras Multilaterais. 2012. Pg. 13.



It is importance Brazil's general development strategy and now maintain a low profile role. They moved from the role of heavy investor in the 1970s towards a secondary role in the 1990s, when they started funding punctual projects and/or studies and the implementation of official policies in the state's framework.

## Institutional Framework and Governance

According to BNDES' statute, its main operations are financial and there are constant references to a broad spectrum of funds, resources and credit that are available for development purposes, to be applied and invested by the bank in various sectors. The BNDES can also offer other financing possibilities, some of which demand no return, referred to as "non-fundable applications" in their Statute<sup>3</sup>, for programs related to education and research, scientific or technological in nature (this includes technical studies and making donations of materials and funds), and in social projects that promote job creation, urban services, health, education, sports, justice, housing, the environment, rural development, culture, among other areas.

Any investment or financial collaboration made by the bank must obey a set of rules that involve (i) technical and financial assessment of the venture, project or business plan, including social and environmental implications; (ii) verification of the refund security, except if not needed by legal determination; (iii) on the basis of the bank's own criteria, evaluation of the morality of the entrepreneurs or the enterprise.

Supervised by the Ministry of Development, Industry and Foreign Trade<sup>4</sup>, officially responsible for setting industrial policies, BNDES' organisational structure has an administrative council as its highest entity, composed of ten members of government, among them the council's president, of which six will be appointed by the supervising ministry, and four respectively by the Ministry of Planning, Budget and Governance (MPOG), the Ministry of Labor, the Ministry of Finance and the Ministry of External Relations.

The current composition of the administrative council also includes two seats for major employers' representatives – FIRJAN and FIESP – and two seats for major workers' representatives. The members from government are all appointed by the President of the Republic and the criteria established by the statute is knowledge and experience for the position, as well as moral and untainted reputation. The member representing the workers is also appointed by the President and must have a substitute in case of absence. All the members' mandates last three years with the possibility of one re-election, but once their mandate expires, they must continue to occupy the position until a new member is appointed, so the seats will not remain vacant.<sup>5</sup>

The council's attributions listed in the statute comprise, among other things, to deliberate, examine and approve the President's vetoes and decisions regarding the bank's orientations for investment and action, as well as their specific governance and budget-related plans, and deliberate on the creation, fusions, acquisitions and extinction of subsidiaries.

<sup>3</sup>Estatuto do BNDES. Article 9, IV and V.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/O\\_BNDES/Legislacao/estatuto\\_bndes.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/O_BNDES/Legislacao/estatuto_bndes.html).

<sup>4</sup>Ministério do Desenvolvimento, Indústria e Comércio Exterior. <http://www.desenvolvimento.gov.br/sitio/>.

<sup>5</sup>Estatuto do BNDES. Article 11.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/O\\_BNDES/Legislacao/estatuto\\_bndes.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/O_BNDES/Legislacao/estatuto_bndes.html).

The council usually meets every trimester of the year but may also meet in extraordinary circumstances, such as if the President demands or by the solicitation of at least two members.

The board of directors is composed of the President, the Vice-President and six directors with no specific designation, all appointed by the President of the Republic and subject to immediate dismissal. The President and the Vice-President have indefinite mandates, while each director has a three-year mandate with the possibility of one re-election. In terms of budget, the board of directors must submit to the administrative council the expenditure program and the management budget for the bank and comment on the trimestral financial demonstrations and reports, which are also submitted to the administrative council.

Effectively, the board of directors runs BNDES, authorising agreements and contracts that constitute responsibilities or compromises to the bank, authorising all hiring of constructions and services, all acquisitions, sales and donations of bank assets, and nonrefundable investments, as well as approving the internal organisation of the bank, the distribution of attributions, and the creation of subsidiaries, offices and agencies <sup>6</sup>. Some of these decisions, however, must be previously sanctioned by the Ministry of Finance, such as the alienation of assets and creation of subsidiaries. The board of directors meets weekly or, extraordinarily, if the President demands or by solicitation of at least five members.

The bank also has in its structure both a fiscal council and an internal auditing committee, which have different attributions and compositions. The fiscal council's main attribution is to examine and assess the financial and budget declarations and balances, having the power to demand official disclosure on budget execution of any office in the bank, meetings' minutes and other deliberations that involve the bank's finances. Other functions may be assumed if demanded by the Law for Open-Capital Corporations<sup>7</sup>, to which the bank is subject as a public financial institution of private legal personality undertaking private sector activities. An example would be their permission to attend meetings of the administration council or board of directors in which there will be deliberation on matters subject to the fiscal council's appreciation<sup>8</sup>.

The BNDES' statute, however, does not establish any effective measures that can be taken by the fiscal council in case of resource mishandling or budget irregularities. Also, there are no accountability measures or provisions in the statute regarding the administrators' and council members' work ethics and professional performance. The three members of the fiscal council are deputed, two by the Ministry of Development, Industry and Foreign Trade and one by the Ministry of Finance, to act as representatives of the National Treasury, nominated by the President of Brazil. They are not subject to any other office within the bank.

As for the internal auditing committee, the members are chosen by the administrative council to whom this committee reports, observing the ground rules for the exercise of these member-positions determined by the National Monetary Council (CMN). The committee's attributions are to recommend an external auditor to be hired; to revise, before publication, the semester's financial demonstrations; to evaluate the effectiveness of independent and internal audits performed on the bank; to recommend to the BNDES' board of directors improvements and

<sup>6</sup>Article 15 of BNDES' Statute.

<sup>7</sup> Lei das S.A. n° 6.404 de 1976. [http://www.planalto.gov.br/ccivil\\_03/leis/L6404consol.htm](http://www.planalto.gov.br/ccivil_03/leis/L6404consol.htm).

<sup>8</sup> Lei das S.A. n° 6.404 de 1976. Article 163, §3°.

changes in policies, practices and procedures whose flaws or deficiencies were identified in the committee's exercise of its attributions; and to compile a report with information on its own activities, including an evaluation of the effectiveness of the internal control systems.

The BNDES has slowly become more than just a bank – it has developed into a system that comprises three other public enterprises and business corporations, one of which acts mostly internationally. According to the bank, the total assets of the BNDES System amounted to R\$625 billion in 2011. The first subsidiary to be created was FINAME, in 1966, with the objective of managing a fund for financing the acquisition of new industrial machinery and equipment. Although under BNDES and functioning as a collaborator, this agency is managed through an autonomous administrative council, which is responsible for using the available funds to finance the production and export of national machinery, as well as import of similar equipment from abroad. Their main objectives are to attend to the growing commercial production of national machinery, to finance the import and foment the export of this equipment, and to aid the expansion of Brazil's production of industrial apparatus, through credit facilities extended to producers and consumers.

Secondly, the BNDESPAR is a business corporation whose social capital is divided in shares, but is also an integral subsidiary of the bank. As the only shareholder, BNDES controls this holding and runs it through an appointed administrative council, a board of directors and a fiscal council. BNDESPAR's official role is to capitalise operations for undertakings controlled by the private sector in accordance to the bank's policies and principles, to support enterprises that are efficient economically, technologically and administratively, with good chances of investment payoffs, and to administer shares and contribute to the strengthening of the stock market by promoting more democratic ownership of corporate capital. BNDESPAR's role extends not only to supporting private groups but rather to concentrate in the state's hands the capacity to stimulate induce certain areas of the economy and thus influence accumulation patterns in the country.

Lastly, the BNDES Ltd., the bank's international arm, is also an integral subsidiary of the bank, created in London with the main purpose of acquiring shares in other enterprises, working as an investment holding. Recently created (2009), this subsidiary represents BNDES' debut in one of the world's most important financial centers and marks definitively the movement towards the internationalisation of Brazilian enterprises, while also demonstrating the state's economic power.

Of all three components of the BNDES' system, BNDES Ltd. is, by far, the subsidiary on which there is the least information available both in budget documents and on the bank's website and reports, although it is subject to the Law for Public Access to Information. Both the BNDES Ltd. and the law, however, are recent developments and the latter has not yet been applied successfully to obtain more detailed information on the bank's London subsidiary. For example, there is no legal statute or internal regulation listed for this subsidiary on BNDES' website, alongside the rest of the system<sup>9</sup>. BNDES Ltd. is not yet fully operational. It still remains only an address in London, where is based, but is seen by BNDES an entity through which to raise money in international markets to fund fusions and acquisitions of Brazilian conglomerates that are planning to expand their operations beyond Brazil's borders.

<sup>9</sup> Legislation of the BNDES System.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/O\\_BNDES/Legislacao/index.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/O_BNDES/Legislacao/index.html).

More recently, the BNDES created two important accountability offices that cover the whole BNDES system: the auditing committee, included in the bank's statute in 2004, and a client relations' service in 2007. The auditing committee, among other attributions, elaborates every semester a report containing assessments on (i) its own activities; (ii) the effectiveness of the BNDES System's internal control procedures; (iii) the recommendations made to the BNDES board of directors, pointing out the ones that were not accepted and why; (iv) the internal and independent audits on the BNDES system; and (v) the quality of budget information and the observance of Brazil's Central Bank financial norms applicable to all financial institutions, both private and public.

The committee is composed of six members, who are appointed and may be dismissed by the bank's administrative council, and are given indefinite mandates. These members may also occupy seats on the administrative council of the bank or other councils. In its turn, the client relations' service is an institutional communication channel between the enterprises that comprise the BNDES system and their clients, dedicated to conflict mediation and the formal treatment of client complaints. Other attributions include proposing corrective measures and improvements regarding their procedures and routines based on the data collected to the high administration of the BNDES System. These propositions are contained in the report compiled every semester with both quantitative and qualitative information on the client relations service's performance, which is submitted to the internal auditors, the audit committee, the board of directors and the administrative council. The head of the client relations' service will be appointed and dismissed by the President of BNDES, also having an indefinite mandate.

## Performance and Investment Options

The election of former President Luiz Inácio Lula da Silva in 2002 marked the definitive role of the BNDES in the government's plans of inducing the emergence of "national champions" to compete with other global leading private corporations, which has been largely executed by the bank. This can be observed in the bank's main credit beneficiaries, such as the banks Bradesco and Itaú-Unibanco, the civil construction enterprises Odebrecht and Andrade Gutierrez, the cellulose producer Votorantim-Aracruz, the mining industry Vale and other large-scale corporations like Ultrapar, Queiroz Galvão, Camargo Correa, Grupo EBX, Gerdau and Perdigão-Sadia. The privileging of these conglomerates through credit lines and financing schemes raised questions about the lack of transparency in terms of the criteria that guide the bank's decision making process and the fact that the beneficiaries all have the economic capacity of capitalising within the private credit and stock market. Also, the BNDES holds important board positions or is a shareholder in many of these enterprises.

In turn, the BNDES has also become a "national champion" in its own category, surpassing investments made by similar international banks and acting as one of the largest financing and stimulating agencies in the country. The bank's available funds have four major sources: (1) transfers from the Workers' Support Fund (FAT), whose objective is to finance activities that create jobs and revenue and qualify the workforce; (2) payments of their conceded credit and financing schemes; (3) profits from their applications and shareholding participations; and (4) transfers from the National Treasury.

Historically, the funds from FAT have been the major stable revenue source of the bank, as noted in the BNDES' report on its own 2011 activities<sup>10</sup>, dedicating 40 per cent of its funds to the bank's activities (the other 60 per cent funds unemployment insurances, salary bonuses and allowances). In 2011, R\$15 billion (US\$7 billion) from FAT funds went to the BNDES, which can be considered a reduced amount if compared with the bank's investments presented in this research and which can be explained by the growing transfers from the National Treasury's since 2008. According to a summary of revenue sources of the Bank in 2011<sup>11</sup>, the FAT composed 39.5 per cent of the bank's funds in 2009, severely reducing this in 2010 and 2011, in which the FAT represented 29.7 per cent and 28.5 per cent respectively; meanwhile, the National Treasury funds increased their participation in the bank's fund transfers in these three years, going from 37.3 per cent in 2009, to 46.1 per cent in 2010, and finally 49.7 per cent in 2011. In the Bank's trimestral report of January 2012<sup>12</sup>, from 2008 to 2011 – in the context of the international economic crisis – the Treasury's was seen to have transferred over US\$115 billion in the form of public debt bonds emissions.

Another example of these transfers by the Treasury is the Law 12.453 of 2011, which updates preceding laws, and in the 1st article, allows the state to concede “economic subventions through the equalization of interest rates in operations contracted” until June 2012 for the purchase and production of capital goods in the energy sector, including technological components and services and export structures and products through the BNDES, in the amount of R\$208 billion (US\$100 billion). This “equalization of interest rates” corresponds to the difference between the final borrower's burden and the cost paid at the source of the funds, plus the revenue made through this investment by the BNDES or the financial agent in the transaction. Also, the 2nd article authorises a credit line from the Treasury to the BNDES for a total amount of R\$100 billion (US\$48 billion), covered by the emission of public debt or security bonds, under long-term interest rates.

This arrangement recently incited oppositional congressmen to include in the 2012 pre-budget statement (LDO) a legal obligation for the executive government to declare their planned emissions of public debt bonds for BNDES' capitalisation in the enacted budget (LOA). The President of the Republic, however, vetoed the legislative demand, and this will definitely negatively impact the transparency and accountability of the bank, guaranteeing that government can maintain freely a “parallel” budget over which Congress and society have little control. Since its nature is to encourage economic and social development, the bank's strongest performance indicator has always been its disbursements, and these have grown consistently since 1999, as shown in the graph below.

<sup>10</sup> BNDES. Relatório de Gestão do Exercício de 2011.

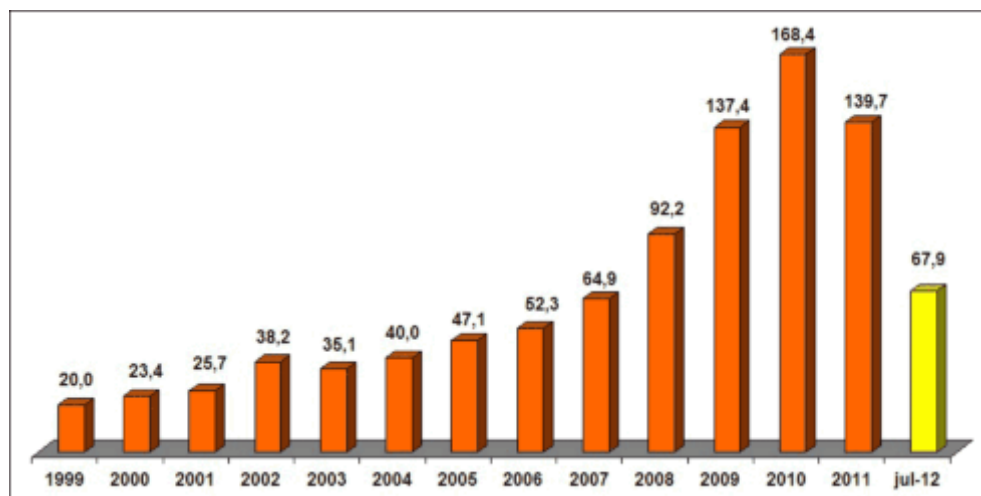
[http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes\\_pt/Galerias/Arquivos/empresa/download/2011\\_Relat\\_Gestao\\_BNDES\\_BPAR\\_FINAME.pdf](http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/2011_Relat_Gestao_BNDES_BPAR_FINAME.pdf), accessed 8 September 2015.

<sup>11</sup> BNDES. Relatório Anual 2011. Revenue Sources.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Hotsites/Relatorio\\_Anual\\_2011/Capitulos/o\\_bndes\\_em\\_numeros/desempenho\\_economico\\_financeiro/fontes\\_de\\_recursos.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Hotsites/Relatorio_Anual_2011/Capitulos/o_bndes_em_numeros/desempenho_economico_financeiro/fontes_de_recursos.html).

<sup>12</sup> Relatório Trimestral Gerencial do BNDES, January 2012.

[http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes\\_pt/Galerias/Arquivos/empresa/download/Relatorio\\_Recursos\\_Financeiros\\_1trimestre2012.pdf](http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/Relatorio_Recursos_Financeiros_1trimestre2012.pdf), accessed 8 September 2015.

**Graph: BNDES annual disbursements in R\$ billion – 1999 through 2012<sup>13</sup>**

Source: BNDES [http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_en/Institucional/The\\_BNDES\\_in\\_Numbers/](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_en/Institucional/The_BNDES_in_Numbers/).

The significant and obvious increase in investments as of 2008 coincides with the latest international economic crisis and the launching of several large-scale government programs such as the Program for Accelerated Growth (PAC), in which the emphasis is on infrastructure and civil construction, and the Program for Sustained Investment (PSI), in which production, acquisition and exportation of capital assets and technological innovation are stimulated – both of which have the bank’s active participation. Most of the bank’s information and indicators focus on the increasing disbursements, but it is important to note that this indicator should not be considered a measure of the bank’s success, since it does not incorporate qualitative considerations, such as fund allocation and impact on economic or social development.

In the BNDES report on its 2011 activities<sup>14</sup>, there is an overview of the major programs and projects in which the bank is involved, of which this research will mention in more detail the *Programa de Aceleração de Crescimento – PAC* (“Growth Acceleration Program”), the *Programa de Sustentação de Investimento – PSI* (“Program for Sustained Investment”) and the *Cartão BNDES* (“BNDES Card”). First, regarding the Bank’s 2011 participation in the PAC, the report points to the consolidation of a potential portfolio of 503 shared projects, for which BNDES has already approved the investment of R\$179 billion (US\$86 billion) that could go up to, with the opening of credit lines, R\$327 billion (US\$158 billion). This portfolio expresses the bank’s emphasis on large-scale investments and the concentration of their transfers to the already enormous energy production sector (of which oil and gas are a part of): of the potential total investments (US\$158 billion) in the 503 projects, US\$125 billion and 310 projects are destined to this sector.

Again, the main indicator for the bank’s role in the PAC is the disbursement of funds and credit. As for the PSI, since its creation in mid-2009 to its predicted cessation at the end of 2011 – noting that the program was extended to the end of 2012 –, the report announces a total of R\$129.5

<sup>13</sup> The values are in Brazilian Reais, but can be grossly converted into American dollars if divided by two.

<sup>14</sup> BNDES. Relatório de Gestão do Exercício de 2011. Pg. 41.

[http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes\\_pt/Galerias/Arquivos/empresa/download/2011\\_Relat\\_Gestao\\_BNDES\\_BPAR\\_FINAME.pdf](http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/2011_Relat_Gestao_BNDES_BPAR_FINAME.pdf), accessed 8 September 2015



(US\$62 billion) in disbursements, of which 80 per cent were destined to the acquisition of capital goods by domestic corporations of all sizes.

Lastly, the program *Cartão BNDES* serves a final illustration of the bank's investment options, since it is dedicated to financing – like a credit card – the purchase and investments of specific products by accredited suppliers by micro, small and medium enterprises in a simplified manner. Regarding this program, the report offers other indicators such as the number of cards distributed, the range of municipalities in which the program is present, and the disbursements made by the bank. Up until the end of 2011, when the report was published, there was “around 472 thousand cards actively valid and amounting to over R\$24 billion [US\$12 billion] in credits already conceded for purchases and investments.”<sup>15</sup> These cards have been distributed in over five thousand of Brazil's municipalities, representing 92.7 per cent of the total municipalities in the country. Of these, over 87 per cent had already used the card effectively. Also, in that year, R\$7.6 billion (US\$3.7 billion) were disbursed by the Bank in operations done through the *Cartão BNDES*, which is a significant increase from the \$4.3 billion (US\$2 billion) disbursed in 2010.

### *From Infrastructure to Mega Sport Events Funding*

The bank is also involved with financing sporting events such as World Cup in 2014, and, according to the referred annual report issued by the Bank (2011), two major programs are being developed. The BNDES ProCopa Turismo – to last from January 2010 to December 2012 – dedicated to transferring approximately R\$1 billion (US\$485 million) to the construction, reform and amplification of the national hotels network, with financing schemes that can spread over 12 to 18 years to return and with investment limits, for the bank, of 100 per cent in case of ventures by small or medium enterprises and of 80 per cent in case of ventures by large-scale corporations. In 2011, four projects were approved to receive financing from the BNDES and they amounted to a disbursement of R\$45.8 million (US\$22 million).

Secondly, the BNDES ProCopa Arenas – to last the same period as the previous program – dedicated to transferring approximately R\$4.8 billion (US\$2.3 billion) to the construction and reformation of the stadiums that will host games during the World Cup and to the urban renewal of their surroundings. In this program, the limits are established as such: the bank can invest up to 75 per cent of the total cost of the venture, restrained to R\$400 million (US\$193 million) per project, including the stadium and its surroundings. In 2011, four projects were approved to receive the bank's investments, none of which are specified in this report, but that amounted to R\$783.3 million (US\$379 million).

In addition, the bank's investments are also not very well distributed between sectors. The emphasis of the investments is on industry and infrastructure, which each take up around 30 per cent of the funds available, respectively, in mechanical, metallurgic, chemical and petrochemical industries, also backed by FINAME's performance, and in construction, electricity and rail transportation. Also, inequalities exist in terms of funding among the different Brazilian regions, while the funding of large-scale ventures and enterprises have been emphasised to the detriment of small and medium-sized businesses. According to the bank's operational statistics, disbursements by region in the period of 2002 to 2011 have always been concentrated in the Southeast region of the country, where the major cities of São Paulo, Rio de Janeiro and Belo Horizonte are located. In 2002, the Southeast represented over 60 per cent (R\$23 billion or US\$11

<sup>15</sup> BNDES. Relatório de Gestão do Exercício de 2011. Pg. 38.

billion) of the investments, while in 2011 it has reduced to a little under 50 per cent (R\$68 billion or US\$33 billion); but the structure of investments by region was maintained – the South continues the second largest beneficiary while the Center-West, followed by the North regions have the slimmer shares of funds. To illustrate, the South region went from R\$6 billion (US\$2.9 billion) or 16 per cent in 2002, and the North from R\$1.9 billion (US\$5.2 billion) or 5 per cent, to R\$ 29.7 billion (US\$14.3 billion) or 21 per cent in 2011, and the North, respectively, to R\$10.9 billion (US\$5.2 billion) or 8 per cent.<sup>16</sup>

As for the size of the enterprises in which the bank invests, large-scale corporations have been historically hegemonic as beneficiaries, although the participation of micro, small and medium enterprises (MPME) has grown significantly since 2002. In that year, R\$8.3 billion (US\$4 billion) was destined to MPME, of which half was for micro-entrepreneurs or enterprises, representing 21 per cent, while R\$29 billion (US\$14 billion), or 78 per cent went to large-scale companies. In 2010, the resources destined to MPME amounted to R\$45.6 billion (US\$21.9 billion), or 27 per cent, while large-scale retained R\$118 billion (US\$56.8 billion), or 70 per cent. The data for the next year (2011), however, show a retreat from investments in large-scale companies, which only amount R\$80 billion (US\$38.4 billion), while the funds to MPME stay stable R\$49.7 billion (US\$23.9 billion), but raise in terms of proportion, taking 34 per cent of the total investments, while the large-scale companies represent 58 per cent.<sup>17</sup>

This means that the vast majority of BNDES activities are related to stable and prosperous corporations and sectors, among which are the private “national champions” and several SOEs in the SPE sector, like Petrobrás and subsidiaries. Recent information published by the bank indicate that a credit line of US\$12 billion was established with Petrobrás to finance their investment plan for three subsidiaries in the 2009-2010 period, which the bank financed through the National Treasury, with public debt bonds.<sup>18</sup>

The BNDES’ net worth amounted to US\$30 billion in 2011, which surpassed the previous years’ standards in Referential Equity, the indicator used by the Brazilian central bank to measure an institution’s financing possibilities. Other indexes, like the adequate capital or Basel index, show that the BNDES System adopts defensive financial measures, holding 20.6 per cent of the equity for every R\$100 financed, which is well above the 11 per cent required by the central bank. BNDES credit portfolio has amounted over US\$198 billion in 2011, representing around 20 per cent of all the credit supply in the National Financial System (SFN). Of these, over 80 per cent are considered long-term credit transactions and medium or low risk investments.

The bank has participated in the internationalisation of Brazilian companies, particularly in Latin America, the Caribbean and Portuguese-speaking Africa, through the creation of aggressive institutional and financial mechanisms to enable increases in investment from these companies in

<sup>16</sup> BNDES. BNDES Transparente. Estatísticas Operacionais. Região. Annual.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/BNDES\\_Transparente/Estatisticas\\_Operacionais/regiao.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/BNDES_Transparente/Estatisticas_Operacionais/regiao.html).

<sup>17</sup> BNDES. BNDES Transparente. Estatísticas Operacionais. Porte de Empresa. Annual.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/BNDES\\_Transparente/Estatisticas\\_Operacionais/regiao.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/BNDES_Transparente/Estatisticas_Operacionais/regiao.html).

<sup>18</sup> BNDES. Sala de Imprensa. “BNDES e Petrobras assinam contrato de R\$25 bilhões” Published 30/07/2009. Viewed 29/09/2012.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/Sala\\_de\\_Imprensa/Noticias/2009/Industria/20090730\\_petrobras.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/Sala_de_Imprensa/Noticias/2009/Industria/20090730_petrobras.html).



the regions mentioned. Since 2002, the bank began financing projects outside of Brazil if they hired services or purchased assets of national corporations, building an international portfolio that amounted to approximately US\$13 billion in 2010. The bank itself is increasingly international, opening offices around the world, such as the representation set up in Montevideo and the London subsidiary BNDES Ltd. in 2009, as well as the Brazilian Credit Agency for Exportations (EXIM Brazil) and the Foreign Trade Guarantee Fund in 2010. The next year, the government authorised the bank to sponsor the acquisition and fusion of Brazilian conglomerates outside the country, while also negotiating a cooperation agreement with representatives of the BRICS to facilitate common transaction and to formulate an institutional framework to provide funds and credit to common projects, possibly creating an international operating entity in the future.

### *Assessment of Key Institutions and Policies*

In spite of its central role in funding and shaping Brazil's economy, BNDES does not have a strong record of following international standards of financial, social and environmental impacts of its huge disbursements. This is due to the fact that the Brazilian legal system does not make it obligatory for finance institutions to take into consideration environmental issues when approving credit operations. Only general legislation such as 1981's National Environmental Policy and the 1988's Environmental Crimes Act, applies.

Brazilian financial institutions, however, have voluntarily adopted self normative instruments such the Ecuador Principles. More recently (in 1995), a number of major Brazilian public and private banks signed the Green Protocol, a Petter of Principles through which five state-owned regional development banks agree to incorporate the environmental dimension in their system analysis and evaluation of projects, and prioritise actions to support sustainable development – however, through market instruments, what may lead to distortions into effective social and environmental protection.

The financial institutions together with the Ministry of the Environment agreed to:

1. Define the criteria for analysis of the environmental dimension in the allocation of credit and financing;
2. Prioritise projects that have greater environmental sustainability;
3. Stimulate the creation of credit facilities for companies that implement environmental management systems and processes of certification, such as ISO 14000;
4. Identify new mechanisms to increase the availability of financial funds for investment in projects that fall into the category of so-called 'sustainable development'.

## **Transparency and External Control**

The BNDES is an IFF that has been defined by its own statute as “*the main instrument for the execution of the Federal Government's investment policy, with the primordial objective of supporting programs, projects, constructions and services related to the country's social and economic development*”<sup>19</sup>.

As such, transparency is the central tool for the assessment of the state's investment policy's success, as well as essential for the construction of complex and accurate indicators for Brazil's

<sup>19</sup> BNDES. Statute. Article 3.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/O\\_BNDES/Legislacao/estatuto\\_bndes.html](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/O_BNDES/Legislacao/estatuto_bndes.html)

development. In terms of the bank's presence in broader legislation, the role expected for the BNDES according to the Pluri-Annual Plans (PPA) is to finance the plan's programs with the objective of reaching the established goals in those that fall under the bank's responsibility, through direct and indirect operations and activities by the accredited financial agents. For the past period (2008-2011), the PPA's development strategy, in theory, gave priority to public policies that aimed to promote wealth distribution; to improve the education system; to increase productivity and competitiveness; to expand markets for mass consumption; to explore resources in sustainable ways; to improve infrastructure, including urban and especially metropolitan; to reduce regional inequalities; and to strengthen democracy and citizenship.

More specifically, the BNDES is also mentioned in the pre-budget document (*LDO*), when it deals with the state's policy for funds applications through their financing and fomenting agencies, which also include the Bank of Brazil (*Banco do Brasil – BB*) and Caixa Econômica Federal (*CEF*). In the past two pre-budget documents, the *LDOs* for 2011 and 2012, the priorities established for the BNDES were basically the same, and are by far the most extensive ones in this section (when compared to the other agencies mentioned)<sup>20</sup>.

Among them, the following were selected on purpose for this research paper because they represent the investment options that the bank does not make or makes with little dedication: (a) the development of productive cooperatives of micro, small and medium-size companies, with the goal of increasing by 50 per cent the bank's investment in this area in relation to the past three years, if demand is properly presented; (d) financing and complementing of costs in the areas of public health, education, the environment, including the prevention, reduction and remediation of desertification, infrastructure, including mobility and urban transportation, coastline navigation, and expansion of the urban pipeline networks for gas distribution, and other public sector projects; (h) financing to support the expansion and development of the economy and enterprises, of local productive arrangements and cooperatives, as well as projects and ventures promoted by Afro-Brazilian and indigenous groups; and (i) financing job and revenue creations by means of microcredit, emphasising projects and ventures lead by Afro-Brazilian, indigenous or female groups.

Other than priorities, the *LDO* also establishes some conditions and obligations for the IFFs, such as situations in which they cannot extend or renew any type of financing or credit lines, the content of annual reports, evaluations on the impact of their credit operations in the reduction of inequalities and unemployment, and the availability, up-to-date, of this information on the Internet<sup>21</sup>. It is interesting to note that among the four situations where financing by IFFs is not allowed, one does not apply specifically to the BNDES and the other represents a technical choice that allows these IFFs to continue to finance ventures that are causing or corporations that have caused social and/or development. In terms of the bank's presence in broader legislation, the role expected for the environmental damages. The first situation does not allow public financing for the acquisition of public assets included in the National Plan for Privatization (PND) created back in 1990 and amended to fit contemporary objectives.<sup>22</sup> It was through the PND, for example, that the state transferred his remaining shares in the privatised *Companhia Vale do Rio Doce (Vale)* to the BNDES, to be used by the bank to extend credit for the restructuring of the economy (at the time opening up to global markets and investors) through the private sector. In the *LDO*,

<sup>20</sup> *LDO* 2011, Lei nº 12.309, de 2010. Article 89, IV. *LDO* 2012. Lei nº 12.465 de 2011. Article 86, IV.

<sup>21</sup> *LDO* 2012. Lei nº 12.465 de 2011. Article 86, §§ 1º e 5º.

<sup>22</sup> Lei nº 9.491 de 1990. Articles 26 e 27.

however, the BNDES – in exceptional cases – is allowed to finance the buyer in a privatisation process if authorised by a specific law<sup>23</sup>.

The second situation prohibits IFFs to lend to or finance institutions whose directors have been convicted of moral or sexual harassment, racism, child or slave labour and/or crimes against the environment. The choice for basing the prohibition on a judicial conviction of individual directors for these crimes is extremely ineffective in avoiding social and environmental damages caused by ventures or enterprises financed by IFFs. Its ineffectiveness is multifold: not only do these crimes require material proof for a conviction, but they are also of a personal nature that involves the individual directors and not the companies' policies or practices; and the judicial system is too slow and inadequate to respond to potential or actual social and environmental damages that are being financially supported by public funds through IFFs.

The bank itself also has its own legislation – the Statute and other norms<sup>24</sup> – and has, since 2008, increasingly offered important information on its activities, disbursements and investment options, through mid- and end-year reports or reports on different aspects of the bank's activities, such as a trimestral balance of their application of funds obtained through the transfers from the National Treasury ("*Aplicação dos Recursos Financeiros Captados junto ao Tesouro Nacional*") and an annual aggregated report (*Relatório de Gestão do Exercício de 2011*)<sup>25</sup> which includes the subsidiaries BNDESPAR and FINAME, but not the BNDES Ltd. These reports are all under the tab of "BNDES Transparent" (BNDES Transparente), launched by the bank in 2009, to share information on the BNDES' operations, public accounts, administered funds, social and environmental responsibility, ethical governance, descriptions of the bank's financial sources<sup>26</sup> financial resource applications, operational statistics, among other themes.

In regards to the application of the funds obtained through the National Treasury, the report is extensive, but covers – most importantly – the evolution of these funds since 2009 and all the legal instruments that allowed the transfers in public debt bonds, such as the Provisional Measures (Medidas Provisórias – MP) and the laws that validated them. A table is presented with all the seven MPs (up until 06/21/2012), their interest rates and the total amounts obtained and, therefore, owed. These amount to over R\$250 billion (US\$120 billion), and the next section of the report examines their application<sup>27</sup>.

<sup>23</sup> LDO 2012. Lei nº 12.465 de 2011. Article 86, §2º.

<sup>24</sup> BNDES System Legislation.

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/O\\_BNDES/Legislacao/](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/O_BNDES/Legislacao/).

<sup>25</sup> BNDES. Relatório de Gestão do Exercício de 2011.

[www.bndes.gov.br/SiteBNDES/export/sites/default/bndes\\_pt/Galerias/Arquivos/empresa/download/2011\\_Relat\\_Gestao\\_BNDES\\_BPAR\\_FINAME.pdf](http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/2011_Relat_Gestao_BNDES_BPAR_FINAME.pdf) in "Annual Balance Publications"

[http://www.bndes.gov.br/SiteBNDES/bndes/bndes\\_pt/Institucional/BNDES\\_Transparente/Processos\\_de\\_Contas\\_Anuais/](http://www.bndes.gov.br/SiteBNDES/bndes/bndes_pt/Institucional/BNDES_Transparente/Processos_de_Contas_Anuais/).

<sup>26</sup> BNDES. Relatório de Gestão do Exercício de 2011. Pg. 41.

[www.bndes.gov.br/SiteBNDES/export/sites/default/bndes\\_pt/Galerias/Arquivos/empresa/download/2011\\_Relat\\_Gestao\\_BNDES\\_BPAR\\_FINAME.pdf](http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/2011_Relat_Gestao_BNDES_BPAR_FINAME.pdf).

<sup>27</sup> See Table IV in pg. 12. BNDES. Relatório Gerencial Trimestral dos Recursos do Tesouro Nacional. 3º Trimestre de 2012. Published October 2012.

[www.bndes.gov.br/SiteBNDES/export/sites/default/bndes\\_pt/Galerias/Arquivos/empresa/download/Relatorio\\_Recursos\\_Financeiros\\_3trimestre2012.pdf](http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/empresa/download/Relatorio_Recursos_Financeiros_3trimestre2012.pdf).

According to another table, the portfolio of projects selected to receive the funds is composed 47.6 per cent by transfers through FINAME – which means they support operations of production and commercialisation of new machinery and equipment produced nationally, through indirect accredited financial institutions – and 20.1 per cent through FINEM – which groups the large-scale investment projects in which the bank invests directly or indirectly with values over R\$10 million (US\$4.8 million) in ventures that intend to implant, expand, modernise or recuperate fixed assets in the industrial, commerce, service, agriculture and cattle raising sectors.<sup>28</sup>

The report does not specify exactly the final beneficiaries of the funds and the amount loaned, although it later briefly mentions the major corporations and activities that received the funds, with no numbers presented.<sup>29</sup> The only values regarding the destination of these funds are presented for the investments contained in the Growth Acceleration Program (PAC), which amount to R\$38 billion (US\$ billion) of the total funds disbursed by BNDES the period between 2009 and 2012 – over R\$250 billion (US\$ billion). Through PAC, Petrobrás alone received R\$10.4 billion (US\$5 billion) along this period and the second largest beneficiary is its new refinery, Abreu e Lima S.A., as part of a industrial-port complex in Northeastern Brazil, which received R\$9.9 billion (US\$4.7 billion).<sup>30</sup>

The improvement in transparency practices on the part of the bank, still contrasts, however, with incidents in which the BNDES has refused to disclose information – especially regarding indirect investments and funding sent abroad – based on the argument of banking secrecy<sup>31</sup>. Regarding projects or enterprises outside of Brazil, there is nearly no information accessible to the general public other than aggregated values of contracts organised by country, but as the bank puts it, *“direct operations in the Foreign Trade sector, done through extension of credit or financing of foreign public entities with the objective of enabling the export of Brazilian goods and services, international contracts subject to confidentiality clauses and commercial secrecy”*.<sup>32</sup>

Regarding governance practices, the bank must adopt public principles like all SOEs and its corporate management is controlled and examined by their own fiscal council, and both by the Federal Court of Auditors (TCU), which is the Brazilian external audit entity, and the General Comptroller Office (CGU) – the country’s internal auditing office. It is relevant to note that the TCU has the power to initiate actual legal procedures if any improprieties are proven, while the CGU has no actual enforcement attributions. The end-year report published by government examines the BNDES in two separate moments: first, in the fiscal and social security budget, together with the other public fomenting agencies, where the report details the bank’s corporate

<sup>28</sup> See Table V in pg. 13. BNDES. Relatório Gerencial Trimestral dos Recursos do Tesouro Nacional. 3º Trimestre de 2012. Published October 2012.

<sup>29</sup> Pgs 23 thru 32. BNDES. Relatório Gerencial Trimestral dos Recursos do Tesouro Nacional. 3º Trimestre de 2012. Published October 2012.

<sup>30</sup> See Graph XVIII and comments in pg. 22. BNDES. Relatório Gerencial Trimestral dos Recursos do Tesouro Nacional. 3º Trimestre de 2012. Published October 2012.

<sup>31</sup> “BNDES resists auditing from the General Comptrollers Office (CGU)”  
<http://m.estadao.com.br/noticias/impresso,bndes-resiste-a-auditoria-da-cgu,456259.htm>.

<sup>32</sup> BNDES. Contratações por país Janeiro a dezembro 2009.  
[http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes\\_pt/Galerias/Arquivos/consultas/ProjetosAEX2009.pdf](http://www.bndes.gov.br/SiteBNDES/export/sites/default/bndes_pt/Galerias/Arquivos/consultas/ProjetosAEX2009.pdf).

plan for the next five years and the expenditures made with resources from this budget area; second, in the investment budget, alongside other SOEs and among the federal financial institutions (IFF). Regarding the first reference to BNDES, the balances for expenditure with contracts and transfers are categorised by region and investment area, followed by a written evaluation of the bank's allocations. In the investment budget, the information is displayed in a more aggregated and comparative manner, and the BNDES is directly referred only when the balance is discriminated by SOE and sector. The table below, from the investment budget of 2010's end-year report, illustrates how much the bank has grown in significance over the past five years, surpassing other IFFs like Basa and BNB to become the third largest SOE in the sector. It is important to note that these values, however, do not include the bank's whole portfolio or expenditures, but only the part of their executed expenditures related to funds from the government's investment budget.

**Table: Executed investment budget by SOE between 2006 and 2010 in R\$ 1000s<sup>33</sup>**

Corporations	2006		2007		2008		2009		2010	
	Value (R\$ thousand)	%	Value (R\$ thousand)	%	Value (R\$ thousand)	%	Value (R\$ thousand)	%	Value (R\$ thousand)	%
BB	442.180	42.8	688.574	61.8	1.148.253	67.9	1.349.439	67.0	1.770.674	71.9
CEF	480.360	44.3	337.594	30.3	438.023	25.9	462.342	22.9	584.621	23.7
BNDES	9.455	0.9	7.967	0.7	37.816	2.2	17.408	0.9	52.873	2.1
BNB	33.331	3.2	32.090	2.9	14.356	0.8	37.471	1.9	21.142	0.9
Basa	70.377	6.8	25.959	2.3	15.184	0.9	5.589	0.3	19.353	0.8
IRB-Brasil RE	9.152	0.9	7.404	0.7	11.908	0.7	5.269	0.3	13.134	0.5
FINEP	140	0	466	0	337	0	6.847	0.3	1.163	0
BNC	0	0	0	0	0	0	130.611	6.5	0	0
Besc	9.068	0.9	13.762	1.2	24.508	1.4	0	0	0	0
BEP	1.570	0.2	460	0	342	0	0	0	0	0
<b>Total</b>	<b>1.033.633</b>	<b>100</b>	<b>1.114.277</b>	<b>100</b>	<b>1.690.726</b>	<b>100</b>	<b>2.014.977</b>	<b>100</b>	<b>2.462.960</b>	<b>100</b>

BNC incorporated in 11/30/2009, Besc incorporated in 09/30/2008, BEP incorporated in 11/28/2008

Source: MP/DEST/SIEST

The auditor's report also contemplates the BNDES in different areas of its text and provides critical information on what is still not transparent in the bank's balances and reports. In the section dedicated to credit policies, the TCU points out that in 2010, the credit operations in the national financial system (SFN) reached the highest rates in Brazilian history, mounting to R\$1.7 trillion and representing 46.4 per cent of the GNP. The allocation of resources to the BNDES in this area (credit lines) has increased in 44 per cent since the previous year and came out to R\$179.8 billion (US\$87 billion) in 2010. Additionally, other bank operations are directly subsidised through subventions by the National Treasury – an estimated R\$9 billion (US\$4.3 billion) between 2009 and 2010 – and many of the credit concessions made by BNDES with low interest rates are at least 10 per cent subsidised by public funds. TCU emphasises that financial and credit benefits offered by the bank to enterprises and entrepreneurs are not fully captured by the controlling and tributary authorities.

<sup>33</sup>An approximate amount in dollars can be reached roughly by dividing these values by two. Found in End-Year Report/Prestação de Contas da Presidência da República. 2010. <http://www.cgu.gov.br/Publicacoes/PrestacaoContasPresidente/2010/Arquivos/PCPR2010.pdf>.

The movement towards transparency was further strengthened by the new Law for Public Access to Information, which demanded the creation of a service dedicated to informing interested citizens (SIC) and a proper procedure for information demands. The application of this law is already visible in the BNDES' structure and website, where a specific webpage offers an organised list that redirects browsers to the available information, such as audit reports, expenditure balances, contracts and agreements, institutional framework, programs and projects, frequently asked questions, and other topics. To solicit information that is not available in the website and published reports, any citizen or organisation can fill a specific form to demand access, though the bank emphasises that information will not be disclosed if it demands additional analysis, interpretation or consolidation of data or deals with services or productions that are not of BNDES' competence. They will also not disclose information that is classified as personal, secret, confidential or reserved, as well as other information classified as fiscal, banking, professional, judicial, and so on.

## Social Control and Participation

Pressure for more transparency and accountability regarding the BNDES' disbursement and investment options have grown proportionally to the bank's portfolio. The negative impact on the social and environmental spheres of ventures with credit or capitalisation from the BNDES strengthened the demands for clearer objectives, civil responsibility and financing withdrawals. In 2007, discontentment in social movements and sectors culminated with the presentation of the *BNDES Platform*, a document prepared by thirty of the most representative social organisations assessing the bank's performance and demanding a redirection of its line of action towards social justice and environmental protection.

This document pointed to the necessity of establishing mechanisms for social control over the bank's activities and of diversifying and decentralising the bank's investments. The proposals and comments contained in the *Platform* had four main (i) publicity and transparency; (ii) social participation and control mechanisms; (iii) the adoption of social and environmental criteria in the election process of projects for funding and supporting; and (iv) the restructuring of the bank's priorities through new sectorial policies.

Until 2009, the *Platform* maintained a direct channel with the Bank President's office with the main purpose of pushing the agendas of adopting (a) a transparency policy regarding information on all projects and funding, and (b) social and environmental impact criteria for the projects the bank finances, especially in the hydroelectric and ethanol production sectors. Through this dialogue, the BNDES did little to reorient his policies and to enforce these criteria on existing contracts, which indicates that the bank does not assume any social or environmental responsibility over the ventures it finances.

The objective of the *BNDES Platform* was more than exercising social control over the bank's budget and balances, wishing to create a more democratic governance of its resources. One of the main points of the document is that the BNDES does not disclose the totality of its portfolios, especially of private investments and allocations,

especially of private investments and allocations, which the bank has begun publishing, lacking clarity, in 2008. That same year, the bank also signed the “Green Protocol” with the Ministry of the Environment, committing to adopt social and environmental criteria when selecting projects and enterprises for credit extensions or funding. The bank also restructured its environmental policies, adopting in 2010 a specific social-environmental policy within its operations, but still has not established strict goals and measures to be taken, meanwhile still financing high-risk or impact ventures.

It is important to note that the *Platform* did not succeed in pushing BNDES criteria ahead due to internal disagreements of this front of social organisations and to the real lack of wish from the bank’s side to move towards a modern way of conducting public business, in terms of social and environmental responsibilities. More recently, other initiatives from the side of civil society organisations have again approached BNDES but with a politically limited view and – not trying to push ahead BNDES’s general criteria – but rather focusing on the issue of transparency, that is already a matter of Brazilian legislation.

These changes came about in the context of the World Bank’s Sustainable Environmental Management (SEM) project for Development Policy Loan (DPL), which in 2009 approved a transfer of US\$1.3 billion of IBRD funds to the BNDES in order to finance the improvement in effectiveness and efficiency of policies and guidelines of the Brazilian SEM system and the further integration of environmental sustainable development principles in the agenda of key economic sectors. This loan followed another, previous, fund transfer from IRBD destined to create more efficiency and celerity to the environmental licensing process (called TAL SAL).

In this social-environmental policy, the bank commits formally to the Brazilian environmental legislation, observing the proper three-step procedure for licensing the projects they finance (previous, installation and operation licenses), and to the evaluation and compensation of possible impacts. The institutional advances were made mostly in the creation of risk-assessment instruments, but still does not clarify the contractual mechanisms that oblige enterprises and entrepreneurs to mitigate and correct expected and unexpected social-environmental impacts, neither the monitoring and control procedures to be exercised during the venture’s operation.

The bank has begun producing sectoral social-environmental guidelines, in order to extend technical support to the different BNDES units that analyse these aspects of the projects, beginning with the sugar and alcohol sector, followed by soy production and cattle growing sectors. According to the bank, these guidelines should serve as orientations and its contents do not create additional obligations other than those in the Brazilian legislation and in the bank’s board of directors resolutions. The BNDES has also developed an environmental classification with three categories that grade the ventures in terms of risks and impacts. The policy determines that these environmental categories establish different procedures in terms of both pre-funding project analysis and monitoring of the venture’s operation, but in most cases, these classifications do not mean any contractual changes, nor do they represent effective obstacles to the occurrence of irregularities, disasters, violations or negative impacts of social rights and environmental laws.



The bank only established additional obligations in terms of social-environmental criteria in three specific economic sectors: (1) of ethanol production, in which the bank cannot finance ventures located in the Amazon or Pantanal biomes; (2) of thermoelectric and fuel production, for which there are restrictions regarding emission of particles into the atmosphere; and (3) of cattle growth and meat production, that must maintain the cattle traceable and a complete list of suppliers. These obligations, however, depend on each beneficiary's own declarations since the bank does not dispose of instruments for independent monitoring of their observance.

In regard to the bank's legal responsibility over the projects and ventures it finances – such as its obligation to avoid, compensate and mitigate eventual damages or impacts – Brazilian legislation establishes the responsibility of financing agents in relation to the enterprises that violate human and environmental rights. This civil and administrative responsibility is clear in the law that disciplines the National Environmental Policy (PNMA),<sup>34</sup> which also determines that the financing agent must observe if there are the necessary licenses for the venture and if the set obligations created by these licenses are being obeyed.<sup>35</sup> Also, any corporation or financial institution is subject to penal responsibility in the case of environmental crimes, including its president, directors, administrators, board members, auditors and others that are directly involved with or that fail to avoid the impact and damages caused<sup>36</sup>.

The main argument contrary to the responsibility of financial agents is the identification of the legal causal link between the financing and the damages caused by the enterprise. Although the argument has some legal basis, it does not apply to the BNDES, since it finances 60 per cent to 80 per cent of the projects' values, the mere possibility of the venture – and therefore, the damage it causes – depends on the bank, implicating its complete responsibility. The BNDES, other than being decisive for most of the enterprises it finances, also holds shares in most of these corporations or in the conglomerates or holdings that control them. This configures the bank's direct and indirect responsibilities.

Despite the referenced legal and institutional framework regarding social and environmental protections, the BNDES continues to finance ventures that involve high risks and costs in these areas. In theory, the PNMA allows the application of legal penalties on project financiers through placing responsibility for damages, but the judicial system is yet to enforce these legislative possibilities. Up until 2007, there were only two known decisions on the matter, made by one of the Federal Regional Courts, in which Caixa Econômica Federal (CEF) and the BNDES – both public financial institutions (IFFs) – were defendants, but absolved of any responsibility. The procedures against the BNDES were initiated by a group of local people who had suffered social and environmental damages that resulted from a mining venture financed by the bank. The Public Prosecutor's Office, however, has declared that the bank can only be held accountable if evidence of the bank's previous knowledge of the possibility of the damage were produced. Even though there is no jurisprudence on a financier's responsibility yet, the growing possibility of the judicial recognition of this legal mechanism has moved organisations to pressure the public offices and to propose proceedings against these financiers, especially public ones like the BNDES and CEF. In turn, these IFFs have gradually began enforcing preventive measures to avoid this possibility, like improving their scrutinising procedures for projects with environmental risks and demanding better guarantees and preventive and damage-control policies from the enterprises.

<sup>34</sup> Law n° 6.938 of 1981 [http://www.planalto.gov.br/ccivil\\_03/leis/L6938compilada.htm](http://www.planalto.gov.br/ccivil_03/leis/L6938compilada.htm).

<sup>35</sup> Article 12 of the Law n° 6.938 of 1981.

<sup>36</sup> Articles 2 and 3 of Law n° 9.605 of 1998 [http://www.planalto.gov.br/ccivil\\_03/leis/L9605.htm](http://www.planalto.gov.br/ccivil_03/leis/L9605.htm).



The *BNDES Platform* has worked towards exposing these contracts in hope of avoiding further social or environmental damages, like the legal representation sent to the Federal Public Prosecutors Office about the ThyssenKrupp CSA, the largest steel and iron industrial complex in Latin America. In this case, BNDES has already liberated 90 per cent of their pledged financial support of US\$1.2 billion even though the venture has innumerable social and environmental risks and was not given the right operational license. The contract between the bank and ThyssenKrupp, which enabled the legal action by the *Platform*, was obtained by one of its institutions – the *Instituto Mais Democracia* – through the Law for Public Access to Information.

# Development Finance in India



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## Setting the Context

Until recently, India offered an exemplary instance of the use of development banking as an instrument of late industrialisation. The turn to and emphasis on development banking in the immediate aftermath of Independence can be explained with reference to two characteristic features of the Indian economy at that time: one, the inadequate accumulation of own capital in the hands of indigenous industrialists; and two, the absence of a market for long-term finance (such as bond or active equity markets), which firms could access in order to partially finance any capital-intensive industrial investment.

This financial structure reflected the underdeveloped nature of the economy in terms of the unduly low levels of domestic saving and investment. As a result, the financial structure was inadequately diversified. In terms of the share of financial assets, the Reserve Bank of India dominated, with 47 per cent of the total, followed by the commercial banks collectively owning 26 per cent and the Imperial Bank with 8 per cent. The gradual decline of the exchange banks, which were established to finance foreign trade, had reduced their share of assets to 5 per cent. Postal savings, cooperatives and insurance companies accounted for 4 per cent each, while pension funds accounted for a mere 2 per cent. Thus, excluding the central bank, banks overwhelmingly dominated the financial structure (Goldsmith 1983).

The extent to which banks could be called upon to assume the responsibility of financing long-term investments is limited. Banks attract deposits from many small and medium (and, of course, large) depositors, who have relatively short savings horizons, would prefer to abjure income and capital risk, and expect their savings to be relatively liquid, so that they can be easily drawn as cash. Lending to industrial investors making lumpy investments, on the other hand, requires

allocating large sums to single borrowers, with the loans being risky and substantially illiquid. Getting banks to be prime lenders for industrial (and infrastructural) investment, therefore, results in significant maturity, liquidity and risk mismatches, limiting the role that banks can play in financing long-term productive investment. Other sources need to be found.

### *Development Finance Institutions*

The situation described above resulted in a shortfall in the availability of long-term finance in a bank-dominated financial system. This was the gap that the state-created or state-promoted development banking infrastructure sought to close. That infrastructure was created over a relatively long period of time and was populated with multiple institutions, often with very different mandates. Funds for the development banks came from multiple sources other than the ‘open market’: the government’s budget, the surpluses of the Reserve Bank of India, and bonds subscribed by other financial institutions. Given the reliance on government sources and the implicit sovereign guarantee that the bonds issued by these institutions carried, the cost of capital was relatively low, which facilitated relatively lower cost lending for long-term purposes.

These development finance institutions (DFIs) were very different from banks, and were modelled along the lines of the Kreditbanken in Germany during its industrial take-off (Gerschenkron 1962). Unlike the latter, they lent not only for working capital purposes, but to finance long-term investment as well, including to capital-intensive sectors. Having lent for long periods of time, they are very often willing to lend more in the future. Since such lending often leads to higher than normal debt-to-equity ratios, development banks closely monitor the activities of the firms they lend to in order to safeguard their resources, which results in a special form of “relationship banking”. Often, this involves nominating directors on the boards of companies who then have an insider’s view of the functioning and finances of the companies involved. This enables corrective action to be undertaken early, as soon as signs of errors in decision-making or operational shortcomings are observed.

Given the role taken on by the development banks, they could not stop with the mere provision of financial resources. They often needed to provide ‘technical assistance’ to a fledgling industrial class for drawing up project plans, identifying technology, implementing the project and even operating plants. This requires more than just financial expertise, so that development banking institutions built up teams of technical and managerial (as well as financial) experts, who were involved in decisions on lending and therefore in deciding on the nature of the investment. This close involvement has made it possible for these institutions to invest in equity as well, resulting in them adopting the unconventional practice of investing in the equity of firms they are exposed to as lenders. This would, in other circumstances, be considered an inappropriate practice, since it could encourage development banks to continue lending to insolvent institutions as they are investors in the firms concerned, and could eventually suffer significant losses due to closure.

Given their potential role as equity investors, development banks provide merchant banking services to firms they lend to, taking firms to market to mobilise equity capital by underwriting equity issues. If the issue is not fully subscribed, the shares would devolve on the underwriter, increasing the equity exposure of the bank. Firms using these services benefit from the reputation of the development bank and from the trust that individual and small investors place in the bank’s ability to safeguard their investments by monitoring the firms concerned on their behalf as well.

Thus, development banks lend and invest. They leverage lending to influence investment decisions and monitor the performance of borrowers. They undertake entrepreneurial functions, such as determining the scale of investment, the choice of technology and the markets to be targeted by industry, as well as extension functions, such as offering technical support. In other words, they are a component of the financial structure that ensures that lending leads to productive investment, which in turn accelerates growth and makes such lending sustainable.

### *The Indian Experience*

India's experiment with development banking began with the establishment of the Industrial Finance Corporation of India (IFCI) in July 1948, and continues to this day, even if in considerably diminished form. The evolution of development banking occurred in three phases. The first phase, which involved the creation and consolidation of a large infrastructure, began with Independence and extended to 1964, when the Industrial Development Bank of India was established. As institutions were established, the scope of development banking in India increased, but even in 1970-71 disbursements by all financial institutions (including investment institutions such as the Life Insurance Corporation [LIC], Unit Trust of India [UTI] and General Insurance Corporation [GIC]) amounted to just 2.2 per cent of gross capital formation.<sup>1</sup>

The second period stretched from 1964 to the middle of the 1990s, when the role of the DFIs gained in importance, with the assistance disbursed by them amounting to 10.3 per cent of Gross Capital Formation in 1990-91 and 15.2 per cent in 1993-94. Thirdly, after 1993-94, the importance of development banking declined. This was particularly sharp after 2000-01, as liberalisation resulted in the exit of some firms from development banking and in a reduction in the resources mobilised by other firms. By 2011-12, assistance disbursed by the DFIs amounted to just 3.2 per cent of Gross Capital Formation.

In the first two periods, the nature of the DFIs, their mandate and the way they obtained resources marked them out as entities that were part of a *dirigiste* regime. During those years, the Indian government followed a highly interventionist development strategy, with controls on trade and foreign investment, regulation of investment choices and decisions, strong exchange rate management and a large public sector.

It is true that even during this period the World Bank, the Asian Development Bank, the International Financial Corporation and bilateral aid institutions were important providers of finance to India. But they did not approve of India's interventionist strategy, and the World Bank was even wary of lending to the public sector for a long time. Thus, India's development finance institutions were also important from the point of view of the state's ability to pursue its own independent strategy, however inadequate that may subsequently have proved.

However, the institutional changes needed to successfully implement the strategy these interventions sought to advance were never made. This was especially true of land reform, the role of which was seen as crucial because productivity increase in agriculture was hampered by land monopoly and predatory absentee landlordism.

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<sup>1</sup> Figures computed from information provided in Tables 13 and 83 of Reserve Bank of India (2013).

Moreover, the desire to “catch up” with developed countries through an emphasis on factory-based industrialisation meant that there was considerable neglect of agriculture, which was seen as a “bargain sector” that would deliver additional output without much investment, largely based on never-implemented institutional changes such as land reform and subsequent cooperativisation (Chandrasekhar 2011). Further, there was little concern for sustainability and the environment, with large projects (such as big dams, chemical plants, power projects and large scale mining) being pushed through despite their adverse environmental effects, with little effort made to mitigate those effects.

### *The Transformation of Indian Finance*

The pattern of financing of investment began to change in the 1980s when the availability of foreign finance from the private financial market (as opposed to the bilateral and multilateral development aid network) opened up, largely because of changes in the international financial system. That access was seen as providing an opportunity to pursue a more outward-oriented development strategy based on all-round liberalisation and deregulation. The balance of payments crisis of 1991 served as the trigger for that transition. An important component of the resulting “economic reform” was financial liberalisation that provided for a growing role for domestic and foreign firms in the financial sector, and offered all financial institutions greater flexibility in mobilising resources and lending and investing them. It was at this point that these domestic and foreign private institutions resented the ability of the DFIs to obtain concessional finance to fulfil their mandate, and thereby compete with them and keep them out of areas that they were earlier least interested in entering, but were now looking to enter.

The resulting pressure to create a ‘level playing field’, to which the government succumbed not because that was unavoidable but because of its own commitment to liberalisation reflected in the Narasimham Committee reports of the 1990s (especially Narasimham 1998), triggered the process of transforming leading development financial institutions into commercial banks, starting with the Industrial Credit and Investment Corporation of India (ICICI) in 2002 and the Industrial Bank of India (IDBI) in 2004. Though the period since then is relatively short, India’s experience during the heyday of development banking and during its early phase of decline is a significant resource for any assessment of the role that specialised institutions can play in the development process.

### *The Institutional Framework*

Over the years, India has created a rather elaborate development banking structure. A number of development banks were established over time, catering to different segments of industry and/or different regions or just adding to the stock of institutions engaged in this activity. The process started immediately after Independence, with the setting up of the Industrial Finance Corporation (IFCI) in July 1948 to undertake long term term-financing for industries.<sup>2</sup> In addition, State Financial Corporations (SFCs) were created under an Act that came into effect from August 1952 to encourage state-level, small and medium-sized industries with industrial credit. In January 1955, the Industrial Credit and Investment Corporation of India (ICICI), the first development finance institution in the private sector, came to be established with the encouragement and support of the World Bank in the form of a long-term foreign exchange loan; it was also backed by

<sup>2</sup> In 1975, the IFCI set up a Risk Capital Foundation in the form of the IFCI Venture Capital Fund to provide soft loans to first generation and technocrat entrepreneurs. IVCF later managed funds of the Venture Capital Unit Scheme of the Unit Trust of India.

a similar loan from the US government financed out of PL 480 counterpart funds.<sup>3</sup> In June 1958, the Refinance Corporation for Industry was set up, which was later taken over by the Industrial Development Bank of India (IDBI). Other specialised financial institutions that were set up included the Agriculture Refinance Corporation (1963), Rural Electrification Corporation Ltd. and HUDCO. Two other major steps in institution building were the setting up of IDBI as an apex term-lending institution and the Unit Trust of India (UTI) as an investment institution; both commenced operations in July 1964 as subsidiaries of the Reserve Bank of India.

That the development banks were special institutions was reflected in the role the central bank had in the development-financing infrastructure. An Industrial Finance Department (IFD) was established in 1957 within the Reserve Bank of India (RBI) and the central bank began administering a credit guarantee scheme for small-scale industries from July 1960. With a view to supporting various term-financing institutions, the RBI set up the National Industrial Credit (Long-Term Operations) Fund from the year 1964-65.

There were also new initiatives at the state level in the 1960s. State governments setup State Industrial Development Corporations (SIDCs) to promote industrial development in their territories. Subsequently, with evidence of growing “sickness” in certain sectors, the Industrial Reconstruction Corporation of India Ltd (IRCI) was established in 1971, and converted into a statutory corporation named the Industrial Reconstruction Bank of India in 1985, with the specific objective of reviving sick and ailing industrial units. Originally established by an Act of Parliament, it was incorporated under the Companies Act in 1997.

Specialised financial institutions set up after 1974 included NABARD (1981), EXIM Bank, which took over some functions related to export-oriented units from IDBI (1982), Shipping Credit and Investment Company of India (1986) (later merged into ICICI Ltd. in 1997), Power Finance Corporation and Indian Railway Finance Corporation (1986), Indian Renewable Energy Development Agency (1987), Technology Development and Information Company of India, a venture fund later known as IFCI Venture Capital Funds Ltd. and ICICI Venture Funds Management Ltd. (1988), National Housing Bank (1988), the Tourism Finance Corporation of India, set up by IFCI (1989), Small Industries Development Bank of India (SIDBI), with functions relating to the micro, medium and small industries sector taken out of IDBI (1989), North Eastern Development Finance Corporation (NEDFi) (1995) and IDFC (1997).

According to the RBI’s Working Group on DFIs, “DFIs can be broadly categorised as all-India or state/regional level institutions depending on their geographical coverage of operation. Functionally, all-India institutions can be classified as (i) term-lending institutions (IFCI Ltd., IDBI, IDFC Ltd., IIBI Ltd.) extending long-term finance to different industrial sectors, (ii) refinancing institutions (NABARD, SIDBI, NHB) extending refinance to banking as well as non-banking intermediaries for finance to agriculture, SSIs and housing sectors, (iii) sector-specific/specialised institutions (EXIM Bank, TFCI Ltd., REC Ltd., HUDCO Ltd., IREDA Ltd., PFC Ltd., IRFC Ltd.), and (iv) investment institutions (LIC, UTI, GIC, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Co Ltd.). State/regional level institutions are a distinct group and comprise various SFCs, SIDCs and NEDFi Ltd.” (RBI 2004: Section 1.4.3).

<sup>3</sup> Public Law 480 enacted in 1954 in the US allowed for the use of surplus agricultural produce (especially wheat) from the US as food aid to developing countries through sale at concessional terms including payment in local currency, with the local currency funds being used for US diplomatic and development expenditure in the country concerned.

The average annual assistance provided by the leading development financial institutions rose from Rs. 29 million during 1948-52 to Rs. 137 million during the five years that followed (1953-57) and Rs. 450 million during 1958-62. This growth then accelerated to take the annual average assistance to Rs.1088 million during 1963-66 and Rs. 1442 million during 1967-71 (Kumar 2013).

But the post-1972 period witnessed a phenomenal rise in financial assistance provided by these institutions (including investment institutions), with the average annual assistance disbursed rising from Rs. 2.5 billion during the period from 1971-72 to 1973-74 to Rs. 25.8 billion during 1980-81 to 1982-83, Rs. 199.65 billion in 1990-91 to 1992-93, Rs. 542.28 billion in 2000-01 to 2002-03 and Rs. 925.39 billion in 2010-11 to 2012-13 (RBI 2013: Table 83). The figures adjusted for inflation (using the deflator for capital formation in the National Accounts Statistics) are Rs. 6.6 billion during the period from 1971-72 to 1973-74 to Rs. 16.1 billion during 1980-81 to 1982-83, Rs. 41.3 billion in 1990-91 to 1992-93, Rs. 83.8 billion in 2000-01 to 2002-03 and Rs. 137 billion in 2010-11 to 2012-13.

As is clear from Table 1, disbursement of assistance by all-India institutions rose continually till 2000-01, after which it collapsed, as the DFIs were transformed or closed. Even small industry-focused financial institutions saw a decline after 2000 for a short period, but registered a robust revival as the SIDBI took on an important role. The other major change was the growing importance of the investment institutions (the LIC, GIC and UTI) in financing development. What needs to be noted, however, is that even these institutions were publicly owned, at least till the collapse of UTI in 1998.

Table 2 provides a picture of the relative roles of different kinds of institutions in development financing since 1970, by which time the various development financing institutions had been established and consolidated. In the early 1970s and till the end of the 1980s, the All India Financial Institutions (IDBI, ICICI, and IFCI) dominated disbursements of resources, accounting for between two-thirds and almost three-quarters of total disbursements. During this time the specialised institutions set up to support small and medium industries at the state and national levels (SIDBI, the SFCs and the SIDCOs) accounted for between 15 and 30 per cent of disbursements and the investment institutions (LIC, GIC and UTI) saw their share rising from less than 10 to about 20 per cent.

In the second phase, stretching from the start of liberalisation to the transformation of the ICICI and IDBI into commercial banks (2002-2004), the share of the All India FIs fell from two-thirds to just 30 per cent, that of the small industry financing institutions remained more or less stable and that of the investment institutions rose to pick up the slack. Finally, after 2004, the share of the All India FIs collapsed to a low of 1.7 per cent in 2012-13 and that of the small industry financiers and the investment institutions rose to 46 and 52 per cent respectively.

The importance of these institutions is clear from the fact that their investments (disbursements) as a proportion of Net Domestic Capital Formation in India rose from less than 5 per cent in the early 1970s to around 24 per cent in 2000-01.<sup>4</sup> Over 70 per cent of disbursements went to the private sector, and took the form of loans as well of underwriting and the direct subscription of shares and debentures. Aggregate disbursements as a ratio of net capital formation in the private sector rose from 24 per cent in 1970-71 to 80 per cent just before the 1991 crisis. The role of some of these

<sup>4</sup> Computed using figures from RBI (2013).



organisations, such as the IFCI and the IDBI, was particularly important in promoting capital formation. This provision of long-term industrial finance was indeed a major source of support for investments in the country, and constituted an important way in which the limitations of the financial structure as it evolved under colonialism was sought to be addressed, and finance was made a tool of development.

**Table 1: Disbursals by Principal DFIs by Category (Rs. Billion)**

	All India Fis	Small industry Fis	Special purpose	Venture	Investment Instns	
	IDBI, ICICI, IFCI	SIDBI, SFCs, SIDCs	IIBI, SCICI, TFC	IVCF, ICICI Venture	LIC, GIC, UTI	Total
1970-71	1.04	0.45	0.00	0.00	0.13	1.62
1971-72	1.34	0.54	0.01	0.00	0.07	1.96
1972-73	1.49	0.61	0.04	0.00	0.20	2.34
1973-74	2.12	0.75	0.05	0.00	0.28	3.21
1974-75	2.86	1.06	0.08	0.00	0.62	4.62
1975-76	3.19	1.25	0.05	0.00	0.32	4.82
1976-77	4.64	1.40	0.11	0.00	0.45	6.60
1977-78	5.59	1.52	0.09	0.00	0.59	7.80
1978-79	8.01	1.95	0.13	0.00	0.52	10.61
1979-80	9.80	2.70	0.13	0.01	1.87	14.50
1980-81	15.53	3.73	0.17	0.01	1.61	21.03
1981-82	19.38	5.09	0.28	0.01	2.32	27.09
1982-83	20.73	6.12	0.38	0.01	2.03	29.27
1983-84	25.35	6.72	0.41	0.01	3.65	36.14
1984-85	28.65	7.95	0.55	0.01	5.08	42.24
1985-86	36.84	9.73	0.68	0.02	8.98	56.24
1986-87	44.06	12.17	0.95	0.03	9.39	66.60
1987-88	54.33	13.91	1.62	0.04	11.53	81.43
1988-89	54.65	15.27	2.54	0.08	16.12	88.67
1989-90	76.00	17.02	3.80	0.15	16.52	113.48
1990-91	80.43	37.08	3.60	0.19	28.39	149.68
1991-92	97.25	42.43	4.04	0.26	42.09	186.07
1992-93	117.59	43.98	7.30	0.33	94.00	263.21
1993-94	146.72	49.37	12.74	0.32	78.77	287.92
1994-95	203.90	63.22	19.76	1.11	65.14	353.12
1995-96	223.79	89.51	31.60	0.63	65.01	410.54
1996-97	278.06	88.69	7.32	0.45	71.23	445.76
1997-98	366.27	87.67	13.40	0.38	86.12	553.84
1998-99	385.15	100.86	18.21	0.29	96.47	600.97
1999-00	461.67	105.47	15.51	1.48	127.64	711.78
2000-01	512.98	100.85	17.70	1.93	127.93	761.39
2001-02	379.18	76.69	11.55	7.82	116.49	591.73
2002-03	83.95	94.94	11.87	3.96	79.02	273.73
2003-04	52.65	52.71	22.87	3.61	169.89	301.73
2004-05	62.75	61.88	0.72	0.00	89.72	215.06
2005-06	1.87	91.00	0.88	0.00	117.71	211.46
2006-07	5.50	102.25	1.20	0.00	277.57	386.53
2007-08	22.80	150.99	1.89	0.00	284.61	460.29
2008-09	33.12	283.18	2.76	0.07	623.57	942.70
2009-10	60.45	319.42	2.93	0.27	537.60	920.67
2010-11	84.00	387.96	3.79	1.30	401.42	878.47
2011-12	56.80	418.12	5.63	2.86	519.68	1003.09
2012-13	15.04	406.82	3.43	2.81	466.52	894.62

Source: RBI (2013), Table 83

**Table 2: Shares of Different Categories of Institutions in Development Financing Disbursals (%)**

	All India FIs	SIDBI, SFCs, SIDCs	Special purpose	Venture	Investment Institutions	Total
1970-71	64.3	27.6	0.0	0.0	8.2	100.0
1971-72	68.3	27.6	0.6	0.0	3.5	100.0
1972-73	63.9	26.2	1.5	0.0	8.4	100.0
1973-74	66.3	23.5	1.6	0.0	8.6	100.0
1974-75	61.9	23.0	1.7	0.0	13.4	100.0
1975-76	66.3	26.0	1.0	0.0	6.7	100.0
1976-77	70.3	21.3	1.6	0.0	6.8	100.0
1977-78	71.8	19.5	1.2	0.0	7.5	100.0
1978-79	75.5	18.4	1.2	0.0	4.9	100.0
1979-80	67.6	18.6	0.9	0.0	12.9	100.0
1980-81	73.8	17.7	0.8	0.0	7.6	100.0
1981-82	71.6	18.8	1.0	0.0	8.6	100.0
1982-83	70.8	20.9	1.3	0.0	6.9	100.0
1983-84	70.1	18.6	1.1	0.0	10.1	100.0
1984-85	67.8	18.8	1.3	0.0	12.0	100.0
1985-86	65.5	17.3	1.2	0.0	16.0	100.0
1986-87	66.2	18.3	1.4	0.0	14.1	100.0
1987-88	66.7	17.1	2.0	0.0	14.2	100.0
1988-89	61.6	17.2	2.9	0.1	18.2	100.0
1989-90	67.0	15.0	3.3	0.1	14.6	100.0
1990-91	53.7	24.8	2.4	0.1	19.0	100.0
1991-92	52.3	22.8	2.2	0.1	22.6	100.0
1992-93	44.7	16.7	2.8	0.1	35.7	100.0
1993-94	51.0	17.1	4.4	0.1	27.4	100.0
1994-95	57.7	17.9	5.6	0.3	18.4	100.0
1995-96	54.5	21.8	7.7	0.2	15.8	100.0
1996-97	62.4	19.9	1.6	0.1	16.0	100.0
1997-98	66.1	15.8	2.4	0.1	15.5	100.0
1998-99	64.1	16.8	3.0	0.0	16.1	100.0
1999-00	64.9	14.8	2.2	0.2	17.9	100.0
2000-01	67.4	13.2	2.3	0.3	16.8	100.0
2001-02	64.1	13.0	2.0	1.3	19.7	100.0
2002-03	30.7	34.7	4.3	1.4	28.9	100.0
2003-04	17.4	17.5	7.6	1.2	56.3	100.0
2004-05	29.2	28.8	0.3	0.0	41.7	100.0
2005-06	0.9	43.0	0.4	0.0	55.7	100.0
2006-07	1.4	26.5	0.3	0.0	71.8	100.0
2007-08	5.0	32.8	0.4	0.0	61.8	100.0
2008-09	3.5	30.0	0.3	0.0	66.1	100.0
2009-10	6.6	34.7	0.3	0.0	58.4	100.0
2010-11	9.6	44.2	0.4	0.1	45.7	100.0
2011-12	5.7	41.7	0.6	0.3	51.8	100.0
2012-13	1.7	45.5	0.4	0.3	52.1	100.0

## *Policy Banks*

It soon became apparent that development banking of the kind described above was not in itself adequate to cater to all of the country's needs. This is because the financial structure must not only contribute to growth by directing investment to crucial investment projects, but it must facilitate broad-based development by delivering credit to sectors that might otherwise be ignored by the financial sector. A typical example of this, for example, is small peasant farming. Credit to support agricultural operations that are seasonal in delivery of produce and subject to much volatility is crucial. But providing credit in small volumes to dispersed and often remotely located borrowers increases transaction costs substantially. Further, the volatility of production, especially in rain-fed agriculture, often results in costly restructuring or large-scale defaults. This implies that the risk premium associated with such lending would also be high.

If these transaction costs and risk premiums are to be reflected in interest rates charged on loans, rates could be so high that the loans concerned cannot be used for productive purposes. This implies that returns on lending to sectors such as these would be significantly lower than normal. This would require the state to intervene in one of many ways. It could insist on "social banking" on the part of ordinary banks, set low ceilings on interest rates chargeable to priority sectors and provide a subsidy in the form of interest rate subvention. Or it could require public banks to lend at low interest rates and cross-subsidise such lending with returns on normal commercial operations. This would imply that the returns expected of such banks would be lower than a normal purely "commercial" benchmark. Or it could create specialised development banks, which are provided state funds at extremely low interest rates to carry out these operations.

Most countries have found that it is best to create separate development banks to provide long-term capital at near-commercial rates and "policy banks" to provide credit to special areas such as agriculture or the small scale sector where interest rates have to be subsidised and grace periods have to be longer. This allows different criteria to be applied to the evaluation of the performance of these banks, with profitability a more important consideration in the case of the former.

Thus, in the sphere of agricultural credit in India, apart from setting up two funds in 1955, namely, the National Agricultural Credit (Long-Term Operations) Fund and National Agriculture Credit (Stabilisation) Fund from out of the profits of the RBI to support the cooperative credit structure, the Agriculture Refinance and Development Corporation (ARDC) was set up in 1975. Subsequently the government established the National Bank for Agriculture and Rural Development (NABARD) in 1981 to provide refinance for institutions engaged in lending in rural areas and coordinating their activities. What does appear to have happened is that during the 2000s, while the importance of the All India DFIs has declined, the government has turned to using the specialised policy banks to direct credit to special interest groups while leaving the role of development finance to the publicly owned investment institutions, the public sector banks (see below) and the private capital market.

## **Assessment of Key Institutions and Policies**

However, till the onset of liberalisation, the development finance institutions were a key element of India's overall development strategy. When India won Independence from the British, it chose to adopt a development path that was unusual and perhaps unique. Despite the country's low level

of per capita income, its geographical vastness, its large population and its social diversity, the government decided to pursue a state-led strategy of development with a central role for development planning, but within the framework of a mixed economy that gave the private sector an important role on the one hand, and a quasi-federal parliamentary democracy, on the other. All of these features, especially the last, garnered interest in the Indian development experiment among observers from across the world.

There were two important and even conflicting elements to that strategy. First, since India's capitalist class was still to consolidate itself in full, the state needed to support the development process with its own investments and channel resources to support the investments of the private sector. That is, the state had to serve as a facilitator and backer of private investment. Second, since development planning had to take into account the societal goals of a spatially and vertically unequal society, the state needed to guide investment in socially desired directions and regulate private capital to ensure it also delivered social benefits rather than merely serving private interest.

This was to be achieved by vesting the responsibility for formulating policy and monitoring implementation in one overarching body. Thus, the Planning Commission in India became a powerful body that not only drew up five year and perspective plans, but had an important say in the policies adopted and pursued by the different ministries and departments that it vetted and monitored. Inasmuch as those policies were aimed at influencing the level and allocation of private investment, the Planning Commission had an impact on the pattern of private sector development. But the government's role was not only regulatory. In its promotional role, it invested to establish the infrastructure and create capacities in sectors that were crucial to development but were characterised by lumpy investments, long gestation lags and low returns. It also provided finance, R&D support and technical assistance to the nascent industrial class. Development financing, delivered through the institutions and framework described earlier was an important component of that institutional support.

An important aspect of the state's intervention was the effort to change how the surplus was utilised. Besides using physical controls such as licensing and foreign exchange allocation, there were four other means through which the state sought to indirectly influence the allocation of the nation's savings. The first was by pre-empting a significant part of the resources mobilised by the banking system, which, other than for the State Bank of India and its subsidiaries, was largely private. A Statutory Liquidity Ratio (SLR), or the proportion of the net demand and time liabilities (or demand deposits and time deposits) of the banking system that had to be invested in gold or "approved securities" was specified. The SLR was set at 20 per cent in 1949, 25 per cent in 1964 and rose to a peak of 38.5 per cent in 1990, before declining under the influence of economic reform to 23 per cent in 2012. While this marked a decline in the extent of pre-emption after liberalisation, India still resorts to this policy to a far greater extent than other countries. However, since the 1980s much of the government's borrowing from the banking system supports its revenue or current expenditures rather than being spent on capital formation. Since the approved securities consisted largely of government securities and public sector bonds, the government was in essence drafting a share of bank deposits for government-designated expenditure and investments.

Second, the government nationalised the insurance companies and used its control over the savings they mobilised to direct resources to priority areas of investment. Third, finding itself unable to influence the allocation of resources mobilised and available to the private banking system, the government chose to nationalise 14 banks in 1969 and another seven in 1980. Finally, using a part of its budgetary resources and some of the 'profits' of the Reserve Bank of India, the state provided development finance institutions the seed money, which they could then leverage, to undertake the financing activities they were mandated to pursue.

### *Financing of the DFI*

Given the nature of and the role envisaged for the development finance institutions created prior to 1980, it was to be expected that the government and the RBI would play an important role in providing them resources. In addition, public banks and the LIC and GIC would also play a role. As is made clear by Table 3, the former two sources accounted for a significant share of resources mobilised by all the All India Financial Institutions, especially the leading institution, IDBI. It shows that the RBI was a major funder of the IDBI. Given its private character and the role envisaged for it, the role of the government and the RBI in financing ICICI declined sharply after the mid-1960s, as expected.

**Table 3: Share of Government and RBI in Total Liabilities of Different DFIs (%)**

	1965	1971	1975	1980
IFCI	36.75	40.84	25.20	6.00
ICICI	42.65	20.81	8.75	1.12
IDBI	82.08	80.57	71.75	47.61
IRCI			43.48	49.43
SFCs	14.63	22.09	28.78	37.54

*Source: RBI quoted in Kumar (2013)*

Access to state funding prior to the reform meant that the development finance institutions were in a position to mobilise resources at interest costs that were much lower than they would have been if they had relied on market sources. This also allowed them to lend at rates that were reasonable from the point of view of the industrial and infrastructural sectors. That made them the first port of call for finance for Indian businesses, which did substantially benefit from the financial support provided by the government in the years before the 1990s. However, it was found that the big business groups were able to garner a disproportionate share of the disbursements made by these institutions, when compared to the share of the former in paid-up capital and sales.

With the government being an important source of finance, it was to be expected that it would exert control over the functioning of these institutions and in determining the leadership of these organisations. This did imply that some political and partisan considerations affected the functioning of the DFIs. It also implied that these institutions were partly protected from close scrutiny by members of parliament and scrutiny by members of parliament and other representatives of the people, since protecting the DFIs was a means of protecting the political executive as well.

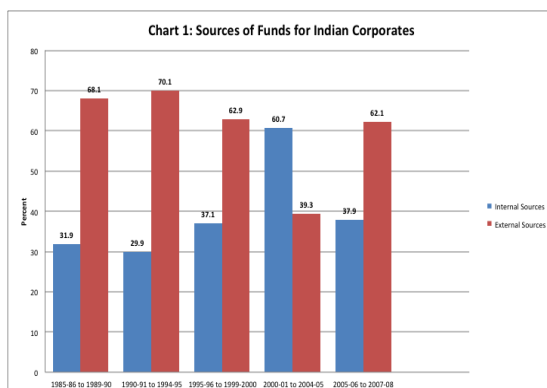
What is interesting is that the government did not use this influence to exert control over the firms the DFIs were involved with. The DFIs, by virtue of providing equity and credit to their clients were eligible to have their nominees on the board of directors of the units concerned. However, in most instances in India, DFI nominees were not merely a passive presence on the boards, but tended to support the incumbent management (who were their original clients) in any battle for corporate control. This meant that, even in cases where there was evidence of mismanagement, the proactive and corrective role of the nominees of the DFI was an exception. This was a major failing, because it was the DFI nominees who could have played a role in setting social, environmental and governance standards and overseeing their implementation, since they were public bodies who could ensure that social benefit was not always trumped by the interests of private profit.

### *New Sources of Finance*

The transformation and shrinkage of the development financing architecture after liberalisation raises a question. Since the requirement for long-term, external financing is unlikely to have completely disappeared, where did the new financing come from? One source of financing was an increased role for internal funds. In fact, internal sources such as retained profits and depreciation reserves accounted for a much higher share of corporate finance during the equity boom of the first half of the 2000s. According to RBI figures (Chart 1), internal sources of finance which accounted for about 30 per cent of total corporate financing during the second half of the 1980s and the first half of the 1990s, rose to 37 per cent during the second half of the 1990s and a record 61 per cent during 2000-01 to 2004-05. Though that figure fell during 2005-06 to 2007-08, it still stood at a relatively high 56 per cent.

Among the factors explaining the new dominance of internal sources of finance, three are of importance. The first of these is increased corporate surplus resulting from enhanced sales and a combination of rising productivity and stagnant real wages (Chandrasekhar 2013). The second is a lower interest burden resulting from the sharp decline in nominal interest rates as compared to the 1980s and early 1990s. Reduced tax deductions because of tax concessions and loopholes form the third factor. These factors have combined to leave more cash in the hands of corporations for expansion and modernisation.

Along with the increased role for internally generated funds in corporate financing in recent years, the share of equity capital mobilised from the capital market in all forms of external or outside finance has also been on the decline. An examination of the composition of external financing (measured relative to total financing) shows that the share of equity capital in total financing that had risen from 7 to 19 per cent between the second half of the 1980s and the first half of the 1990s, subsequently declined to 13 and

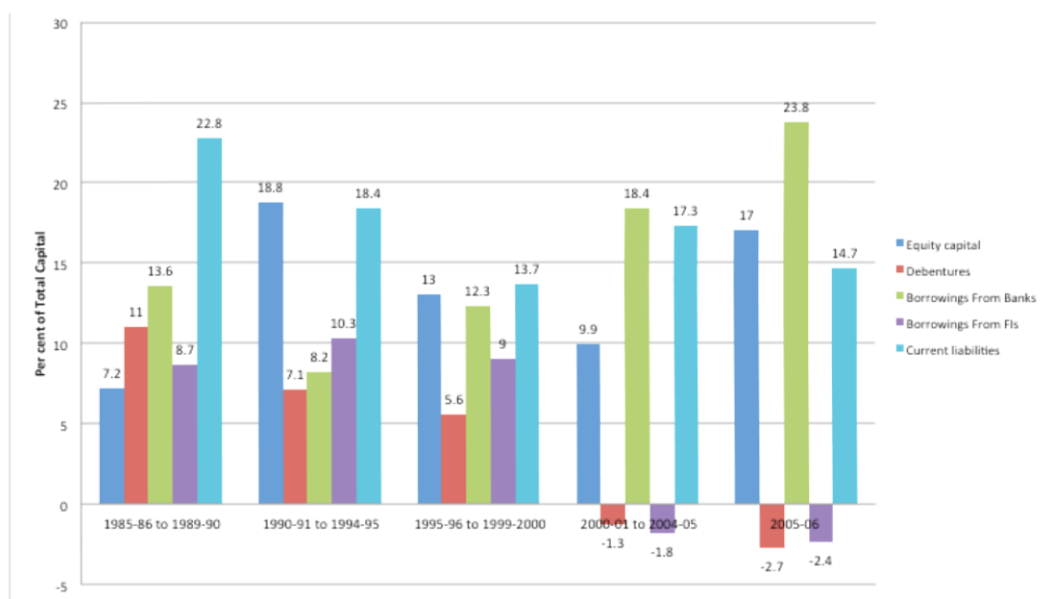


10 per cent respectively during the second half of the 1990s and the first half of the last decade (Chart 2). Further, between 2003-04 and 2006-07, which was a period when FII inflows rose significantly and stock markets were buoyant most of the time, equity capital mobilised by the Indian corporate sector rose from Rs. 676.2 billion to Rs. 1.77 trillion (Chart 3).

Not all of this was raised through instruments issued in the stock markets. In fact, a predominant and rapidly growing share amounting to a whopping Rs. 1.46 trillion in 2006-07 was raised in the private placement market involving, inter alia, negotiated sales of chunks of new equity in firms not listed in the stock market to financial investors of various kinds, such as merchant banks, hedge funds and private equity firms. While not directly a part of the stock market boom, such sales were encouraged by the high valuations generated by that boom and were as in the case of stock markets made substantially to foreign financial investors.

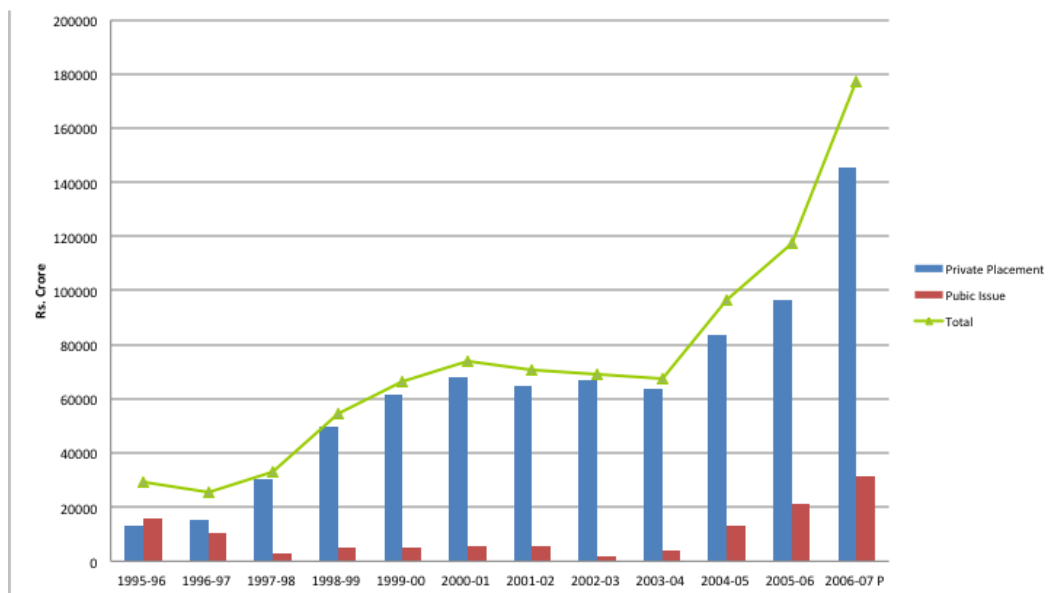
Private placement also helped raise debt capital. According to the Securities and Exchange Board of India (SEBI), resources mobilised through the private placement of bonds rose from Rs. 1,185 trillion in 2007-08 to Rs. 3,615 trillion in 2012-13. The public issue of bonds, on the other hand, mobilised just Rs. 170 trillion in the latter year. As a result of the surge in private placement, outstanding bond-based corporate debt in India is reported by SEBI to have risen from Rs. 7,520 trillion at the end of March 2010 to Rs. 12,901 trillion at the end of March 2013.

**Chart 2: Components of External Capital**



The dominance of private placement in new equity issues is to be expected since a substantial number of firms in India are still not listed in the stock market. On the other hand, free-floating (as opposed to promoter-held) shares are a small proportion of total shareholding in the case of many listed firms. If, therefore, there is a sudden surge of capital inflows into the equity market, the rise in stock valuations would result in capital flowing out of the organised stock market in search of equity supplied by unlisted firms. The only constraint to such spillover is the cap on foreign equity investment placed by the foreign investment policy of the government.



**Chart 3: Mobilisation of Capital Through Equity Issues**

However, it is not clear whether these sources can meet the financing requirements for infrastructural development in India. According to the official High Level Committee on Financing Infrastructure (Planning Commission 2012), infrastructural spending during the Tenth Plan (2002/03-2006/07) amounted to Rs. 9,161 billion at 2006-07 prices. On the other hand, projections for the Eleventh Plan placed investment during 2007/08-2011/12 at Rs. 20,562 billion, of which 95 per cent or Rs.19,448 billion had been realised. This compares with disbursement in constant 2005-06 prices of Rs. 1,473 billion by leading financial institutions during the Tenth Plan, and Rs. 3,417 billion during the Eleventh Plan. Not surprisingly, the share of public investment in the financing of infrastructural investment was 78 per cent during the Tenth Plan and 62 per cent during the Eleventh. Thus, public funding, including direct funding from the government's budget, accounts for a significant share of infrastructural investment, though private investment has risen in importance.

One route through which private funding occurs is public-private partnerships, which have grown in importance. According to the Planning Commission (2013), the World Bank has found that "India has been the top recipient of Private Participation in Infrastructure (PPI) activity since 2006 and has implemented 43 new projects which attracted total investment of US\$20.7 billion in 2011. India alone accounted for almost half of the investment in new PPI projects in developing countries implemented in the first semester of 2011. The Report maintained that India remained the largest market for PPI in the developing world. In the South Asian region, India attracted 98 per cent of regional investment and implemented 43 of the 44 new projects in the region." Clearly, this success is not unrelated to the willingness of the government to contribute substantially to these projects as investor and provider of support such as Viability Gap Funding under a scheme notified in 2006 "to enhance the financial viability of competitively bid infrastructure projects which are justified by economic returns, but do not pass the standard thresholds of financial returns." (Planning Commission 2013).

There is also a group of new institutions that have been set up to provide long-term finance, often created with sponsorship from the state. Important among them is IDFC, created on the basis of the recommendation of the 'Expert Group on Commercialisation of Infrastructure Projects' in 1997. In 2003, IDFC raised \$200 million for the India Development Fund, which was an 'infrastructure-focused private equity fund'. It has since gone to market repeatedly to raise resources. By 2009, the company (which by then had gone public and been listed) had lent more than Rs. 200 billion (Rs. 20,000 crore) to 200 projects. IDFC is today India's predominantly private infrastructure financing company with the government's equity share down to just 18 per cent.

Another infrastructure company set up with government sponsorship was the India Infrastructure Finance Company Ltd (IIFCL), which commenced operations in 2006. The company supports infrastructure projects with direct lending, refinancing and takeout financing. Till the end of March 2013 the company had assisted 299 projects with sanctions of Rs. 51,88.87 billion and disbursements of Rs. 265.82 billion.

In 1987, the Central Bank of India (CBI), Housing Development Finance Corporation Limited (HDFC) and Unit Trust of India (UTI) promoted Infrastructure Leasing & Financial Services Ltd (IL&FS) with the mandate to promote infrastructural investment in the country. As of now Orix Corporation, Japan (23.3 per cent), Abu Dhabi Investment Authority (11.2 per cent), HDFC (9.9 per cent), Central Bank of India (8.4 per cent) and the State Bank of India (7.06 per cent) are the main shareholders.

Thus, over a period of time a set of quasi-public and large private companies are being given the task of financially supporting infrastructural development in India. However, thus far, the burden of financing has fallen on the government. In fact, according to some observers the benefits of infrastructure promotion are garnered by the private sector and the costs borne by the government. When projects prove unviable, public or government-sponsored entities suffer losses. But when profits are made, it is the private sector that benefits. With government finances under strain, this route to financing infrastructure development may prove difficult to sustain. Public investment financed with tax revenues seems to be the obvious but little favoured route to infrastructural provision.

### *Multilateral Agencies and Infrastructure Finance*

These trends on the domestic financial front have been considerably strengthened by the support they have received from multilateral institutions like the World Bank, the Asian Development Bank and the International Finance Corporation. While World Bank support for infrastructural investment in South Asia in general and India in particular fell from \$9.5 billion in 1993 to \$5.5 billion in 2002, partly because of evidence of damaging environmental effects, there has been a revival since then. Currently the World Bank is engaged in setting up a new Global Infrastructure Facility, which will combine Bank funds with investments by sovereign wealth funds and pension funds in securities floated by the bank, to finance infrastructure in developing countries. The ADB too has been an important player and recently (in October 2013) approved a \$700 million facility to support the Government of India's drive to substantially increase infrastructural investment in the country.

## *Commercial Banks and Infrastructure Development*

Finally, what is noteworthy is that, with the decline of development banking and, therefore, of the provision of finance by the financial institutions (which have been converted into banks), the role of commercial banks in financing the corporate sector has risen sharply to touch 24 per cent of the total in 2003-04. Scheduled bank credit to large and medium industries rose by 727 per cent over 10 years ending in March 2012-13, i.e., it grew at a compound rate of 25 per cent per annum. This compares with an increase of 266 per cent and an annual growth rate of 14 per cent over the preceding ten years. The ratio of scheduled commercial bank credit to GDP, which fluctuated in the 20-22 per cent range right through the 1990s, rose from there to exceed 55 per cent by 2012. This occurred during the period when GDP growth accelerated. As a result, internal resources and bank finance dominate corporate financing and not equity and private development finance, which receive all the attention because of the surge in foreign institutional investment and the media's obsession with stock market buoyancy.

It is true that during this period the share of commercial bank credit flowing to industry had fallen from 48.8 per cent at the end of March 1998 to 39.6 per cent at the end of March 2011. But given the sharp increase in the overall volume of credit, this did imply that the absolute amount of credit flowing to the industrial sector was still high. The real change was in the direction of credit flow within the industrial sector, with a rising share flowing to the infrastructural sector. The figures are dramatic. The share of infrastructural lending in the total advances of scheduled commercial banks to the industrial sector rose sharply, from less than 2 per cent at the end of March 1998 to 16.4 per cent at the end of March 2004 and as much as 31.5 per cent at the end of March 2012 (Chart 4). That is, while the share (though not volume) of lending to industry in the total advances of the banking system has fallen, the importance of lending to infrastructure within industry has increased hugely. Four sectors have been the most important here: power, roads and ports, and telecommunications, and more recently a residual 'other' category, reflecting substantially, in all probability, the lending to civil aviation.

Under normal circumstances banks are not expected to lend much to these areas as it involves significant maturity and liquidity mismatches. As noted earlier, banks draw deposits from savers in small volumes with the implicit promise of low income and capital risk and high liquidity. Infrastructural investments require large volumes of credit and do involve significant income and capital risk, besides substantial liquidity risk. Increased equity flows from corporate or high net worth investors and the expansion of sources of long-term credit like a bond market are thus necessary to support infrastructural investment.

Neither of these, especially the latter, occurred in adequate measure. Rather, the development financial institutions with special access to lower cost financial resources, which were created as providers of long term-finance, were shut down as part of liberalisation. Hence, besides recourse to external commercial borrowing, many infrastructural projects had to turn to the banking system. As is to be expected, private banks have been unwilling to commit much to this risky business. So it is the public banking system (besides a couple of private banks) that has moved into this area, possibly under government pressure, leading to the kind of losses that were exemplified by the collapse of Kingfisher Airlines.

There have been two other sources to which corporates have turned in their search for borrowed resources. One is to the domestic bond market, which, though considered relatively inactive, has in recent years delivered significant funds through the private placement route. The other is to foreign lenders, through the increasingly liberalised external commercial borrowing route that has been energised with tax concessions.

India's external debt has risen sharply, more than doubling over a six-year period from \$172 billion at the end of March 2007 to \$390 billion at the end of March 2013. Much of this \$218 billion increase in outstanding debt is on account of private debt. Sovereign debt rose from \$49 billion to just \$81 billion, falling relative to GDP from 5 to 4.4 per cent between end-March 2007 and 2013. On the other hand, non-government debt rose from \$123 billion to \$308 billion, or from 12.5 per cent of GDP to 16.7 per cent of GDP, accounting for 85 per cent of the increase in debt over those two points in time. Within the latter, External Commercial Borrowing (ECB), which reflects corporate borrowing, rose from \$41.4 billion at the end of March 2007 to \$121 billion at the end of March 2013.

Thus, the gap created by the transformation of development finance was filled in a variety of ways. There was a shift towards bank credit and external commercial borrowing. There was a trend towards the sponsorship of new, non-government or quasi-government development finance institutions, particularly for the infrastructural sector. There was increased reliance on internal resources. And there was a growing role for external commercial borrowing and private equity in corporate financing. All of these had implications that we return to later in this paper.

## Impact / Assessments

In sum, that the development banks were central to the industrialisation and the development effort till the onset of liberalisation cannot be denied. Their resources were crucial and the choice of areas to which they were willing to lend, which was tied to the pattern of development prescribed by the Five Year Plans, ensured that the allocation of investment was moved in directions warranted by larger development goals. Further, with state control and influence over financing, projects that are supported can be chosen to privilege promoters, locations and technologies that would help ensure reduced concentration of economic power, greater regional dispersion of economic activity and the realisation of larger goals such as employment generation, foreign exchange saving and adherence to social and environmental standards. That some of these objectives were indeed kept in mind (however, inadequately) cannot be denied. But addressing the question of the extent of shortfall from some ideal is handicapped by the absence of benchmarks that can be reasonably set. This implies that the extent to which government intervention using the instrumentality of development banks failed is difficult to assess.

However, it is to be expected that the decline of development banking and state presence undermines even the possibility of pursuing goals of the kind mentioned above. If the financial sector is left unregulated, in economies with substantial private assets and an important role for private agents in investment decision-making, market signals would determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This could result in the problems conventionally associated with a situation where private rather than overall social returns determine the allocation of savings and investment.

To start with, the allocation of investment may not be in keeping with that required to ensure a certain profile of the pattern of production needed to ensure sustained growth. An obvious way in which this happens is through inadequate investments in the infrastructural sector characterised most often by lumpy investments, long gestation lags, higher risk and lower profit. Given the “economy-wide externalities” associated with such industries, inadequate investments in infrastructure would obviously constrain the rate of growth.

While factors such as this could limit the rate of growth, the private-profit driven allocation of savings and investment could also affect variables such as the balance of payments, the employment elasticity of output growth, and the regional dispersion of economic activity. It could aggravate the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and direct savings to already well-developed centres of economic activity.

### *Environmental Impact*

An area in which this distortion caused by market-driven lending is visible is environmental protection. Globally, one impact of project financing that has received attention in recent times is the environmental fallout of the projects that are funded. The Finance Initiative of the United Nations Environmental Programme (UNEP) seeks to partner with more than 160 financial institutions across the world and persuade them to take environmental and sustainability concerns on board when deciding on project funding. To that end, a set of Principles of Responsible Investment (PRI) and a Global Reporting Initiative (GRI) have been framed. More recently in 2003, ten leading banks together with the International Finance Corporation (the private sector financing wing of the IMF) declared adherence to the Equator Principles, which are voluntary guidelines for categorising, assessing and managing environmental risks when providing project finance in excess of \$10 million. The Equator Principles are reportedly based on the International Finance Corporation’s (IFC) Performance Standards on Environmental and Social Sustainability, and on the World Bank Group’s Environmental, Health and Safety Guidelines. In India, YES Bank and IL&FS have joined UNEP’s Finance Initiative and IDFC has adopted the Equator Principles. However, it is too early to assess whether this declared commitment does make a difference in practice, especially since there is no formal, independent monitoring mechanism.

Overall, however, initiatives such as these have received only limited attention in India, where the environmental consequences of large projects are required by law to be identified and assessed through an Environment Impact Assessment (EIA) needed for obtaining environmental clearance from the government. The EIA that was an administrative requirement till 1994 was made mandatory for a range of projects through the EIA Notification issued under the Environment Protection Act, 1986. Financial Institutions and banks are not supposed to release funds unless environmental clearance has been obtained. This may be seen as taking the environmental compliance issue out of the purview of the DFIs, and placed in the hands of specialised bodies. Yet, there have been several projects funded by the DFIs that have been extremely controversial from an environment point of view (Mandal and Venatramani 2012).

Topping the list are projects in the power sector, especially hydel projects like the Maheshwar Hydro-Electric Project (HEP). Among the earliest of the Independent Power Projects (IPP), Maheshwar was awarded in 1993 to the Shree Maheshwar Hydel Power Corporation Limited (SMHPCL) set up by the S. Kumar's group, which had a major presence in textiles but no experience in power production. Estimates suggest that the project was expected to adversely affect more than 50,000 people inhabiting 61 villages in the Narmada Valley.

The Madhya Pradesh government signed a power purchase agreement (PPA) with SMHPCL guaranteeing purchase of power from the project for a period of 35 years at a price that, even then, was much higher than prevailing power prices. However the project came under attack from civil society activists right from the beginning because of the displacement it would result in and the adverse impact it would have on the livelihoods of the local population. As a result of the controversy all foreign financial institutions and potential foreign collaborators withdrew from the project, implying that the Rs. 20 billion plus required to bring it to fruition had to be financed locally, with 30 per cent in the form of equity and 70 per cent in debt. The promoters, committed to contributing just 20 per cent of the equity, initially brought in only a fraction of that.

In the event, though the justification for bringing in a private promoter was to save on government financing, the Madhya Pradesh government (directly and through the electricity board), the IFCI, the IDBI, the Power Finance Corporation and a host of public sector banks ended up committing most of the financing required either as a combination of equity and debt, or just plain credit. Further, even though the project was not fully cleared on environmental and rehabilitation grounds, the financial institutions opted for premature disbursements of their contributions.

Unlike many other projects surrounded by environmental controversies, SMHPCL has not been able to start commercial operations, despite having displaced people, only 20 per cent of whom have been compensated. Close to two decades after the signing of the PPA, the MP government is considering cancelling it, and loans provided by the financial institutions have turned into non-performing assets, with no hope of recovery.

The problem occurs not only in the power sector. Another case is, for example, the Lavasa super-high-end residential project launched in 2004 by Hindustan Construction Corporation (HCC) in a hill town near Mumbai. The project has attracted credit from private banks like ICICI Bank and Axis Bank, and not so much from the DFIs, as the project is a real estate undertaking. The Lavasa project is under attack from the Ministry of Environment and Forests (MoEF) for not seeking clearance under the Environment Protection Act (1986) and for violation of the 1994 Environmental Impact Assessment notification. As a consequence the project has suffered huge delays and cost overruns, and has not been able to generate the revenues needed to meet its debt service commitments. Much of the company's debt is now non-performing.

There have, of course, been instances of companies meeting environmental standards. A case in point is Indian Coal Mining Ltd. (ICML), which was set up by the private sector Calcutta Electric Supply Corporation to manage the Sarshathali coal mines leased to it by the Ministry of Coal in 1993 in order to ensure coal supplies to the Budge Budge thermal power plant. The Environmental and Social Impact Assessment study commissioned by ICML set the cost of rehabilitation and resettlement at relatively high levels. ICML has reportedly not only delivered the resources, but used a tri-sector partnership approach—involving the company, government and civil society organisations—to implement the resettlement plan and to oversee afforestation efforts to

compensate for the loss of tree cover as a result of the project. The company has received funding from the International Finance Corporation, which is the principal financier of the project.

### *Role of Civil Society, Judiciary and Government*

Although large projects funded by DFIs and banks have been conscious of environmental impacts and attempted to follow national guidelines or international best practices, this has largely been the result of pressure from civil society, the judiciary and the government. India has had a long history of successful civil society opposition to environmentally damaging projects. An early instance was the Save Silent Valley Movement. In 1970, the Kerala State Electricity Board launched a 240 MW hydroelectric project in Silent Valley, an area of virgin tropical forest stretching over 8950 hectares in Palghat District of the state of Kerala. The project was justified by the power it was expected to deliver to a power-deficit state, the irrigation it would offer across a 100 sq. km. area, and the jobs it would provide to a state afflicted by high levels of unemployment. However, what became clear as a result of the intervention of conservationists and environmental experts was that the project would destroy much of the tropical forest and with it much biodiversity, including the rare lion-tailed macaque.

Despite these warnings the governments at the state and central levels were adamant about going ahead with the project and received much support from the media, with a few exceptions. The project was formally approved in 1973. The official National Committee on Environment Planning and Coordination set up a task force chaired by Zafar Futehally, which while recommending that the project should be scrapped, also specified a set of safeguards that should be adhered to if the government did indeed choose to go ahead with the project. As expected, the government promised to implement those safeguards and decided to proceed with the project.

However, taking the cue from the warnings put out by naturalists, civil society organisations came together to launch the Save Silent Valley Campaign and opposed the project on the streets, through mass educational programmes and in the courts. After a long struggle that lasted nearly a decade the government announced its decision to call off the project and designate Silent Valley as a National Park (Dattatri 2011)

The Silent Valley Movement is seen by many as having provided the inspiration for subsequent civil society resistance to environmentally damaging projects, such as the Narmada Bachao Andolan and the movement against the Tehri dam. Success has not been as marked in all cases, though the tenacity of these movements faced with adamant governments is indeed impressive. The Silent Valley experience also pushed the government to establish an environment clearance procedure involving, as noted earlier, a mandatory environmental impact assessment report to be submitted to the Central Government for any major project that had ecological implications. The EIA has been an important tool used by environmental watchdogs to introduce an element of transparency into project clearances.

There are two other instruments that have been used to monitor government provision of environmental clearance and ensure large projects do not have strongly adverse effects on the environment even if they are not entirely neutral. One is the use of the Right to Information (RTI) Act and procedure to obtain crucial information. The other is to turn to the courts with



public interest litigation. A revealing example of the use of the RTI Act to obtain crucial information is the exercise of this right by Kalpavriksh Environment Action Group to obtain information on environmental impact clearance and monitoring in the case of eight dams: Teesta Low Dams 3 and 4 HEP (West Bengal), Teesta V HEP (Sikkim) Athirappilly HEP (Kerala), Tipaimukh HEP (Manipur), Lower Subansiri and Kameng HEPs (Arunachal Pradesh), Parbati Stage II project (Himachal Pradesh) and Pala Maneri HEP (Uttarakhand) projects.

A case study (Kohli, Menon and Sansariya 2012) on the use of this instrument concludes as follows: “The RTI Act has substantially helped in tracking the environment clearance, wild life related conditions (NBWL) and the compliance of environmental clearance conditions. By and large, there has not been much delay in receiving information or of the responses being incomplete. Since most of these were very specific to projects and did not require any processing of information, the MoEF has been prompt in providing the information. In on going campaigns however, this has been a critical source of information and will continue to be so.”

The experience with the courts has been mixed. There are many instances where the court has come out strongly in favour of environmental protection. A case in point is with respect to the mining industry in Goa. Indiscriminate mining leads to a host of problems such as reduction – or the drying up altogether – of water sources (springs, wells), siltation of agricultural fields with mining silt leading to loss of livelihoods, and dust and noise pollution. These consequences led to a flood of Public Interest Litigation (PIL) cases being filed in the High Court and even directly in the Supreme Court. In one of these cases, for example, the grant of post-facto clearances to industrial projects and mining leases was challenged, leading to an order that required all mining leases and several thousand industrial units to submit themselves for environment assessment. Many other similar victories have been won (Alvares 2009).

However, there have been instances where the courts have been reluctant to intervene. Thus, in 2000, the Supreme Court in its judgement on the Sardar Sarovar Project refused to entertain submissions from the Narmada Bachao Andolan about the environmental effects of large dams. Noting that conditional clearance for the project had been given in 1987, it declared that pleas related to submergence, environment studies and seismicity could not be raised at that late stage.

## Conclusion

The Indian experience thus far seems to be that government regulation, and instruments like the RTI Act and public interest litigation used by civil society activists and democratic forces, rather than guidelines and principles adopted by the development banks, have been the major agents for change with regard to concern for the environmental impact of large projects. However, publicly supported and owned development finance institutions could have, over time and under government and civil society influence, made a difference here. This would have been even more likely when environmental impact assessment is seen as a central feature of planning for development, which is an emerging tendency.

Private financial institutions focused on profit are likely to be less willing to take environmental concerns on board, especially if they result in the loss of profit opportunities or cause a reduction in profitability. But the pressure of activism within a democratic framework is forcing even largely private institutions to voluntarily adopt UNEP’s Finance Initiative guidelines and the Equator principles.

It hardly bears emphasising that a multilateral development bank like the BRICS bank can serve as a developmental catalyst, especially for poorer countries. But such a bank must be provided access to resources at costs that makes the development banking objective feasible, it should be governed by a publicly accountable management and take on board civil society representatives, it should be subject to social and environmental benefit goals and not just profitability requirements, and it should explicitly incorporate concerns such as sustainability into its agenda. India's experience with development banking suggests that it would be inclined to promoting greater private participation in financing the bank's activities and favour lending to projects that directly or indirectly ensure private profit rather than social benefit. Moreover, it is unlikely to emphasise environmental and social concerns when lending and investment decisions are made.

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# Development Finance in the BRICS Countries: A Review from China



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## Introduction

As the world recovers from the turmoil of the financial crisis, emerging economies are increasingly calling for a more equal say in global economic governance. In March 2013, at the conclusion of their fifth annual summit in Durban, South Africa, the leaders of the BRICS nations (Brazil, Russia, India, China and South Africa) issued the *eThekweni Declaration*, which set out an action plan for future BRICS cooperation. The declaration made clear that as the development and reform of the global economy continues, BRICS countries will push to make their voices heard. Setting the tone for the future direction of BRICS cooperation, the declaration stated:

*The prevailing global governance architecture is regulated by institutions which were conceived in circumstances when the international landscape in all its aspects was characterised by very different challenges and opportunities. As the global economy is being reshaped, we are committed to exploring new models and approaches towards more equitable development and inclusive global growth by emphasising complementarities and building on our respective economic strengths. (Fifth BRICS Summit 2013)*

The *eThekweni Declaration* announced that an agreement had been reached among BRICS members to establish a joint development bank aimed at “mobilizing resources for infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries”. At the same time, a BRICS Business Council was launched in order to encourage investment, trade and expansion of business cooperation between member countries. It was also announced that a US\$100 billion Contingent Reserve Arrangement (CRA) would be established to create a safety net against possible future financial crises in the BRICS countries (Fifth BRICS Summit 2013).

The BRICS' announcement that they would establish a new development bank was met with a great deal of interest by the global media and those engaged in on-going debates around global finance. Although BRICS' declarations have stated that the New Development Bank (NDB) will "supplement the efforts" of already established multilateral and regional financial institutions, the establishment of the bank represents a potentially significant step towards increasing the role and influence of the BRICS nations in global economic governance. This will inevitably lead to a shift in the existing status quo. For some, the prospect of a BRICS Development Bank raises opportunities for increased South-South cooperation and a challenge to the hegemony of the established international financial institutions. Others are concerned that this new bank may lack the detailed social and environmental safeguards and policies that the established financial institutions already have in place. However, much of this debate has occurred in the dark, and until the BRICS' sixth summit in mid-2014, very little was known about how the bank would be structured and run. This changed after the *Fortaleza Declaration* was issued at the sixth BRICS summit, and the details of the NDB and CRA were formally announced (Sixth BRICS Summit).

Although details are now available regarding the organisation and structure of the NDB, several key questions still need to be resolved, in particular concerning what types of projects the bank will finance, what policies it will establish regarding issues such as transparency and governance, and what form its social and environmental safeguards will take. The BRICS members aim to bring the bank online by 2016, which means these questions will soon be answered. In the meantime, it is important to understand each member state's current approach to development finance, as the operations of the bank will no doubt be influenced by its members' collective experiences.

China's domestic approach to development finance began to develop in the late 1990s, and in the last decade China has also become a major actor in global development finance. These experiences are likely to play a key role in the development and management of the NDB. This paper seeks to provide an overview of China's overseas development finance activities by focussing on the two major financial institutions that are active overseas: China Development Bank and the Export-Import Bank of China. It examines the approaches of the two banks, their social and environmental safeguards, and discusses some of the key trends and challenges that they have encountered in recent years. This is followed by a brief overview of the structure of the NDB and China's role in this newly established institution. It is hoped that the findings of this paper can feed into debates that are ongoing, both within China and globally, and contribute to a clearer understanding of how China's experiences may shape the New Development Bank.

## Development Finance in China

Over the past thirty years China has transitioned from being an entirely planned economy to one which incorporates market principles. The Chinese government has played multiple roles in defining the trajectory of the country's economic development, including: creating, developing and managing market demand and supply, adopting laws and regulations promoting economic reform, developing institutional framework and attracting and stimulating foreign investment (Li and Li 2007). The traditional finance mechanisms, i.e., policy finance and commercial finance, have played a major role in China's economic growth, but over the last ten to fifteen years 'development finance' has become increasingly important, filling the gaps left by traditional financing mechanisms.

Li and Li (2010) define development finance, or ‘kaifaxing jinrong’ (开发性金融), as a financing mechanism used by government-authorised financial institutions that utilises market-oriented operations and market performance as a foundation, and aims to develop institutional systems and markets in order to realise the government’s economic and social development goals. The China Development Bank is seen as the pioneer of development finance in China, and defines development finance as:

*A financial form and a financial method designed to serve the country’s development strategy, solve the bottlenecks to economic and social development, safeguard the country’s financial stability and boost its economic competitiveness by using medium and long-term investment and financing as the tool and combining state credit with market operation (China Development Bank 2011)*

Development finance in China is targeted at a broad range of areas. This includes infrastructure development at the national and city levels, including construction of highways, rail, telecommunications and power supply. Urban planning and development is a major focus, as is the development of special economic zones and industrial zones. In rural areas development finance has been used to enhance the capacity of agricultural enterprises and to develop rural transport connections, energy infrastructure, schools and safe drinking water. Development of social housing and provision of housing loans for low- and middle-income families is also an important aspect of China’s development finance (China Development Bank 2011).

The principal institutions responsible for implementing China’s policy-oriented finance operations are the China Development Bank (CDB), the Export-Import Bank of China (China Eximbank) and the Agricultural Development Bank of China (ADBC). These three ‘policy banks’ were established in 1994 as part of China’s national investment and financial systems reform, and were set up in order to separate policy-oriented finance from commercial finance (China Development Bank 2011). This split allowed China’s ‘big four’ state-owned commercial banks (Bank of China, China Construction Bank, Agricultural Bank of China, and Industrial and Commercial Bank of China) to focus more on their commercial operations (Downs 2011).

### China’s Policy Banks

China Development Bank: The CDB provides medium to long-term financing facilities for activities aligned with China’s national economic strategy. The bank allocates resources to priority areas including: national infrastructure, basic industry, key “emerging sectors”, and national priority projects. It seeks to promote coordinated regional development and urbanisation by financing small and medium-size enterprises, education, healthcare, agriculture, low-income housing, and environmental initiatives. The CDB also plays a major role in facilitating China’s overseas investment and global business cooperation (China Development Bank 2014). At the end of 2013, the bank’s total assets balance was RMB 8.18 trillion (over US\$1.32 trillion) with outstanding loans reaching RMB 7.14 trillion, or over US\$ 1.15 trillion (China Development Bank 2014). The CDB has supported major projects including the Three Gorges Dam and the South-North Water Transfer Project, as well as various power grids, road and high-speed railway connections. As will be discussed later, the CDB has transitioned towards becoming a commercial entity, although it still plays a crucial role in financing China’s policy objectives.



*Export-Import Bank of China:* China Eximbank's mandate is to facilitate the export and import of Chinese products, assist Chinese companies in offshore project contracting and outbound investment, and promote international economic cooperation and trade (Export-Import Bank of China n.d.). By the end of June 2013, the bank's total assets reached approximately RMB 1.88 trillion (US\$304.11 billion), with its loan balance standing at RMB 1.45 trillion (US\$234.10 billion) (Export-Import Bank of China 2013). China Eximbank has financed projects in China and across the globe, including loans to the oil, shipping, construction and real estate sectors.

*Agricultural Development Bank of China:* The ADBC is a state-owned agricultural policy bank with the mission to promote the development of agriculture and rural areas. It seeks to achieve this by raising funds for the implementation of agricultural policy and by providing credit to industries specified by the central government. The ADBC also provides credit to agriculture-related commercial businesses, and acts as an agent of the treasury in allocating special funds for supporting agriculture (Agricultural Development Bank of China n.d). In 2013, its total assets reached RMB 2.62 trillion (US\$422.57 billion), with a total outstanding loan balance of RMB 2.50 trillion (US\$404.01 billion) (Agricultural Development Bank of China 2014).

## China and Global Development Finance

Over the last decade, China's role in overseas development finance has grown significantly. In 2011, the Financial Times reported that, for the first time, lending to developing countries by the China Development Bank and China Export-Import Bank had exceeded that of the equivalent arms of the World Bank. The definition of 'development finance' or 'kaifaxing jinrong' provided above can also be applied to some aspects of the overseas operations of the CDB and China Eximbank. However, China's overseas financing incorporates both market and non-market based approaches, and utilises various mechanisms, including concessional loans, preferential and market-rate loans, resource-backed lines of credit, export sellers' credits and buyers' credits, among others. In some cases, various mechanisms may be combined into a single package. As discussed later, the two banks only release limited data concerning the details of financing for specific projects, which makes it challenging to determine which projects may be categorised as development finance, and which are straightforward commercial operations. The remainder of this section therefore looks at China's outbound financial flows in general.

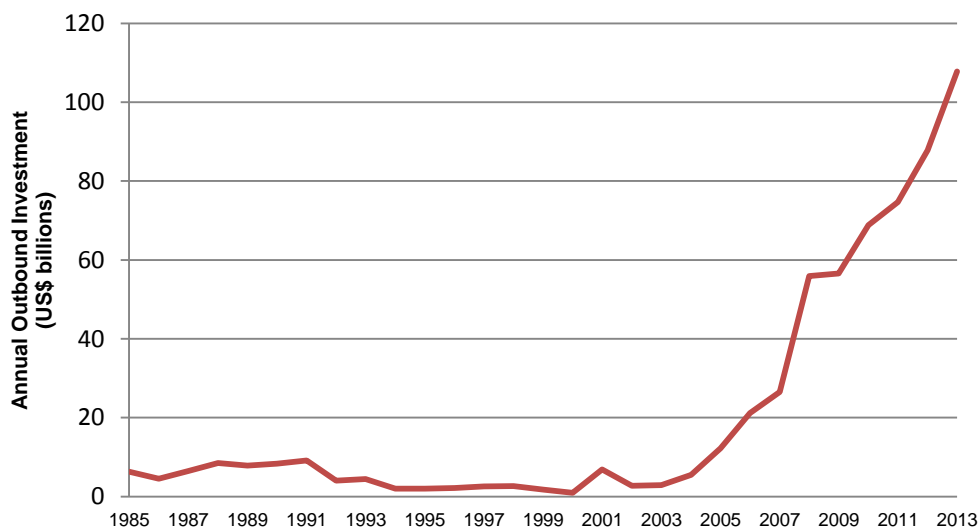
China's rapid increase in overseas financial flows has been encouraged through the country's 'going out' strategy, which was formally recognised in the 10th Five-Year Plan (2001-2005). The plan encouraged domestic companies to invest in overseas construction projects, promote trade and export of products, services and technology, and called on companies to invest overseas in the exploitation of strategic natural resources. In order to support overseas investment, the government has committed to provide financing, insurance, foreign exchange, tax incentives and other services (The People's Republic of China 2001). The 11th Five-Year Plan (2006-2010) renewed government support for the going out strategy (The People's Republic of China 2006), as did the 12th Five-Year Plan (2011-2016), which called for the acceleration and expansion of outbound investment (The People's Republic of China 2011).

While China's overseas investment has increased rapidly over the last ten years, it is difficult to accurately assess the exact amount of investment flowing out of China. In addition to Chinese government statistics, there are various other non-official statistics and data sets that seek to track



China's overseas investment, each using different criteria and methods for data collection. However, one thing that is clear is that investment has increased steadily since around 2004. According to China's Statistics Bulletin on overseas investment, China's outbound foreign direct investment (OFDI) reached US\$107.84 billion in 2013. This figure was over 40 times higher than in 2002, when investment flows stood at just US\$2.7 billion. The Statistics Bulletin indicates that in 2013 China's accumulated overseas stock stood at over US\$660 billion (Ministry of Commerce et al. 2014), Figure 1 illustrates the rapid rise in China's OFDI over the last decade.

**Figure 1: China's Outbound Foreign Direct Investment by Year, 1985-2013**

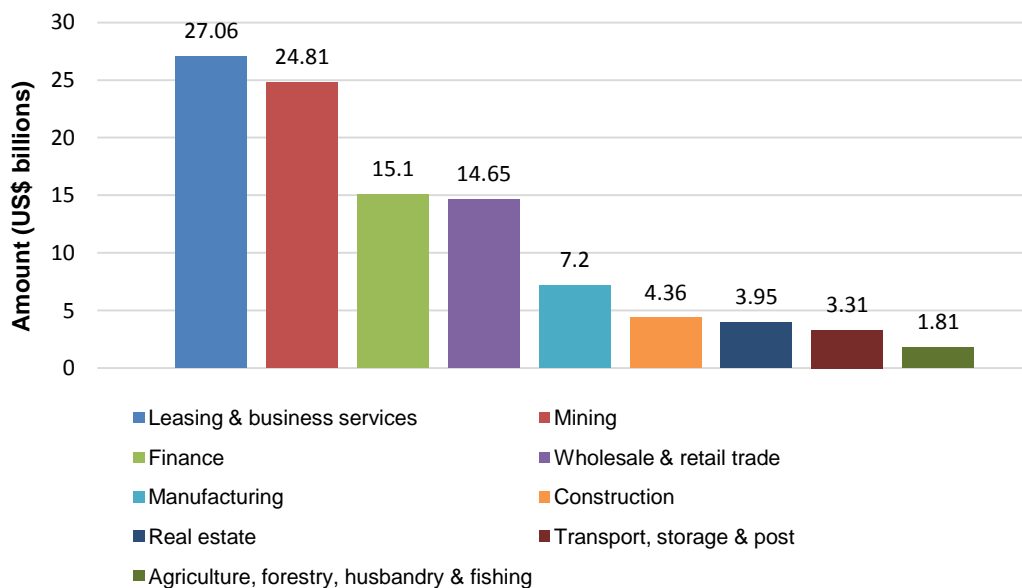


*Sources: United Nations Conference on Trade and Development (1985-2001) and Ministry of Commerce of the People's Republic of China et al. (2002-2013)*

Due to the methods used by China to document its outbound investment, it is challenging to obtain a clear and comprehensive picture of the final destination of outbound financial flows. The statistics of the Ministry of Commerce are based on information submitted by companies during the registration and approval process. This information often reports the initial destination of investment, rather than the final (Rosen and Hanemann 2009). As can be seen in the Statistics Bulletin for 2013, outbound investment is heavily concentrated in Hong Kong, which is likely to be a 'stopping off' point, rather than a final destination for many investments. In 2013, Hong Kong was the top destination for overseas investment, accounting for 58.4 per cent of the total. The Cayman Islands was second with 8.6 per cent, followed by the United States, which accounted for just 3.6 per cent of official outbound investment flows (Ministry of Commerce et al. 2014). It is also difficult to paint an entirely clear picture regarding which sectors Chinese investment is flowing to. China's official outbound investment statistics use 18 different categories to classify OFDI flows. The majority of these categories are clear, for example, construction, real estate, and mining. However, the category that has consistently received the most investment is "business and leasing services", which accounted for US\$27.06 billion (over 25 per cent) of China's investment in 2013 (Ministry of

investment in 2013 (Ministry of Commerce et al. 2014). This is a vague category and could overlap various sectors. For example, one academic study on this issue found that a large portion of investment reported as “business and leasing services” actually went into the mining sector (Wang and Huang 2012).

**Figure 2: Top Ten Sectors for China's OFDI in 2013**



*Source: Ministry of Commerce of the People's Republic of China et al. (2014)*

Although the above statistics contain some vague categories, it is clear that Chinese overseas OFDI is targeting strategic sectors, and in 2012 China's Premier stated that the government would encourage investments and mergers in key sectors overseas, including energy, raw materials, manufacturing and construction (Ding 2012). Both the CDB and China Eximbank play a pivotal role in supporting these investments.

In addition to overseas investment, China's official development assistance (ODA) has also grown considerably. For many years little was known about the details of China's foreign aid program, with only limited information available on its geographical and sectoral breakdown. In an effort to increase transparency, the Chinese Government issued its first white paper on aid in 2011. This was followed by a second white paper in mid-2014. Emphasising the unique approach of China's aid program, the 2011 paper states: “Adhering to equality and mutual benefit, stressing substantial results, and keeping pace with the times without imposing any political conditions on recipient countries, China's foreign aid has emerged as a model with its own characteristics” (Ding 2012). Between 2004 and 2009 foreign aid increased on average by 29.4 per cent (State Council of The People's Republic of China 2011), and between 2010 and 2012, China dispersed RMB 89.34 billion (US\$14.41 billion) in foreign aid (State Council of The People's Republic of China 2014).

In 2012, almost 52 per cent of China's aid went to Africa, followed by just under 30 per cent to Asia. Of the 550 aid projects implemented between 2010 and 2012, the majority supported "public facilities" and "economic infrastructure". "Public facilities" includes hospitals, schools, water supply and other public infrastructure and accounted for 360 projects during this period. 156 economic infrastructure projects were implemented, including transport, communication and power supply projects (State Council of The People's Republic of China 2014).

Chinese aid falls into three main categories: grants, interest-free loans and concessional loans. Grants and interest-free loans come directly from China's state finances, whereas concessional loans are provided by China Eximbank and subsidised by the state. Of the total RMB 89.34 billion dispersed in 2010-2012, grants accounted for 36 per cent, interest-free loans 8 per cent, and concessional loans 56 per cent (State Council of the People's Republic of China 2014). For the purposes of this paper, concessional loans are of most interest, and they are returned to later.

China characterises its aid as mutually beneficial, helping recipient countries to build their own capacity for self-development, improving peoples' livelihood, and promoting economic growth and social progress. Through its aid program, China has sought to develop friendly relations with other countries and create a strong foundation for economic and trade cooperation. In some cases different financing mechanisms may be combined, and market-based, zero-interest and/or concessional loans may be included in a package, as was the case in the Bui Dam in Ghana, which combined both commercial and concessional financing.

### **The Bui Dam, Ghana**

Ghana's Bui Dam was developed by the Chinese state-owned company, Sinohydro. After the completion of an environmental impact assessment, the Ghanaian Government and Sinohydro signed a contract for the development of the project and in 2008 signed loan agreements with China Eximbank. The total value of the loan package was US\$622 million; a US\$60 million loan from the Government of Ghana and two lines of credit from Eximbank. The Eximbank loans included a commercial buyer's credit of US\$292 million, which had an interest rate of 2 per cent over Commercial Interest Reference Rates, and a repayment period of 20 years. The remainder was made up by a concessional loan of US\$270 million, with an interest rate of 2 per cent (Hensengerth 2013).

Both loans are subject to a five year grace period during which only interest is payable and the principal of the loan does not have to be repaid. During this time, the Chinese Government has committed to purchase 30,000 tonnes of cocoa from Ghana at global market prices. Revenues from these purchases pay off interest on the Eximbank loans, and after the dam is operational revenues from electricity generation will be used to repay the loan (Hensengerth 2013).

The case of the Bui dam illustrates the intersection between commercial development finance and development assistance. This diverse loan package also provides an example of resource-backed credit, which is returned to later.

## Key Government Institutions Involved in Overseas Investment and Aid

A number of government institutions play a role in the approval and management of China's overseas development finance. This has been covered in detail elsewhere, and the following section therefore provides only a brief overview of key institutions.

*State Council:* The State Council is China's most senior administrative body. It is chaired by China's Premier and includes the heads of all major government agencies. The State Council drafts laws and regulations and supervises China's ministries and various other entities. It is directly involved in the approval process for overseas projects, but only for those projects that are worth more than US\$2 billion and which involve "sensitive" countries, regions or industries (National Development and Reform Commission of The People's Republic of China 2014).

*National Development and Reform Commission (NDRC):* The NDRC is the main government body responsible for developing and implementing strategies related to national economic and social development. Overseas investment projects worth over US\$1 billion or which involve sensitive countries, regions or industries require NDRC approval (National Development and Reform Commission of the People's Republic of China 2014).

*Ministry of Commerce (MOFCOM):* MOFCOM is responsible for formulating strategies, guidelines and policies for developing domestic and foreign trade and international economic cooperation. Overseas projects in sensitive countries, regions or industries must be approved by MOFCOM, but all other projects only require registration with MOFCOM or provincial level commerce departments (Xinhua 2014). MOFCOM previously played a much bigger role in approving overseas investments, however, regulations issued in 2014 greatly increased the threshold at which approval is required from the MOFCOM, NDRC and State Council. Most outbound investments now only require registration, rather than approval. This change aims to create a more streamlined process and promote increased outbound investment.

*State Administration of Foreign Exchange (SAFE):* SAFE is under the authority of the People's Bank of China and is responsible for supervising and monitoring flows of China's foreign exchange reserves (State Administration of Foreign Exchange n.d.).

*China Banking Regulatory Commission (CBRC):* The CBRC is responsible for developing the rules and regulations for the supervision of China's banking institutions. It aims to promote financial stability, promote financial innovation, and enhance the competitiveness of the Chinese banking sector (China Banking Regulatory Commission n.d.). The CBRC has issued guidelines including provisions for Chinese banks' overseas financing.

Under the authority of the State Council, three ministries are responsible for China's overseas development assistance. The Ministry of Foreign Affairs plays an advisory role, while the Ministry of Finance is responsible for the foreign aid and multilateral aid budgets. MOFCOM implements the aid program and directly administers China's zero-interest loans and grants in cooperation with the Ministry of Foreign Affairs, and channels China's concessional loans through the Eximbank (Cabria 2013).

## China's Development Banks

Both the China Development Bank and China Export-Import Bank play an important and unique role in providing overseas development finance. As already mentioned, both banks utilise a range of financing mechanisms. Both are active domestically and overseas – both in developing and developed countries – and while they play an important role in providing development finance, this is not their only role. The following section provides a background on the two institutions and discusses some of the key instruments they utilise in overseas financing.

### *China Development Bank*

In 1998, Chen Yuan took over the management of the CDB and began to explore the development finance model, which was later institutionalised throughout the bank's operations (Chen 2000). This fostered the bank's rapid growth, and by the end of 2002, CDB had a total assets balance of over RMB 1.04 trillion (US\$173.6 billion) (Research Academy of China Development Bank 2011), which increased to RMB 8.18 trillion (over US\$1.32 trillion) in 2013 (China Development Bank 2014). In 1997, the year before Chen Yuan took over and reform of the CDB began, the bank's non-performing loan ratio stood at over 42 per cent, but this dropped to less than 5 per cent four years later (Downs 2011). Non-performing loans had dropped to less than one per cent by 2013 (China Development Bank 2014), and the CDB has become one of the largest development banks in the world.

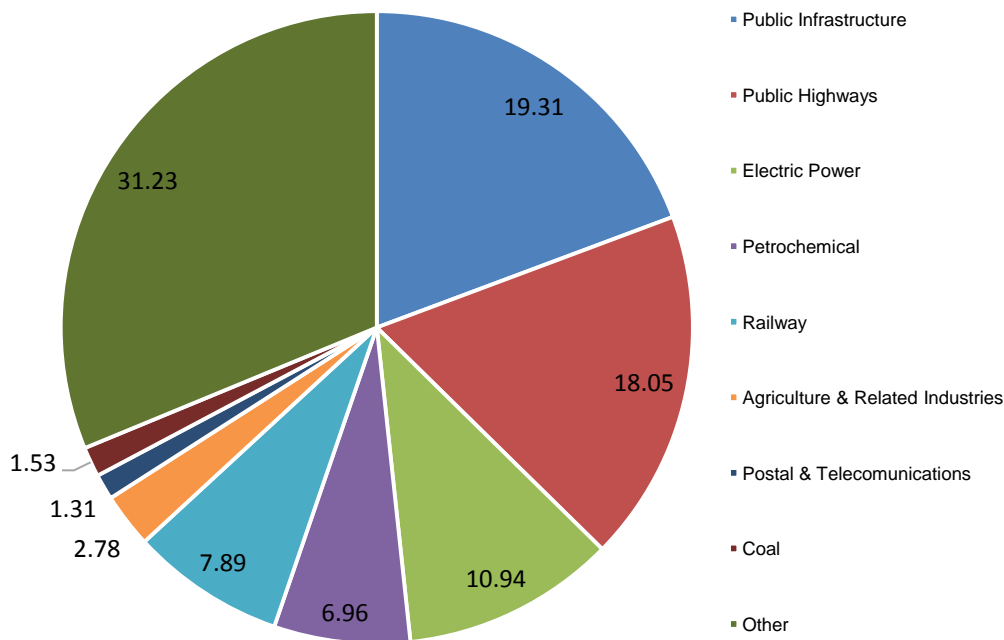
In 2008, the CDB became a commercial joint-stock bank. Although the bank remains state-owned and continues to finance projects that support national policy objectives, its mission statement affirms that it is “committed to market-based practices that stimulate solid performance, innovation and sustainable growth” (China Development Bank 2014). The bank's main shareholders are China's Ministry of Finance (50.18 per cent) and the state-owned investment company Central Huijin Investment Ltd. (47.63 per cent), but no shares have been sold to the public (China Development Bank 2014). CDB has a Board of Directors and a Board of Supervisors, and in 1999 established an International Advisory Council in order to broaden its international perspective and accelerate its progress towards becoming a top tier international bank (China Development Bank 2014).

In 2013, it was reported in a number of sources that the CDB was pulling back from its attempts to convert to a fully commercial institution. With CDB increasingly lending to private companies in recent years, it has been reported that China's commercial banks have become frustrated that they cannot compete with the banking giant. Chinese media group *Caixin* has reported that CDB executives wish to return the institution to acting purely as a policy bank, while the Ministry of Finance is opposed to this as it would have to take full liability for the bank's loans. As things currently stand, the bank continues to behave both as a policy bank and as a commercial bank, which has led to calls for its role to be more clearly defined (Zhang 2013). While the CDB still promotes itself as a bank working to support state policies, it has expanded its commercial activities rapidly, creating an institution which some believe to be too complex to adequately regulate (Zhang 2013). It remains to be seen how the bank will evolve in the near future.

After its formation in 1994, the CDB initially focussed on financing domestic infrastructure projects but the bank has since expanded its portfolio and rapidly increased its overseas lending.

As can be seen in Figure 3, the CDB continues to focus on financing infrastructure projects, with public infrastructure accounting for the largest share of outstanding loans. Transport, communication, agriculture, energy, oil and coal are also major areas for CDB financing.

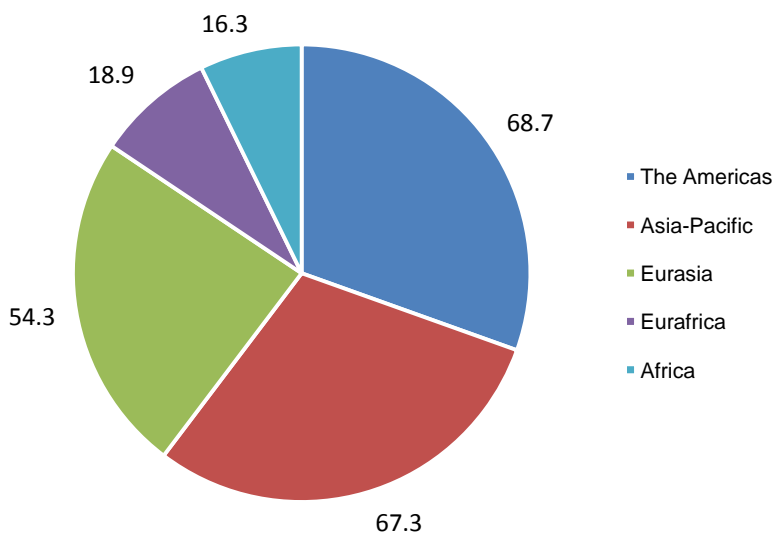
**Figure 3: CDB Outstanding Loan Balance Breakdown by Industry (%)**



*Source: China Development Bank, 2014*

The above breakdown applies generally to CDB lending, and does not distinguish between domestic and international operations. However, the bank’s 2013 annual report confirms that infrastructure, agriculture, “social sectors”, and energy are key sectors for overseas finance. In 2013, 15.42 per cent of the CDB’s loans went overseas (China Development Bank 2014), and up to the end of that year the bank had outstanding foreign currency loans of US\$250.5 billion and offshore yuan-denominated loans totalled RMB 63 billion. In the words of the Bank this “further cemented its status as a pillar of overseas investment and financing in China” (China Development Bank 2014).

Available data suggests that the CDB is China’s largest lender in Latin America. According to one estimate, CDB accounted for more than 80 per cent of China’s loan commitments to the region between 2005 and 2012 (Gallagher et al. 2012). Other major destinations of CDB financing up to 2012 were the UK, Russia, India, Indonesia and Australia, although these figures are skewed by a handful of very large deals (Matisoff 2012). The CDB’s 2013 Sustainability Report indicates that Asia-Pacific and The Americas were the biggest recipients of overseas loans, with loan balances reaching US\$68.7 billion and US\$67.3 billion, respectively. Figure 4 shows the full breakdown, although it should be noted that it is not clear which countries are within the “Eurafrica” category (China Development Bank 2014).

**Figure 4: Distribution of CDB's Overseas Loan Balance in 2013 (US\$ billions)**

Source: China Development Bank (2014)

The CDB has a number of financing vehicles at its disposal, several of which are discussed below.

*Commercial loans:* The CDB provides loans to Chinese companies pursuing overseas investments. The bank's commercial loans are generally offered at market rates, and a study of Chinese finance in Latin America found that CDB rates were usually higher than those of the World Bank's International Bank for Reconstruction and Development (Gallagher et al. 2012).

*Support for mergers and acquisitions:* Mergers and acquisitions have become an important vehicle for Chinese companies seeking to expand their overseas investments. According to China's Statistics Bulletin on overseas investment, this has risen from just US\$3 billion in 2004 to US\$ 52.9 billion in 2013. Of this total transaction amount, US\$33.79 was direct investment, accounting for almost one third of China's outbound investment that year (Ministry of Commerce et al. 2014). In a number of cases these acquisitions have been supported by the CDB. For example, in 2011 CDB provided Jinsheng Industry Holding EUR 100 million to acquire a 50 per cent share in Germany's EMAG group, the world's leading machine tools manufacturer (Research Academy of China Development Bank 2011). In 2013 China National Offshore Oil Corporation (CNOOC) completed the US\$15.1 billion acquisition of the Canadian energy company Nexen. This was China's biggest every foreign acquisition and was supported in part by a US\$325 million loan from the CDB (China Development Bank 2014).

*Resource-backed loans:* The CDB has extended resource-backed lines of credit to foreign energy companies and government entities in various countries, including Brazil, Ecuador, Venezuela and



and Angola. These loans are repaid by the delivery or sales of commodities from the borrowing country. This model is usually employed when the borrower lacks the capacity to guarantee loan repayment but has resources that it can offer instead. Although many of these arrangements involve oil or mineral resources, this is not always the case. For example, the loan for the Bui Dam in Ghana (discussed earlier) was secured in part by cocoa bean exports.

*Equity funds:* The bank is also expanding overseas through private equity funds. This includes the China-Africa Development Fund, or CAD Fund, which seeks to support investments in infrastructure, manufacturing, energy and agriculture projects (discussed below).

*Special loan programs:* The CDB also has a number of special loan programs. For example, the bank is responsible for implementing the “Special Loan for the Development of African SMEs” program, which operates under the framework of the Forum on China-Africa Cooperation (FOCAC). The program aims to help African countries stabilise employment and develop local markets and economies. Up to the end of 2011 the program had committed US\$783 million to various projects (China Development Bank n.d.).

### **The China Africa Development Fund**

In 2007, China approved the establishment of the China-Africa Development Fund. With a total investment of US\$5 billion, the fund aims to encourage and support Chinese investment in Africa, promote economic cooperation, and advance Africa's economic development. According to the CDB, the fund embodies the principles of “enhancing friendship, treating each other as equals, extending mutual support and promoting common development”. The fund targets four main areas: agriculture and manufacturing industries, infrastructure, natural resources, and industrial parks set up by Chinese enterprises (CAD Fund n.d.).

According to the CDB the fund emulates the model used by international equity investment funds and operates independently of government. The fund does not provide aid or credit, rather it invests directly in projects, and therefore takes on the risks of project failure as well as receiving dividends if projects succeed. African enterprises can apply for CAD Fund investments if they operate in partnership with a Chinese company (ibid.). The CDB states that CAD Fund projects will bring in investment of over US\$10 billion from Chinese enterprises, which will translate to increased annual exports of US\$2 billion (China Development Bank 2013). Up to the end of 2013, CAD Fund has financed and supported 75 projects with funds totalling US\$2.83 billion (China Development Bank 2014).

In theory, the approach of CAD Fund should lead to more profitable projects, as investment decisions are based on an assessment of potential profit. Additionally, this approach does not burden the countries or investors with debt. The fund's principles state that it will conduct environmental assessments and fulfil its social responsibilities, but its operations to date are far from being a model for transparency, and the fund's website includes no comprehensive list of investments so far.

While the CDB operates as a semi-commercial entity, it still serves Chinese government policy. The bank's overseas investments support the strategic interests of China, and the CDB plays a central role in supporting China's going out strategy. There are numerous motivations behind China's going out strategy, one of which is the acquisition of natural resources such as oil and

minerals. China has a shortage of a number of key mineral resources, such as copper (Tse 2013), and the country relies heavily on imported iron ore for its domestic steel production (KPMG China 2011). The CDB has supported the operations of various mining companies seeking to obtain these vital resources, including the state mining giants CHALCO, Minmetals and Baosteel. The Chinese Government has also encouraged national oil and gas companies to go out, and the CDB has supported oil and gas ventures in countries including Venezuela, Russia and Brazil, and has extended financing to various national resource companies including CNOOC, China National Petroleum Company (CNPC) and China Petroleum and Chemical Corporation (Sinopec) (Research Academy of China Development Bank 2011).

Although China's need for resources is certainly great, the motivations behind the going out strategy are much more complex than simply acquiring resources. Through its support of Chinese companies going out, the CDB supports the development of Chinese industrial capacity, expertise and market access. Ultimately, China hopes to continue to build world class enterprises that can compete in the global market, and in turn build the reputation of China as a major actor in global trade and investment. For example, in 2009 the CDB's EUR 530 million loan to COSCO's container terminal in Greece not only aimed to support the Chinese shipping company's overseas expansion but also "enhanced Chinese capacity and status in international maritime affairs" (ibid.).

The CDB has grown to become a major force in global development finance, and its rise has been rapid. The bank now has projects across the world in a variety of sectors, and while it has experienced some significant successes over the past decade, it has also been connected to a number of controversial cases. This includes CNPC's Sino-Myanmar oil and gas pipelines, Asia Pulp and Paper's activities in Indonesia and elsewhere, as well as hydropower projects in various countries from Africa to Southeast Asia. While the CDB has been criticised for its involvement in some projects, it has made efforts to strengthen its risk management and safeguards systems in recent years. This is returned to later in the paper.

### *Export-Import Bank of China*

China Eximbank is an export credit agency, and as such is not strictly speaking a development bank. However, the bank plays a crucial role in supporting China's going out strategy, and in addition to commercial lending is also responsible for China's concessional lending. The bank is wholly owned by the Chinese government and under the supervision of the State Council. Its mandate is to facilitate the export and import of Chinese mechanical and electronic products and complete sets of equipment, assist Chinese companies in offshore project contracting and outbound investment, and promote international economic cooperation and trade (Export-Import Bank of China n.d.). In addition to its concessional lending, which is a relatively small part of its portfolio, Eximbank supports Chinese companies by providing export seller's credits, export buyer's credits, commercial loans and guarantees, among other services.

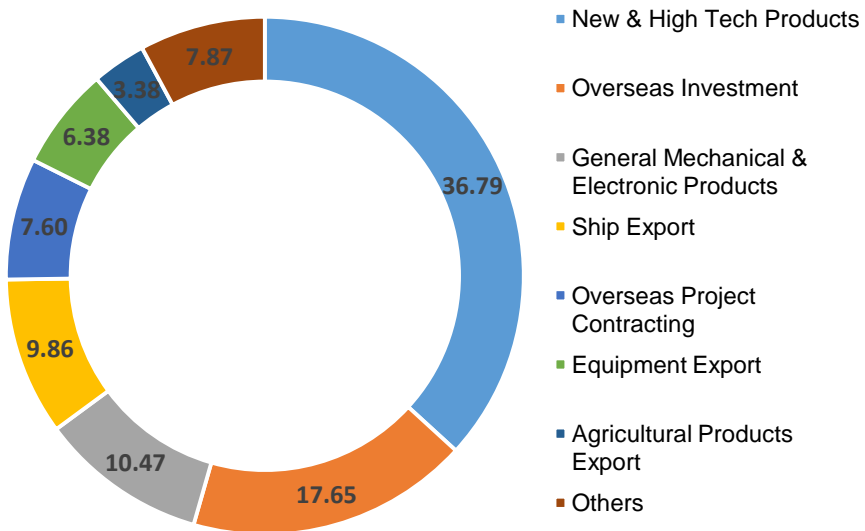
In 2013, Eximbank signed new loans worth RMB 999.5 billion (US\$160.6 billion) and dispersed RMB 803.3 billion (US\$129 billion) (Export-Import Bank of China 2014). These transactions covered a range of areas including shipping, transport infrastructure, oil and gas, energy, telecommunications, manufacturing, and agricultural products. The bank does not publish a

detailed breakdown of its foreign loans, but its overseas activities are clearly extensive. In late 2013 it was reported that over the next 12 years Eximbank will provide 70-80% of China's financing for infrastructure in Africa. (Shih 2013). The bank provides financing through a number of mechanisms, several of which are discussed in more detail below.

*Loans for overseas investment and offshore contracting:* China Eximbank provides commercial loans to Chinese companies investing or contracting overseas (Export-Import Bank of China n.d.). For example, the Kamchay Hydropower dam in Cambodia, discussed later in the paper, was developed by the Chinese state-owned company Sinohydro and supported by a commercial loan from the Eximbank.

*Export seller's credits:* Eximbank offers short-term credits to Chinese exporters in order to help them finance foreign sales. For example, in 2012 Eximbank supported machinery exports by state-owned XCMG Group with export seller's credit (Export-Import Bank of China 2013). In 2013, Eximbank dispersed export seller's credits for RMB 192.4 billion (US\$30.9 billion), the breakdown of which is illustrated in Figure 5. This also includes loans for overseas investment and contracting (Export-Import Bank of China 2014).

**Figure 5: Disbursement of Eximbank Export Seller's Credit by Sector in 2013 (%)**



Source: China Export-Import Bank (2014)

*Export buyer's credits:* Eximbank also offers longer-term credit to foreign buyers to assist export of Chinese goods and services. For example, in 2012 Eximbank provided export buyer's credit to support an oil processing centre at Atyrau Oil Refinery in Kazakhstan (Export-Import Bank of China 2013). In 2013, the bank dispersed export buyer's credits totalling RMB 54.3 billion (US\$8.7 billion) (Export-Import Bank of China 2014).

*Import credits:* Eximbank also provides import credits, and in 2013 signed import credit agreements for RMB 172.2 billion (US\$27.7 billion) (ibid.). Import credits may be issued to Chinese companies to support import of capital goods and for the construction of facilities supporting imports. Eximbank also uses import credits to support the import of resources, energy, raw materials, spare parts, semi-finished and finished products (Export-Import Bank of China n.d.).

*Concessional loans and preferential export buyer's credits:* Eximbank is the only body permitted to grant overseas concessional loans and preferential export buyer's credits (Export-Import Bank of China 2014). As part of China's overseas aid program, these loans are granted at below market rate with a lengthy repayment period to projects that will contribute to economic and social development and utilise Chinese goods and services (see box below).

*Resource-backed loans:* As is the case with the CDB, Eximbank also provides resource-backed credit. For example loans have been granted to Angola for oil-backed infrastructure and the Democratic Republic of Congo for mineral-backed infrastructure and mining projects (Bräutigam 2010).

*Investment funds:* The bank is active through several investment funds. This includes the China-ASEAN Investment Cooperation Fund (CAF), a US denominated off-shore quasi-sovereign private equity fund focussing on infrastructure, energy and natural resources. The current size of the CAF is US\$1 billion, although the long-term goal is US\$10 billion (China-ASEAN Investment Cooperation Fund n.d.). The fund represents an interesting example of cooperation between Chinese and international financial institutions, as the International Finance Corporation (IFC) has invested US\$100 million in the fund (International Finance Corporation n.d.). Additionally, in 2012 the Inter-American Development Bank and the China Eximbank announced that they had reached an agreement to collaborate on a joint investment platform for Latin America and the Caribbean that will mobilise up to US\$1 billion for equity investments to promote sustainable economic development in the region (Inter-American Development Bank 2012).

Eximbank also provides various other services, including on-lending of loans from other governments or international financial institutions, currency swaps, guarantees, among others. The bank sometimes offers package loans for a specific project which incorporate various lending mechanisms, for example: export buyer's credit to the borrowing country and export seller's credit to the Chinese investor. The Bui Dam case (mentioned earlier) is an example of such a package, and was also supported by a concessional loan and an agreement to pay back loan interest with agricultural commodities.

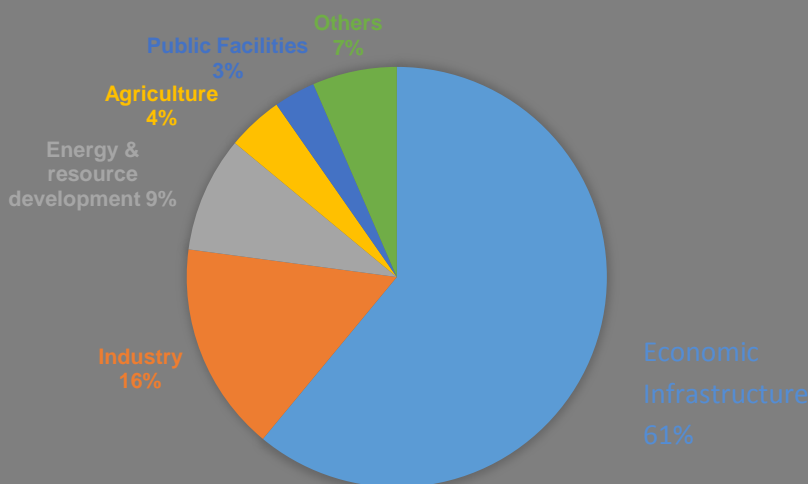
### Concessional Loans

According to the State Council's 2014 White Paper on China's Foreign Aid, China provided RMB 49.76 billion (approximately US\$8 billion) in concessional loans between 2010 and 2012. Concessional loans are used mainly to support projects that generate both economic and social benefits, large and medium-sized infrastructure projects, or to provide complete plant, mechanical and electrical products or technical services (State Council of the People's Republic of China 2014). The interest rate of China's concessional loans is below the benchmark rate set by the

People's Bank of China, and according to the State Council's 2011 white paper on foreign aid, the interest rate is 2-3 per cent with a repayment period of 15 to 20 years (including a five to seven year grace period) (State Council of the People's Republic of China 2011).

By 2009, China had provided concessional loans to 325 projects in 76 countries. Figure 6 illustrates the sectoral breakdown of these loans and shows that the majority of projects were classed as "economic infrastructure", which includes transportation, communication, and power supply projects. This was followed by loans to industry, including projects developing the textile, machinery, and chemical industries (ibid.).

**Figure 6: Sectoral Distribution of China's Concessional Loans (up to 2009)**



According to Bräutigam (2011) concessional loans can only be granted for projects with a minimum value of RMB 20 million (US\$3.2 million) which involve at least 50 per cent use of Chinese goods and services, including contractors. Concessional loans were granted in 2013 for projects including the Alternative North-South Road Project in Kyrgyzstan, developed by China Road and Bridge Corporation, and a coal-based fertilizer plant in northern Vietnam developed by a subsidiary of CNPC (Export-Import Bank of China 2014).

While concessional loans are an important part of Eximbank's lending portfolio, they account for only a small percentage of the bank's lending, and the majority of Eximbank's activities are commercial (Bräutigam 2011).

As is the case with the China Development Bank, China Eximbank plays a key role in supporting the strategic policy objectives of the Chinese Government. For example, the Karakoram Highway, which was supported by an Eximbank concessional loan, aims to improve channels for China-Pakistan economic and trade exchanges, facilitate border trade and enhance friendship between the two countries (Export-Import Bank of China 2013). The bank has supported domestic projects such as the dredging of inland waterways in Shanghai, which aims to enhance transport capacity of the Shanghai harbour and help the city develop into an international shipping centre (ibid.). As will be returned to later, Eximbank is also promoting "green"

financing, and has supported technology upgrading in several steel, paper-making, and nonferrous metal companies and has financed biomass, wind and solar power projects (ibid.). This move towards green lending also supports the Chinese Government's call for increasing environmentally friendly investment.

Eximbank plays an important role in facilitating and supporting Chinese companies going out, with overseas investments and contracting accounting for over 25 per cent of the bank's export-oriented lending in 2013. As can be seen above, the Eximbank has a comprehensive set of financing mechanisms at its disposal, all of which support extending the global reach of Chinese companies. Eximbank states on its website that its efforts to promote international exchanges and cooperation and develop its business cooperation with other countries has contributed to "common development and growth and building a harmonious world". It is certainly true that the bank has supported major investments in developing countries, many of which have the potential to benefit both Chinese investors and the host nation. However, as is the case with the CDB, Eximbank has come under scrutiny for its association with a number of problematic projects, including the Merowe hydropower dam in Sudan and loans to Angola's oil industry. The Eximbank has also developed basic safeguards which seek to address potential social and environmental impacts of its financing, which is the focus of the following section of this paper.

## **Safeguards and China's Overseas Development Finance**

China's overseas investment and financing has received a huge amount of attention in recent years, with many observers suggesting that safeguards, especially those relating to environmental and social impacts, are lacking. Generally speaking, there appears to be a consensus that more needs to be done to improve the standards of China's overseas development activities, and a number of government bodies have taken steps to address these concerns.

### *Social and Environmental Guidelines Applying to Chinese Overseas Investment and Finance*

"Green finance" policies first emerged in China in the mid-1990s and have been evolving since. Most recently in 2012, the China Banking Regulatory Commission (CBRC) issued its Green Credit Guidelines, which built on earlier policies. The Guidelines cover issues including due diligence, client compliance review, and project performance assessment. Article 21 of the Guidelines explicitly addresses overseas investment, and states:

*Banking institutions shall strengthen the environmental and social risk management for overseas projects to which credit will be granted and make sure project sponsors abide by applicable laws and regulations on environmental protection, land, health, safety, etc. of the country or jurisdiction where the project is located. The banking institutions shall make commitments in public that appropriate international practices or international norms will be followed as far as such overseas projects are concerned, so as to ensure alignment with good international practices. (China Banking Regulatory Commission 2012)*

It is not just financiers that are subject to guidelines when implementing overseas projects, companies investing overseas are also expected to follow guidelines issued in February 2013 by China's Ministry of Commerce (MOFCOM) and Ministry of Environmental Protection. The Guidelines for Environmental Protection in Foreign Investment and Cooperation require overseas investors to respect local customs and beliefs, abide by local regulations, and promote harmonious development of the economy, environment and local communities. They also state that investors should conduct environmental impact assessments and create plans to mitigate negative impacts, and after projects become operational enterprises should monitor pollution levels. The guidelines emphasise that companies should improve communication with local people and gather opinions and suggestions concerning the operation and environmental impact of development projects (Ministry of Commerce and Ministry of Environmental 2013).

Although there are currently no mechanisms in place to enforce the implementation of these guidelines, the Green Credit Guidelines are intended for both commercial and policy banks, and both CDB and Eximbank are expected to implement them.<sup>1</sup> Likewise, the MOFCOM guidelines lack enforcement mechanisms, but they provide a foundation for improved overseas operations. China's State Council and the State-owned Assets Supervision and Administration Commission (SASAC) have issued basic principles and guidelines which state that enterprises operating overseas should act responsibly, abide by local laws and regulations, and respect local customs. Specific guidelines have also been issued related to forestry and mining, and there are plans to develop guidelines for the overseas rubber industry, but again, all of the current guidelines lack enforcement mechanisms.<sup>2</sup> In addition to the above investment and finance guidelines, CDB and Eximbank have also adopted their own environmental and social guidelines which have relevance to their overseas financing.

### *Social and Environmental Policies of the China Development Bank*

The CDB claims to have developed a set of policies and internal performance indicators that are based on the principles of the United Nations Global Compact. Although the bank has published summaries and has mentioned these policies in its sustainability reporting, the full documents are not publicly available so it is not possible to conduct a detailed analysis.

The CDB has a project appraisal department, and its project assessments include an appraisal of the environmental and social risks of proposed projects. All loan applications must include an environmental impact assessment (EIA) completed by an independent evaluator, and the bank can reject loans solely on environmental grounds. If necessary, the bank can write environmental standards and costs into loan covenants in order to oblige borrowers to carry out their environmental commitments (Matisoff 2012). According to an article on the CDB's website, the bank "strictly control[s] environmental and social risks so as to promote a multilateral win-win outcome", and issues credit ratings to its customers which take into account environmental performance. Bank customers who are penalised for environmental infringements may have their credit rating lowered, potentially jeopardising future loans. In serious cases the CDB may suspend lending (China Development Bank 2013). CDB's 2012 Sustainability Report asserts that its environmental and social risk management systems are in line with "relevant international guidelines, policies and regulations", and states:

<sup>1</sup> For an analysis of the Green Credit Guidelines in practice, see Friends of the Earth and BankTrack (2014).

<sup>2</sup> For more detail see Greenovation Hub (2014: 63-7).



*The Board of Directors, the Risk Management Committee of the Headquarters and managers at various levels have become increasingly concerned with environmental and social risks. They take these risks into serious consideration in credit approvals, and they have tightened the control over credit extensions, boosted customer and industrial ratings and improved relevant policies and rules and approval procedures to enhance the evaluation of environmental benefits (China Development Bank 2013).*

The CDB has published annual sustainability reports since 2007, and in 2010 established a social responsibility department and incorporated its social responsibility index into performance evaluations. In 2006 the bank became the first large state-owned Chinese bank to join the UN Global Compact, and in 2011 became a member of the UN Environmental Programme Finance Initiative. The CDB has not signed up to the Equator Principles, but in 2008 established an internal Equator Principles Working Group, and claims that the principles are being gradually applied in its business development (ibid.).

The development of the CDB's social and environmental policies represent a positive step towards improving the standards of overseas projects. However, while the CDB claims that its policies and systems follow international standards, this is impossible to verify as the full assessment and monitoring systems are not publicly accessible. There are no known policies for public participation or access to information regarding CDB funded projects, and no grievance mechanisms exist for people who feel that they have been negatively impacted by the bank's projects. Project appraisals are conducted behind closed doors and no documents are published regarding assessments and approvals. This lack of transparency limits the effectiveness of the existing social and environmental policies. Unlike international financial institutions such as the World Bank and Asian Development Bank (ADB), which disclose proposed and active projects on their websites, the CDB has no publicly accessible database that provides project details, documentation or details of project assessments. This creates a barrier to accessing information on CDB financed projects, and also means it is not possible to identify cases, if such cases exist, where the CDB has investigated borrowers for non-compliance and compelled them to bring projects into line with lending guidelines.

### *Social and Environmental Policies of the Export-Import Bank of China*

Eximbank has also made progress towards developing improved environmental and social policies. In 2004 the bank adopted a brief environmental policy, although this was not published until 2007 (International Rivers 2012). In 2008 the bank published more detailed Guidelines for Environmental and Social Impact Assessments of the China Export and Import Bank's Loan Projects. The guidelines include details on the evaluation process for overseas projects, and require that Environmental Impact Assessments (EIAs) are conducted both during the pre-loan period and after Eximbank financed projects begin implementation (Export-Import Bank of China 2008). Under the guidelines borrowers must abide by the environmental laws and regulations of host governments, and in cases where host country environmental protection mechanisms and assessment standards are lacking, borrowers should either follow China's domestic standards or international practice (ibid.).

The guidelines state that implementation of overseas projects must respect the land and resource rights of local people, deal with resettlement issues in an appropriate manner, and that projects with severe environmental impacts should be subject to public consultation. Eximbank can negotiate amendments to a borrower's project plan based on their environmental and social assessments, and if necessary can request that environmental and social conditions are written into loan contracts. The guidelines state that the bank should inspect projects during construction and implementation stages, and borrowers are required to report to the bank regularly on the implementation status and report the emergence of unforeseen social or environmental impacts. If serious impacts do occur during construction or operation and the borrower does not remedy them, Eximbank may cease loan disbursement and demand early repayment (ibid.).

According to Eximbank's website, a higher threshold is applied to highly-polluting or energy-intensive projects during the loan assessment process, whereas "environmental-friendly" sectors are more likely to receive lending support. It also states that during the project implementation "stringent" standards are observed and "real-time risk warning management" is put in place to raise the alarm if a project fails energy efficiency or environmental standards, or if the company violates relevant environmental regulations (China Export-Import Bank 2014).

Much like the CDB, Eximbank has made positive steps to develop a framework to deal with the potential social and environmental impacts of its financing both in China and overseas. However, the guidelines are still basic and lack detail, and as in the case of the CDB, Eximbank's assessment process is not open to public scrutiny and results are not disclosed. While the bank's guidelines touch on important issues such as environmental assessment, resettlement and public consultation, these concepts are not expanded or clearly defined, and the guidelines lack clear steps for ensuring, for example, that resettlement is conducted in an appropriate manner. Eximbank also lacks any grievance mechanism for those who may be negatively impacted by the projects that it finances, which again limits the utility of these guidelines.

Figure 7 provides a comparison of the environmental guidelines of CDB and Eximbank with those of the World Bank and IFC. This indicates that while both of the Chinese banks have made progress in developing standards, key gaps remain. A particular concern as mentioned above is the lack of grievance mechanisms and independent monitoring. The absence of these components both limits the utility of the existing safeguards and reduces the accountability of the CDB and China Eximbank.

**Figure 7: Safeguard Comparisons**

<b>Environmental Guidelines</b>	<b>World Bank</b>	<b>IFC</b>	<b>CDB</b>	<b>Eximbank</b>
Ex-ante environmental impact assessment	X	X	X	X
Project Review of Environmental Impact Assessment	X	X	X	X
Industry-specific social and environmental standards	X	X		
Ensure compliance with host country environmental laws and regulations	X		X	X
Ensure compliance with international environmental laws and regulations	X			
Public consultations with communities affected by the project	X	X		X
Grievance mechanism	X	X		
Independent monitoring and review	X			
Establishing covenants linked to compliance	X	X		X
Ex-post environmental impact assessment			X	X

*Source: Kevin P. Gallagher, Amos Irwin and Katherine Koleski (2012)*

## **Positive Impacts and Challenges Raised by China's Approach to Overseas Development Finance**

In a relatively short space of time, China has become a major actor in overseas development finance. UNCTAD statistics show that in 2013 China's outward investment ranked third in the world behind the US and Japan (Ministry of Commerce et al. 2014). The CDB and Eximbank have played a major role in providing financing for a significant portion of this investment. As the overseas presence of Chinese enterprises and financial institutions has grown, so has scrutiny of Chinese investors and financiers. The Chinese Government and media are often eager to promote the positive impacts of Chinese overseas investment and development assistance and its potential for 'win-win' cooperation with host nations. Likewise, many leaders in recipient countries have expressed strong support for Chinese investment. However, there is also a great deal of coverage that is critical. This section of the paper looks at some of the major impacts that

China's overseas development finance is having, but also addresses a number of challenges that have emerged.

### *Chinese Finance is Supporting the Development of Key Sectors in Developing Countries*

As illustrated throughout this paper, much of China's development finance is directed to key sectors such as infrastructure, agriculture, energy, and transportation. The development of these areas is a crucial foundation for economic growth in developing and emerging economies, and for this reason Chinese investment and aid have been warmly welcomed by many countries. The CDB and Eximbank have considerable experience in financing such projects, both at home and overseas, and have the ability to mobilise significant resources to fund major development projects across the globe. With strong state support for Chinese companies going out, and an economy that has largely weathered the financial crisis, China is able to provide comprehensive economic development packages to countries seeking funds and expertise to develop their pillar industries.

While strong infrastructure is essential to ensure growth, development in this area also comes with considerable risks, and there are numerous examples of Chinese funded projects that have run into problems. In some cases this has soured diplomatic relationships, for example, in 2013, Botswana's President raised concerns about the approach of Chinese investors, stating: "You know, we have had some bad experiences with Chinese companies in this country...The best way I can put it is that we are very, very particular now; we are going to be looking very carefully at any company that originates from China in providing construction services of any nature" (Kotch 2013). These comments were in part a response to reportedly poor performance of Chinese construction companies working on government infrastructure contracts, including projects financed by Chinese banks and official development assistance. A number of high profile controversies occurred around issues including tendering procedures, delays, quality of workmanship, allegations of corruption, labour relations, and occupational health and safety problems. In 2012, state-owned Sinohydro had a government contract terminated and reportedly left the country (Youngman 2013).

Although the case of Botswana is not necessarily representative of the experiences of Chinese companies in all the countries in which they are investing, it can be regarded as a warning as to what can go wrong if overseas investment and finance is not implemented and supervised well. In order to avoid or mitigate financial, political, social and environmental impacts, strong safeguards need to be adopted and applied to overseas development projects. Although this is an area in which China has made progress in recent years, there is still much room for improvement.

### *Safeguards for Overseas Financing Need to be Improved and Implemented Transparently*

As China's regulations, policies and guidelines for overseas investment and financing have evolved, so have those of the CDB and Eximbank. These developments are certainly positive, but much more work needs to be done to improve the existing policies and bring them closer to international standards. While the banks' guidelines touch on important issues such as legal compl

compliance, EIAs, resettlement, and communication with the public, they still lack detail. Currently Eximbank and CDB do not have sector specific guidelines for their financing, and this ‘one-size fits all’ approach is not adequate to deal with the diverse impacts that projects may have in, for example, the forestry, hydropower and mining sectors.

Resettlement and compensation is also an extremely sensitive matter that must be handled cautiously by incoming developers, and represents an issue that Chinese financiers have not yet developed strong policies to deal with. In China, when land acquisition is necessary in order to make way for development projects, local governments often play a major role in facilitating the relocation and compensation process. In countries with weak legal and regulatory systems, limited local government capacity and/or poor governance, resettlement is not always handled appropriately, which makes it risky for investors to rely on local systems alone. However, this is common practice for Chinese investors, who often see management of resettlement and compensation as being the responsibility of the local government (Cao and Wang 2012). Strong mechanisms are needed to ensure that relocation is done in an appropriate way and that compensation is adequate and paid in good time. Institutions such as the World Bank, IFC and ADB have policies that lenders are required to implement, but at present no Chinese financiers have such detailed policies in place.

Of course, the existence of strong policies and guidelines alone is not enough to avoid negative impacts in overseas projects, the important thing is that these safeguards are implemented. At present, project assessment by the CDB and Eximbank is non-transparent and there is no guarantee that public engagement will be ensured during project appraisal. EIA reports and environmental management plans are often not made public, and there are no grievance mechanisms in place for people who are impacted by CDB or Eximbank financed projects. In the absence of strong safeguards, projects risk running into problems during both construction and implementation, and there are a number of cases where this risk has become a reality.

### **The Kamchay Hydropower Dam, Cambodia<sup>3</sup>**

In 2006 Sinohydro signed a 44-year Build-Operate-Transfer (BOT) agreement to develop the Kamchay Hydropower Project in southern Cambodia. Construction on the project began in 2007 and ended in December 2011, at a cost of approximately US\$280 million. Cambodia suffers chronic electricity shortages, which this project is helping to address by supplying power to the capital as well as the province where it is located and neighbouring areas. However, problems emerged during project development which could have been avoided if both the financier and developer had stronger safeguards in place.

The Prime Ministers of China and Cambodia signed an agreement approving the project in July 2005, and Cambodia’s Ministry of Industry, Mines and Energy signed the BOT contract with Sinohydro in February 2006 (Hensengerth 2014). However, the final EIA was not approved by the Ministry of Environment until 2012, despite the fact that project construction commenced in 2007 and the dam became fully operational in December 2011.

The EIA process was non-transparent, and there was no meaningful consultation with affected communities. A 2013 study found that local community members had “largely been left out of

<sup>3</sup>For a more comprehensive assessment of this project see Grimsditch (2012).

any participatory processes related to the dam's construction" and lacked knowledge about the dam (Gätke and Un 2013). In the absence of a final approved EIA, there was no agreed and publicised Environmental Management Plan in place during project construction.

Although local people were compensated for loss of agricultural land, no measures were taken to support local people whose livelihoods depended on collecting and selling non-timber forest products from the local forests. The dam flooded many of the areas that they previously harvested and blocked access to others. Other local people who depended on tourism at a nearby scenic spot were also not consulted or provided with any support after tourism at the site dried up.

Although Eximbank had policies in place requiring the borrower to follow local laws, including conduct of an EIA and consultation with local people, they were clearly inadequate. The EIA process was flawed and consideration for local livelihoods limited. As a result, many local people suffered a drastic loss of income which could have been avoided if livelihood restoration policies were in place.

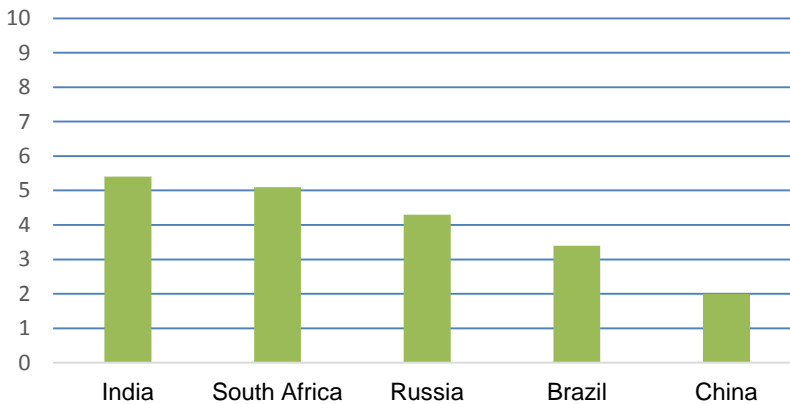
### ***Lack of Communication, Public Disclosure and Transparency Threatens Sustainability***

At present neither CDB or Eximbank maintain publicly accessible databases of the projects that they are involved in, and the only official source of information on specific projects is contained in annual reports and scattered news releases. The information made available is far from comprehensive and tends to provide only basic project details. In a number of cases it is only possible to identify Eximbank or CDB involvement in a project by reviewing media reports, as the institutions themselves do not publicly disclose their involvement in all projects. In the absence of such disclosure, opportunities for public oversight are severely limited.

Chinese investors are often criticised for focussing too much on building high-level relationships and overlooking the need to communicate with local communities and civil society (Wang 2012). The same could be said of Chinese financiers. When incoming investors and financiers are seen to be too close to the government, discontent can emerge among local people, especially in cases where the government is unpopular or not seen as legitimate by segments of the local population. A recent high profile example of this can be seen in the Myitsone hydropower dam project in northern Myanmar. The unpopular project became a rallying point for local people who were concerned about its potentially drastic social and environmental impacts and felt that they had not been properly consulted. In the face of unusually strong public opposition, the US\$3.6 billion project was suspended by the Myanmar Government, no doubt at great loss to the developer (Watts 2011).

In 2013, Transparency International released a report ranking companies from emerging economies according to their anti-corruption and transparency commitments. The 33 Chinese companies that were assessed received an overall rating of 2 out of 10, which as shown in Figure 8 was lower than all of the other BRICS countries (Kowalczyk-Hoyer and Côté-Freeman 2013).

**Figure 8: Transparency International - Average Transparency Scores of Companies from BRICS Countries**



*Source: Transparency International (2013)*

The Chinese companies assessed by Transparency International included several mining, oil, construction, and holding companies, a number of which have extensive overseas operations. As most of the overseas financing of the CDB and Eximbank flows to Chinese firms, this raises potential risks for the banks, and provides further support for developing enhanced safeguards to ensure transparency and combat corruption.

#### *Accusations of 'Resource Grabbing'*

Some critics of China's overseas investment and finance have criticised China's quest for resources. While there is certainly an emphasis on resource acquisition, as stated earlier, there are multiple motivations behind China's going out strategy – and China is certainly not the only country that is seeking to obtain resources from around the globe. Furthermore, many countries are actually seeking to attract Chinese investment in resource development. Governments of developing countries are often eager to attract Chinese investment as domestic companies may lack the technical and/or financial capacity to develop their natural resources alone. Developed economies such as Canada and Australia have also sought to attract Chinese investment in natural resources, especially since many established western resource companies suffered the impacts of the financial crisis and lost access to finance for new projects.<sup>4</sup>

Resource-backed loans in particular have been the focus of criticism and accusations of 'resource grabbing', however, these types of commodity backed agreements are not unique to China, and developed countries have also utilised this approach to resource investment in the developing world. Although these loans may tie up resources, the system allows countries with poor credit ratings to access financing for major developments. Nonetheless, a concern that remains is the lack of transparency in which these deals are often agreed. The President of China Eximbank has stated that the bank uses market prices in repayment arrangements for its commodity-backed loans (Bräutigam 2011), but this is not always easy to verify when loan agreements are not made public. For example, a major US\$9 billion resource for infrastructure deal was signed between

<sup>4</sup> For a more detailed discussion on the development of China's overseas mining industry see Greenovation Hub (2014).



China and the Democratic Republic of Congo in 2007, but was not made public, despite the huge value and potentially far reaching impacts of the agreement. This deal, which was partially financed by China Eximbank, was negotiated behind closed doors, the contract bidding process was not well publicised, and only limited information was made available regarding environmental and social impacts (Global Witness 2011).

Concerns regarding China's overseas resource investments tie in closely with the discussion on safeguards, disclosure and transparency. Resource investments in any country come with inherent risks, and this is especially true in countries with weak legal systems and poor governance. Increased transparency in resource deals is also necessary to reduce the risk of corruption and increase public confidence. Again, this can be aided by investors and financiers adopting and implementing strong safeguards.

### *Lending to 'Green' Industries is Increasing*

Although both the CDB and Eximbank still provide considerable financing to the fossil fuel industries, in line with the Chinese Governments call for financial institutions to support environmentally friendly economic growth, both banks are expanding their portfolios in new areas and developing their 'green credit' portfolios. Green lending is being directed to projects such as recycling, watershed management, sewage treatment, environmental protection, industrial upgrading and clean/renewable energy, among others.

At the end of 2013, the CDB's outstanding loans for environmental protection and energy conservation projects stood at RMB 894.5 billion (US\$143.8 billion). This was up by 5.8 per cent on 2012, and according to the bank, has contributed to savings of 65 million tons of standard coal and 170 million tons of water, and reduced emissions of carbon dioxide by 170 million tons and sulphur dioxide by 3 million tons (China Development Bank 2014). As part of its goal of supporting emissions reductions, the bank also supports inefficient coal plants and manufacturing industries to upgrade and modernise machinery and processing facilities. This is alongside support for clean energy projects include wind and solar power, but also more controversial projects such as hydropower and nuclear energy.

Eximbank also states that it is strengthening its support to low carbon and renewable energy projects, energy efficient industries and emissions reduction. In 2012, loans in these areas reached almost RMB 140 billion (US\$22.5 billion), a year-on-year growth of 18 per cent. The bank also supports technology upgrading in high emissions industries such as steel production, with loans reaching RMB 100 billion (US\$16 billion) in 2012, an increase of 24 per cent on 2011 (Export-Import Bank of China 2013). According to its 2013 annual report, the bank has made efforts to cut investment to industries that are currently over capacity. Industries such as cement, aluminium and cement processing are notoriously over capacity in China, and the Chinese Government has stepped up efforts in recent years to reduce production. In support of these efforts, new loans given to these industries by Eximbank in 2013 were mainly used for energy conservation and emission reduction, technical upgrading, mergers and acquisitions and overseas expansion (Export-Import Bank of China 2014).

It is encouraging that the two banks are making efforts to increase lending to areas such as renewable energy and emissions reduction. As more information becomes available regarding the strategic focus of the New Development Bank, many will be eager to see whether or not this includes commitments to prioritise lending to 'green' industries such as those discussed here.

### *Applying China's Domestic Development Finance Model Overseas*

As mentioned earlier in this paper, the China Development Bank is seen as the pioneer of development finance in China. Of the five BRICS countries, China's overseas development finance is by far the largest, and the experiences of the CDB may therefore have considerable influence on the operations of the proposed BRICS New Development Bank.

Although the CDB has become increasingly independent over the last decade, its operations are still closely linked to the policies and priorities of the Chinese Government, and the bank is very much a product of the Chinese political and economic system. It has therefore had to adapt its approach when financing overseas projects, but there are similarities in its overseas and domestic agendas. In China the CDB has focussed heavily on infrastructure, roads, railways and energy, much as it does overseas. Supporting urbanisation has been a key domestic priority for the bank, and CDB financing for urban development has played a major role in the development of China's land market. Improved infrastructure leads to higher land prices, which creates a source of collateral that local governments can use for securing further financing for urban development. Following this pattern, many of China's cities have grown exponentially over the last two decades.

The economic benefits of China's investment in infrastructure are readily apparent. This investment has been a major factor in the country's phenomenal growth and has directly contributed to lifting many millions of people out of poverty. However, there are downsides to this model. While land markets have developed, local governments often seek to obtain land at the cheapest possible price and fully utilise its potential as collateral. In recent years both Chinese and international media coverage has included reports on conflicts and violent incidents connected to disputes over land acquisition and compensation. The system has also created what many see as a property bubble, and local governments have amassed huge debts. In June 2013 the National Audit Office reported that government debts at all levels have reached RMB 20.69 trillion (US\$3.45 trillion) (Zhongxin Net 2013).

It is well-known that China is currently dealing with a number of domestic challenges which are in part a symptom of the rapid development the country has experienced. Likewise, problematic overseas projects have also received extensive coverage. However, there is still clearly a demand for Chinese finance and investment across the world, as evidenced by continued year-on-year increases in China's OFDI. Many developing and emerging economies no doubt wish to emulate China's domestic economic successes, and have welcomed Chinese investment. In 2014, China successfully laid the foundations for the new multilateral Asia Infrastructure Investment Bank, which in addition to the New Development Bank, potentially broadens China's global financial influence further. With this in mind, the final part of this paper turns to China and the NDB.

## China and the New Development Bank

Although the New Development Bank has not yet become fully operational (as of the time of writing), documents that emerged from the sixth BRICS summit in Fortaleza provide information on the objectives and structure of the bank. In the *Fortaleza Declaration*, the BRICS members stated that the NDB will mobilise resources for “infrastructure and sustainable development projects” in the BRICS and other emerging and developing countries (Sixth BRICS Summit 2014). It is widely acknowledged that there is a shortfall in financing for infrastructure development, and this issue is also raised in the *Fortaleza Declaration*. The establishment of the NDB is seen as an opportunity to address this gap and also strengthen cooperation between the member countries.

As illustrated throughout this paper, China has extensive reserves of both foreign currency and Chinese yuan that can be mobilised to support development projects across the globe. Although China is by far the biggest economic power within the BRICS nations, the *Fortaleza Declaration* emphasises the shared nature of responsibilities within the NDB. The bank’s initial authorised capital is US\$100 billion, with initial subscribed capital of US\$50 billion. Contributions of this subscribed capital will be shared equally among the founding members. Under the *Agreement on the New Development Bank*, when the bank becomes operational, key roles will be divided between the members as follows:

- ⇒ Russia: The first chair of the Board of Governors.
- ⇒ Brazil: The first chair of the Board of Directors.
- ⇒ India: The first President of the Bank, after which the position will rotate between founding members. Each founding member shall have one vice-president (apart from the country holding presidency).
- ⇒ China: The headquarters of the Bank will be located in Shanghai.
- ⇒ South Africa: The New Development Bank Africa Regional Center shall be established in South Africa concurrently with the headquarters (BRICS Nations 2014).

The agreement on the NDB, which was signed at the sixth BRICS summit, has provided detail on the structure and management of the bank, but there are still a number of outstanding questions that are yet to be resolved. Crucially, there is a lack of clarity regarding what type of safeguards the NDB will put in place to mitigate and remedy the potential social and environmental impacts of projects that it supports. As mentioned throughout this paper, a major factor impacting on the quality of China’s overseas development finance is the lack of high quality safeguard mechanisms. It must be kept in mind that the current policies in place at multilateral institutions such as the World Bank, IFC and ADB have developed over many years, and it will no doubt take time for the NDB to establish and implement its own mechanisms. However, the NDB can take inspiration from existing international standards when developing its own policies. Along with social and environmental standards, policies covering transparency, corruption, procurement, etc. must be developed in order to ensure that the NDB’s goal of promoting “sustainable development” is achievable.

Although many observers have characterised the establishment of the NDB (and other new multilateral initiatives) as a challenge to the existing institutions, the *Fortaleza Declaration* states

that the NDB will mobilise resources and “supplement the efforts of multilateral and regional financial institutions for global growth and development” (ibid.). However, it is no secret that BRICS members are disappointed with the slow pace of reform at the International Monetary Fund (IMF). At the 2014 G20 summit the BRICS members issued a statement in which they expressed “disappointment and serious concern at the non-implementation of the 2010 IMF reforms, and its impact on the Fund’s legitimacy and credibility” (BRICS Leaders 2014). Additionally, China in particular is reported to be frustrated with its limited influence at the World Bank and ADB.

The creation of the bank is new territory for all the BRICS members, and when the bank does become fully operational it will no doubt take time to establish itself. The bank’s founding documents emphasise the equal roles of the members, and all five countries have much to bring to the table in terms of both domestic and international development finance. However, only time will tell what role the bank will eventually have in the global development finance landscape.

## Conclusion

Since the 1980s, China has invested heavily in its infrastructure, and in the process has developed its markets, connected previously under-served regions, promoted industrialisation and modernisation, and raised its GDP exponentially. This has contributed to the alleviation of poverty on a scale unmatched by any other nation. With the Chinese Government’s strong engagement in the country’s economic development the pace of China’s growth has been swift, but with such rapid development comes costs such as uneven economic growth, low efficiency in resource and energy utilisation, and misuse of investment capital. In addition to issues around local government debt and the long-term risks that this raises, the most obvious downside of China’s rapid growth is the massive environmental degradation that the country is currently trying to address.

China has taken lessons learned at home and applied them abroad, financing infrastructure in developing and emerging economies, while simultaneously building the capacities of Chinese industries, gaining access to global markets, and obtaining valuable natural resources – all of which are crucial for sustaining China’s domestic growth. Since overseas investment rocketed in 2004, the country’s financial and regulatory institutions have experienced a steep learning curve. In particular, the experiences and approaches of the CDB and China Eximbank, the two major state-backed institutions engaging in global development finance, could potentially have a critical impact on the development and approach of the New Development Bank.

While developing countries may seek to emulate the success of China’s infrastructure and urbanization push, there are important lessons that can be learned from the challenges the country now faces domestically. China’s experiences financing overseas development projects also provide important lessons. Although its policy banks have increased lending to environmentally friendly projects and developed environmental guidelines and policies, the fact cannot be ignored that both CDB and Eximbank still support a number of highly polluting industries. Similarly, despite the development of policies and guidelines related to social impacts, many Chinese investments have encountered problems overseas including accusations that they have dealt poorly with community consultation and displacement issues, and several high profile cases have

been implicated in corruption. The other BRICS nations can learn much from China's use of domestic and overseas development finance – both its successes and challenges – and it is crucial that these lessons are integrated into the development and operation of the New Development Bank.

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MZUKISI QOBO

# Development Bank and Civil Society in South Africa



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## Introduction

Development finance institutions (DFIs) and other multilateral development banks are becoming more aware of the importance of engaging with non-governmental organisations (NGOs) as critical stakeholders (see Curtis 2004; World Bank 2000; World Bank 2006; UN 2003). Consultative processes involving DFIs and NGOs or civil society organisations (CSOs) are important for enhancing the scope and effectiveness of DFI programmes, as well as facilitating the development of good best-practice frameworks.

This paper offers a critical review of the practices of South Africa's DFIs, with particular attention given to the Development Bank of Southern Africa (DBSA) and the Industrial Development Corporation (IDC). We look at their relationship with political agencies, their governance structures, capitalisation, and priorities for the range of projects that they finance. We also take a closer look at their framework for project assessment, with a specific focus on their methodologies for environmental and social impact assessment.

As we show in this paper, the level of engagement in South Africa between DFIs and civil society is very low and almost non-existent. Here, we use civil society to refer to the social movements that exist outside of the state. This includes non-governmental and community-based

organisations. There is no obligation on the part of DFIs to directly engage civil society. There is no evidence of a deep commitment to public participation processes. The fact that, in many instances, the financial commitments of DFIs are made indirectly to state-owned enterprises (SOEs) undertaking major infrastructure work, to mining companies in the form of equity or debt, and to municipalities, renders DFIs complacent about engagement with the public. Further, there are no credible and independent evaluation and monitoring tools to ensure that after funding had been committed the recipients adhere to agreed-upon environmental and social objectives.

Although there is limited engagement with civil society, we found that South African DFIs comply with international standards and best practices, and often apply rigorous standards in assessing the social and environmental impacts of projects that they finance. This is largely for reputational purposes and in adherence to a much “higher floor” of regulatory norms that exist within South Africa, compared to the countries where IDC makes investment commitments in the continent.<sup>1</sup> In the section below, we first sketch out the context of the political economy within which South African DFIs are realising their purposes and mandate, and the constraints that they face in financing and undertaking projects.

### *Why is Public Engagement Important?*

Extensive consultation with civil society is a good business practice as this can enrich the DFIs’ social credibility and encourage ethical conduct. DFIs need to find ways to engage with the public and with organisations that are active in the area of environmental and social impact. This also helps to build trust with stakeholders beyond the government. In the same way, a lack of positive ties between DFIs and NGOs at the community or local levels can make it difficult for DFIs to be effective, especially in contexts where CSOs play an active role in monitoring the environmental and social impacts of infrastructure projects.

There are three sets of issues that should be taken into account when assessing the nature and scope of DFI–civil society engagement:

The first is the positioning and relevance of NGOs and other civil society bodies in the overall work of the DFI. How are NGOs defined as stakeholders or development partners? This is mostly embodied at the strategic or thematic levels of the institution’s mandate or operational policies and it may be optional or mandatory. For instance, civic groups can be brought into consultation processes with respect to overall policy, where the objective could be to share information, discuss strategic or thematic issues of mutual concern, and to explore pathways towards more effective and mutually beneficial engagement.

In some instances, consultations can also be ad-hoc and optional, depending on the nature of the project and its requirements. An interface between the DFI and the NGO sector could also allow the DFI to fulfil its mandate, especially where it is explicitly required to consult with NGOs about aspects of its work concerned with pro-poor, environmental or sustainable-development goals (this also applies to private corporations that have to think about “sustainability” alongside shareholder value and financial performance.)

The second dimension of the DFI–NGO relationship is operational cooperation in project design. Does the nature of stakeholder engagement also imply the inclusion of NGOs in the

<sup>1</sup> This is based on confidential focus group interviews with individuals working closely on infrastructure issues, 3 September 2013.

implementation and monitoring of projects? How far is the DFI willing to go to include the views of the NGO community? Meaningful engagement with NGOs could include the processing of loans and technical assistance, where the DFI can consult NGOs to tap into their practical and research knowledge.

The third element is the need for DFIs to support capacity building and institutional development in NGOs as part of a broader effort to improve human and social capital, which is necessary to effect DFI policies on sustainable development and poverty reduction. For example, the Asian Development Bank (ADB) provides such support to governments and to NGOs/CSOs in order to both strengthen government-NGO/CSO cooperation and build productive trilateral development partnerships in sustainable development. This is based precisely on the recognition that the successful design and execution of projects requires a degree of cooperation – or stakeholder management – between DFIs and NGOs.

For African-based DFIs, these trends are evolving in different ways and also vary across regions, countries and cultural contexts as well as in the nature and scope of projects involved. Nonetheless, the different ways in which civil society engages with DFI work in Africa have been documented, as they are seen as instrumental to informing and refining their policies and strategies.

In this paper we look at two South African DFIs – the Development Bank of Southern Africa (DBSA) and the Industrial Development Corporation (IDC) – that are active in the spheres of infrastructure development and financing large-scale projects within South Africa as well as outside. Both organisations were created under apartheid, with the IDC established in 1940 to undertake secondary industrialisation as well as to lend financial weight to the creation of Afrikaner industrialists, and the DBSA coming into being in 1983 to “perform a broad economic development function within the homeland constitutional dispensation” (DBSA n.d. a).

## South Africa’s Developmental Paradigm

South Africa’s DFIs are expected to play a “developmental” role, which this report argues is weakly defined and lacks coherence. According to Pempel (1999, 139), developmental states “define their missions primarily in terms of long-term national economic enhancement” and “actively and regularly intervene in economic activities with the goal of improving the international competitiveness of their domestic economies”. While the debates on the merits of South Africa as a developmental state (or not) are outside of the scope of this paper, the country seems to exhibit few of the characteristics that were present in most of the Asian countries that transformed themselves from economic backwardness to prosperity. There is neither the bureaucratic depth nor sufficient convergence between the state and a broad array of societal interests that would enable the state to notch up similar achievements in a short period of time. Moreover, South Africa’s conception of its developmental paradigm lacks coherence, definition and performance indicators.

Significantly, though, DFIs are one vehicle for state intervention in the economy to promote growth and employment creation and achieve equity objectives. The South African government justifies its strategic management and active use of state-owned enterprises/entities (SOEs) and DFIs in the name of building a developmental state. In this context, our paper focuses mainly on

the outward-oriented DFIs, in particular the DBSA, which has an explicit mandate to finance infrastructure projects in southern Africa and also promote regional integration. We also cover the IDC, to a more limited extent, whose project coverage extends far beyond the southern African region to the broader continent.

The South African government views its DFIs as instruments for achieving a range of developmental objectives to improve quality of life: to enhance public service delivery, increase economic growth, improve infrastructure and create jobs (Chabane 2013). This repositioning of DFIs and SOEs is indicative of the broad thrust of the country's development strategy.

Leveraging the balance sheet of some of the DFIs for large-scale public sector investment is a particular emphasis of the New Growth Path (NGP) that does not feature as strongly in the National Development Plan (NDP). Unlike countries whose DFIs are only concerned with building a diversified portfolio of investments to realise good returns, it appears that South Africa is trying to balance a politically defined development mandate while simultaneously working towards commercial objectives to ensure the long-run sustainability of DFIs.

Since 2010, the IDC has been recalibrated to work within the political structures of the department of economic development (EDD), which, along with the department of trade and industry (DTI), drives the state's interventionist agenda. Accordingly, job creation has become central to the IDC's mandate. The IDC is also expected to fulfil some of the goals set out in the NGP, the economic strategy that is a brainchild of EDD.

The DBSA and the IDC both have domestic and external mandates that have changed over time under the political guidance of various post-apartheid administrations. Some of the key objectives of the government's development programme, to which the DFIs are expected to respond, include improving the overall performance of the economy, stimulating growth to reach the 5 per cent threshold, facilitating job creation, increasing public investment in infrastructure, and providing more support to economic sectors that are prioritised by the state.

However, the relationship between the DFIs and the government ministries under which they fall is not without discontent. While there is a fair degree of convergence regarding the pursuit of developmental objectives at the domestic level, there are somewhat conflicting views within the state, as well as between the state and the IDC in particular, regarding the precise objectives for external engagements.

The IDC has for many years maintained an arm's-length relationship with the state. The scope of its autonomy was eroded since supervision shifted from the DTI to the EDD, which was run by a former trade unionist, Ebrahim Patel.<sup>2</sup> The DBSA, on the other hand, falls under the political guidance of the National Treasury. Both DFIs have boards that, although approved by the relevant ministers, are expected to operate independently and conform to a corporate-governance regulatory framework.

## **Development Bank of Southern Africa (DBSA) – An Overview of Structure and Function**

The functions and specific objectives of the DBSA are fully outlined in the Development Bank of

<sup>2</sup> During interviews at the IDC, senior professionals alluded to a new dispensation of micro-management since IDC was shifted to the EDD.



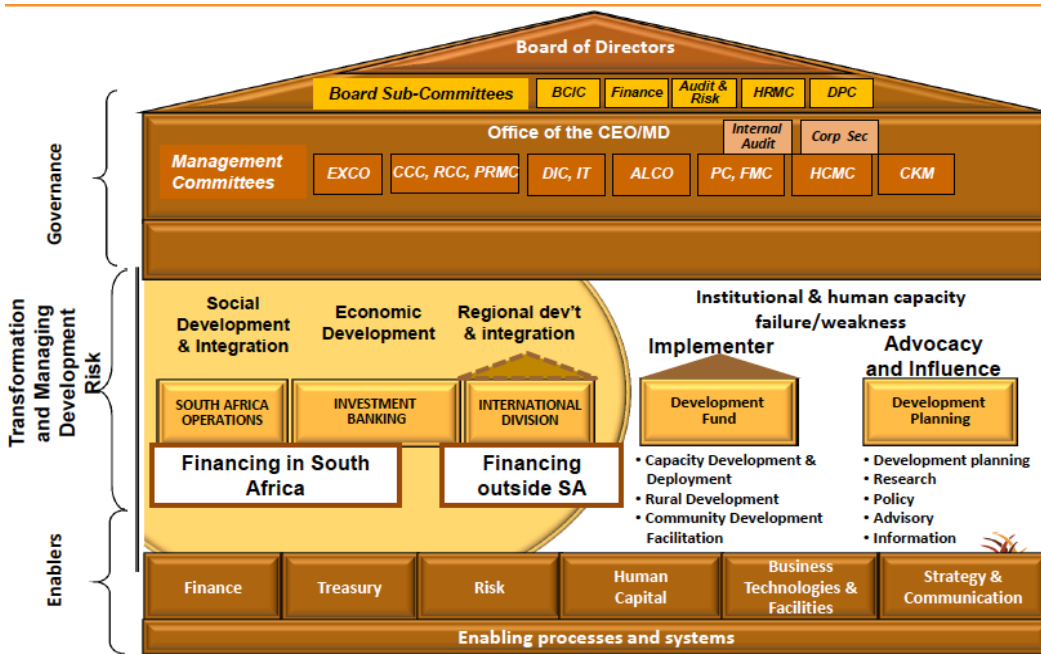
Southern Africa Act (No. 13 of 1997). Essentially, they aim at promoting local economic development in municipalities, and drive infrastructure development in South Africa and the region. The South African government is the sole owner and thus the parent of the DBSA, and thus able to exercise ultimate control. The Ministry of Finance acts as the governor and shareholder representative, determining the bank’s mandate and holding the board of directors accountable for managing the bank in a manner that fulfils this mandate.

The DBSA has a unitary board structure with 14 members, 12 of whom are independent non-executive directors, and one a non-executive director representing the National Treasury. The chief executive officer is the sole executive director.

The board of directors is governed by the DBSA Act and its regulations, as well as the provisions and recommendations of the King III Code, which is a soft regulatory mechanism to guide companies on corporate governance issues. It is based on the “comply or explain” principle that is prevalent in the European Union and the United Kingdom, as opposed to more punitive codes with a “comply or else” approach, such as the Sarbanes-Oxley Act in the United States.

The DBSA is also regulated in terms of the Public Finance Management Act (PFMA) (No. 1 of 1999), which aims to create a more effective financial accountability system for public entities. According to the PFMA and accompanying Treasury regulations, DBSA is classified as a Schedule 2 public entity. Such entities enjoy full managerial autonomy, with the government only intervening in its capacity as a majority or sole shareholder. Figure 1 illustrates this organisational framework as of August 2013.

**Figure 1: DBSA organisational framework (as of August 2013)**



Source: DBSA Role in Infrastructure Development Presentation to CESA, Reuben Matlala November 2012, DBSA



The DBSA played an active role as a lender to municipalities. Part of this role was also to provide capacity-building support to help municipalities undertake and implement local economic development more effectively. This support role became more pronounced during the period between 2006 and 2010 so as to address capacity deficits in municipalities and accelerate local economic development as a priority.

The DBSA has evolved further and currently seeks to establish itself as a centre of excellence for infrastructure development in markets beyond the sub-region. This role is increasingly important, especially since infrastructure remains the key growth constraint in most emerging and poor countries in Africa. It is for this reason that the DBSA has also been designated the focal point in South Africa for the BRICS Development Bank, which South Africa hopes to use to accelerate infrastructure development in the African continent and help deepen regional integration, in line with the “Africa Agenda” of its foreign policy.

There is no evidence of any substantive discussions within the BRICS Development Bank framework of governance norms and the kind of principles that would define good practice. Issues related to environmental sustainability, the kind of projects to lend to or not to lend to, and accountability to stakeholders are not discernible in various pronouncements about the BRICS Development Bank.

### *Governance Mechanisms*

The following governance mechanisms are used by the DBSA to identify sustainability and manage risk:

- ⇒ **Code of ethics:** Defines ethical standards to be upheld, including the protection of bank assets.
- ⇒ **Audit and risk committee:** Oversees financial management and is guided by a terms of reference that define the roles for management, internal auditors, the board of directors and other staff, as well as fiscal, fiduciary, and accountability mechanisms.
- ⇒ **Fiduciary oversight procedures:** These guide project appraisal processes and ensure the quality and monitoring of follow-up actions during implementation. All projects approved by the DBSA are reviewed using fiduciary policies.
- ⇒ **Comprehensive project appraisal procedures:** These are institutional, financial, human and regulatory risks assessments aimed to provide institutional checks and balances throughout the life of a project. Each appraisal commences with a risk assessment, including strategic, legal, environmental and reputational risks, to ensure that the bank’s intervention is sustainable and the intended development objectives are achieved.
- ⇒ **Commitments to external initiatives:** Linked to its governance mechanisms are also its external memberships, which can be strategic to its operational fiduciary reputation, but also as avenues for learning, networking, partnership and knowledge management. These include: the Africa Venture Capital Association (AVCA); NEPAD Business Foundation (NBF); SADC Development Finance Resource Centre (DFRC); Association

of African Development Finance Institutions (AADFI); World Economic Forum (WEF); and the United Nations Environment Program Finance Initiative (UNEP-FI, whose members sign a statement that commits them to sustainable development, sustainable management and public awareness and communication. These are voluntary commitments with no enforcement mechanisms).

While there is potential for conflicts of interest between the DBSA and the government to occur, such instances have yet to be reported and profiled. At the regional level, however, there is potential for a political backlash if, for instance, SADC member states do not have a sense of ownership of the DBSA and perceive it as an expression of South African interests. This could also play into negative perceptions of South Africa as a domineering economic power in the region.

## DBSA Policy Frameworks for Strategic Direction and Implementation

As noted earlier, since 1997 and the promulgation of the new act, the DBSA has expanded its mandate and refined its focus. Principally, it has been positioned to support municipalities to accelerate the delivery of infrastructure. This expanded mandate came about due to domestic market and institutional failure in infrastructure service delivery; DBSA expertise and capability to mobilise adequate technical capacity; and DBSA services which are provided on a cost recovery basis (DBSA 2010).

Delivering infrastructure at scale and efficiently on behalf of the state is one of the roles of the DBSA. It is expected to work with government institutions tasked with managing integrated infrastructure planning domestically (Patel 2013). These include government departments and policies and other SOEs, such as:

- ⇒ **National Treasury:** Provides the budget for national infrastructure projects that the DBSA is aligned with or has responsibility for.
- ⇒ **Office of the Speaker of Parliament:** Established the Parliamentary Budget Office, which will assist parliament to scrutinise the use of resources by government. A specialist from DBSA was seconded to undertake comparative research to design the model of the Budget Office.
- ⇒ **Infrastructure Development Cluster:** Comprises all infrastructure sector departments in government. Here, the DBSA is involved in overseeing and integrating infrastructure planning and implementation.
- ⇒ **Presidential Infrastructure Coordinating Commission (PICC):** Inaugurated in September 2011 as an infrastructure coordination and decision-making forum, the PICC is headed by the president and assisted by the deputy president. It brings key ministers, premiers and metro mayors together to promote infrastructure integration and coordination across various parts of the country, with priority accorded to poor regions. DFIs such as the DBSA and the IDC contribute technical capacity with reference to financing.

- ⇒ **Department of Performance Monitoring and Evaluation (DPME):** The DBSA also collaborates with the DPME, which is located in the Presidency and facilitates delivery agreements for all infrastructure departments as well as monitoring their implementation.
- ⇒ **The 2010 New Growth Path:** Through collaboration with the department of economic development; the NGP's Jobs Fund is administered by the DBSA.
- ⇒ **The 2011 National Development Plan (NDP):** Through collaboration with the National Planning Commission (NPC); the NPC, located in the Presidency, is tasked with developing a long-term vision and strategic plan for South Africa. It also advises cabinet on crosscutting issues for South Africa's long-term development. The NDP makes detailed recommendations on infrastructure and sees the DFIs as part of the "fiscal armoury" of the state, whose role is to make possible the implementation of government's developmental objectives.
- ⇒ **Integrated Infrastructure Plan 2022:** Guides the DBSA's engagement with the PICC and the NPC.
- ⇒ **Presidential Review Committee on State-Owned Entities:** Aims to align SOEs with the government's development agenda, including that of infrastructure development. The final report of the review contains some references to the role of the DBSA and the IDC.
- ⇒ **Cooperative governance:** The DBSA is directly engaged with the departments of health, education, transport, water, and trade and industry, among others, with this engagement being guided by memoranda of agreement. DBSA engagement ranges from programme and project preparation to the configuration of appropriate financing and institutional solutions.
- ⇒ **Collaborative relationships:** The DBSA also works with other DFIs and SOEs involved in infrastructure development, including the IDC, Eskom, Transnet and Telkom. The Presidential Review Committee on SOEs makes broad recommendations on improved oversight, coordination and collaboration between these entities, such as the proposed DFI Council.
- ⇒ **BRICS economic country strategy:** The DBSA is central in the efforts to conceptualise and develop the BRICS Development Bank and is already a signatory to the BRICS inter-bank lending mechanism. The DBSA participates in a multi-department strategy process that includes the department of international relations and cooperation (DIRCO), the National Treasury, the EDD and the DTI.

It is evident that the DBSA has a considerable set of responsibilities in the sphere of infrastructure projects. Without a doubt, it requires a massive capital base and strong balance sheet if it is to execute projects efficiently and effectively. In addition, South Africa has too many strategies, plans and collaborative relationships that often pull in different directions on key issues, effectively hampering progress in any direction.

## *DBSA Sources of Funding*

The bank raises its funds from capital markets, being rated major international agencies (DBSA n.d. b), and also receives an allocation from the National Treasury. The funding model is made up of a mix of internally generated sources, borrowing from international and domestic capital markets, and credit lines from supranational and bilateral development finance institutions and commercial banks including the Agence Française de Développement (AFD), the European Investment Bank, the German Kreditanstalt für Wiederaufbau (KfW), the Department for International Development (DFID) of the United Kingdom and the Japan International Cooperation Agency (JICA).

Resources for regional projects are mobilised mostly through strategic partnerships with various regional and international partners. The bank also receives budget allocations from the government, although there is no explicit government guarantee for the bank's funding. Nonetheless, the South African government can consider requirements for recapitalisation of the bank to help it manage its liquidity risk. An example of this is the Minister of Finance's 2012 recommendation to parliament for an amendment to the DBSA Act to increase its capital from the current R4.8 billion to R20 billion (DBSA 2012). The government also allocated R2.4 billion in 2012 for the recapitalisation of the bank; a large component of these funds was allocated for local socio-economic development.

## *Loan Portfolio, Domestic and Regional*

Even though the DBSA has approved a significant pipeline of projects for developmental purposes, there is no coherent paradigm of development that prevails in South Africa. There is no consensus on South Africa's development strategy. In 2011/2012, the DBSA approved projects to the value of R24.8 billion (DBSA 2012). Of this disbursement, 61 per cent was for South African projects, with 44.4 per cent of that going to energy projects, 25.7 per cent to entrepreneurial and manufacturing activities, and 11.6 per cent to communication infrastructure. Of the 278 municipalities in South Africa, 172 are on the bank's loan book. Exposure thus remains well diversified across a broad spectrum of sectors, especially energy, transportation, information and communications technology (ICT), and roads and drainage infrastructure.

Significant funding (70 per cent) goes to businesses that focus on public sector development, concentrated in the economic hubs of Gauteng, Kwazulu-Natal, and the Western Cape. The bank increased its project development support to government programmes for the 2013/14 financial year.

Development finance support outside of South Africa in 2011/12 totalled US\$380 million, of which the notable loans included US\$900 million for the Kilwa Energy Project in Tanzania; US\$110 million for Banco BAI in Angola; US\$150 million to Banco Africano de Investimentos, which is an Angolan sovereign-backed special lending programme to small and medium enterprises aimed to facilitate the diversification of the country's oil-dominated economy, and a US\$79 million senior debt facility signed for the expansion of the Nova Cimangola cement plant in Angola.

The Nova Cimangola project is considered the DBSA's largest commitment to Angola to date; it is also linked to the DBSA's strategy to invest in sectors that support the feasibility of other infrastructure projects. As Finance Minister Pravin Gordhan noted in his 2013 medium-term budget speech, the DBSA has provided almost US\$150 million for road projects in Angola in 2013, and made commitments to fund US\$300 million to energy projects in Tanzania and the Democratic Republic of Congo (Gordhan 2013).

In addition, the DBSA has made commitments to the reconstruction of Zimbabwe by finalising disbursements of US\$46.4 million on the US\$140 million loan to the Zimbabwe National Road Administration (Zinara). This is reported to be the bank's biggest commitment to Zimbabwe thus far. The bank also disbursed US\$130 million to the National Road Fund Agency in Zambia for the rehabilitation of five priority roads along the North-South Corridor.

Another significant disbursement was an amount of US\$54.2 million to the Eastern and Southern African Trade and Development Bank (PTA Bank), a strategic DFI of the Common Market for Eastern and Southern Africa (COMESA), for product diversification and lengthening the tenure of its loans to its clients. PTA Bank is viewed as one of the DBSA's strategic partners in the region. The DBSA also supports the Development Bank of Zambia, the Infrastructure Development Bank of Zimbabwe, the Tanzania Investment Bank and the East African Development Bank.

From 2011, the DBSA adopted a "deployment strategy" to provide human resources support to its regional locations. The bank has started initiatives to enhance its relationships with strategic markets and to improve collaboration with relevant development institutions on the African continent. Such collaborative mechanisms are expected to help improve the standard of operations of the host institutions, harmonise approaches to dealing with development challenges in Africa, and to create mechanisms to increase the rate of project identification and development (DBSA 2012).

Given Africa's vast infrastructural needs, there is little doubt that institutions such as the DBSA have a pivotal role to play, but there has to be a very strict and careful evaluation of the types of projects that the bank funds. Without an open process of public engagement and intense parliamentary scrutiny of its funding model, the bank could disburse money for projects that could be deleterious to sustainability. Any hope of getting Africa's growth on an even keel through increasing trade flows depends on creating an infrastructure boom within on a clear governance framework that places a premium on financial, social and environmental sustainability. The financing required to close Africa's infrastructure deficit is projected to amount to US\$93 billion annually until 2020 (Battacharya and Romani 2013).

In 2013, SADC developed a Regional Infrastructure Development Master Plan (RIDMP). Modelled on the European Investment Bank and other regional funding ventures, the cost of putting it into operation is estimated at US\$500 billion. SADC countries will initially contribute US\$1.2 billion or 51 per cent towards the fund with the remaining financial component to be covered by the private sector (37 per cent) and international partners (12 per cent).

The bank's country-based engagement policy within SADC is divided into three categories:

- ⇒ **Low income and post-conflict countries (maximum strategic development projects):** the DRC, Angola, Zimbabwe and Madagascar
- ⇒ **Countries with strong bilateral and multi-country projects:** Botswana, Mozambique, Lesotho, Namibia, Swaziland, Tanzania, Zambia and Zimbabwe
- ⇒ **Countries with acceleration opportunities:** Namibia, Lesotho, Zambia and Botswana.

There is also an expanded focus to regions beyond SADC including COMESA, the East African Community (EAC) and the Economic Community of West African States (ECOWAS).

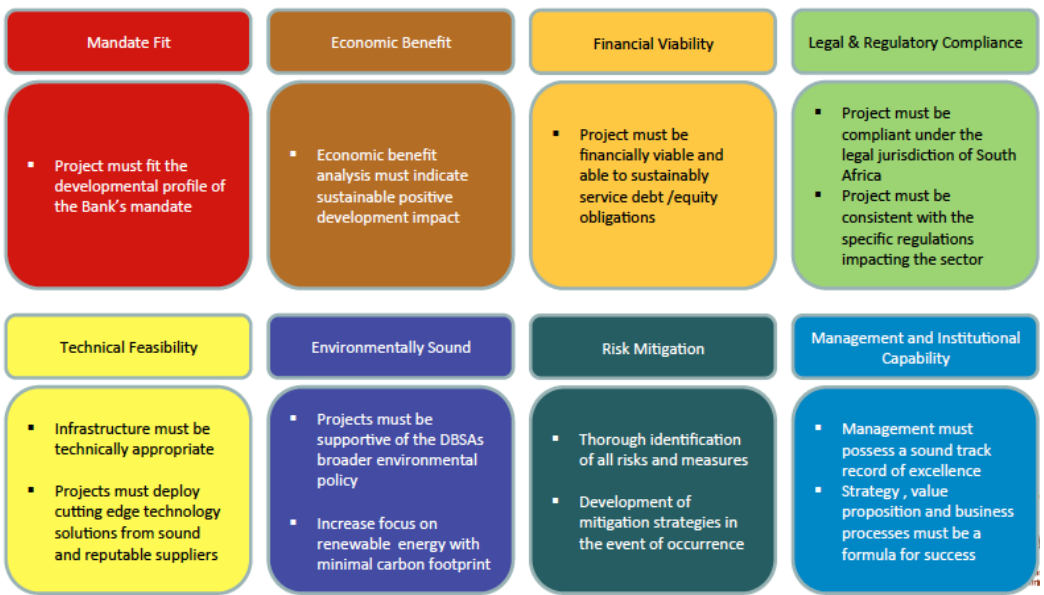
Initiatives aimed to transform the infrastructure landscape include the North-South Corridor, with an envisaged reach from the port of Durban to the copper-belt region of the DRC and Zambia, with an extended link to Dar es Salaam. Proposed projects include 59 road projects; 38 rail projects, and 6 bridge projects (Zuma 2012). In an address at the African Union (AU), President Jacob Zuma also pointed to the technical expertise that the DBSA can offer in project preparation funding.

An even bigger picture extends this North-South Corridor to cover infrastructure expansion from the Cape to Cairo. The IDC also provides expertise to these projects when they stretch beyond the southern Africa region, which is the DBSA's remit. These projects are often spoken of in a sweeping manner, with little serious reference to environmental considerations or the norms that should underpin them. It is as if this is secondary, or politicians are leaving the issues up to the whims of technocrats (COMESA-EAC-SADC 2014).

### *Project Assessment Criteria*

The DBSA's assessment criteria for potential investment have a dual focus on developmental impact and financial sustainability (see Figure 2).

**Figure 2: Various Assessment Dimensions**



*Source: DBSA & SAIEA 2009: Handbook on Environmental Assessment Legislation in the SADC Region*

The assessment process is cyclical, and involves the initial transaction origination, investment appraisal and credit assessment. This appears to be a streamlined process, designed to ensure that all investment projects are scrutinised and aligned with the bank's mandate, although the rigour of the environmental and social impact assessment is hard to ascertain. The DBSA has an in-house, fully fledged and independent Operations and Evaluation Unit that assesses its work. Independent assessments are conducted after the completion of programmes/projects. This important exercise documents key lessons learnt for the consideration and design of future projects. The DBSA uses a partial general macroeconomic equilibrium model based on a social accounting matrix (SAM) to calculate the socio-economic impact of its projects. The model specifically incorporates the sectoral investment focus of the bank.

*Policy provisions and mechanisms for stakeholder and civic engagement*

The DBSA has neither explicit provisions nor mechanisms for public participation. However, as a government-owned entity with a public policy mandate, it is expected to be accountable. This also applies to the IDC, which is discussed below.

Two supplementary pieces of legislation, namely the Municipal Systems Act (No. 32 of 2000) and the Municipal Structures Act (No. 117 of 1998), also provide a legal framework for local government public participation. Importantly, however, stakeholder engagement is conditioned by the definition of the bank's stakeholders, the nature of business being undertaken, and the requirements for accountability reporting as provided in its corporate governance guidelines.

In principle, the DBSA maintains an open dialogue with its stakeholders, defined as "those



entities or individuals that may be significantly affected by the Bank’s activities, products and services, and that may be expected to affect the ability of the DBSA to carry out its mandate successfully” (DBSA 2012).The bank identifies its five main stakeholders as investors and lenders; clients; employees; national and local government; and the community. Table 1 summarises the stakeholder engagement matrix that highlights specific modes of engagement and the rationale for each stakeholder.

**Table 1: DBSA Stakeholder Engagement**

Main stakeholder	Why DBSA engages	How it engages	The engagement is concerned with
<b>Investors and lenders</b>	to create an informed perception and a positive investment environment	<ul style="list-style-type: none"> <li>- meetings with analysts and investors</li> <li>- announcements of results</li> <li>- group website</li> <li>- Annual Report</li> </ul>	<ul style="list-style-type: none"> <li>- financial performance</li> <li>- market trends and issues</li> <li>- future prospects</li> </ul>
<b>Clients</b>	to understand clients’ needs and enhance developmental impact	<ul style="list-style-type: none"> <li>- client and market surveys</li> <li>- marketing campaigns</li> <li>- social media</li> <li>- sponsorship</li> </ul>	<ul style="list-style-type: none"> <li>- brand perception and expectations</li> </ul>
<b>Employees</b>	to enhance employees’ engagement and their commitment to the DBSA and its corporate strategy	<ul style="list-style-type: none"> <li>- unit meetings</li> <li>- training and development</li> <li>- results presentations, performance reviews</li> <li>- internal media and whistle-blower hotline</li> </ul>	<ul style="list-style-type: none"> <li>- development, wellness and training</li> <li>- strategic matters, financial performance and code of conduct</li> </ul>
<b>National and local government</b>	as per legislative requirements and national priorities	<p>regular communication with</p> <ul style="list-style-type: none"> <li>- National Treasury</li> <li>- department of cooperative governance and traditional affairs</li> <li>- standing and select committees on finance</li> </ul>	<ul style="list-style-type: none"> <li>- compliance requirements</li> <li>- skills development and training</li> <li>- employment equity</li> </ul>
<b>Community</b>	social responsibility expectations and brand building opportunity	<ul style="list-style-type: none"> <li>- corporate social investment initiatives</li> </ul>	<ul style="list-style-type: none"> <li>- communication on investments in socio-development and performance evaluation</li> </ul>

Source: DBSA Integrated Annual Report 2012/2013

The engagement process with stakeholders appears linear and top-down. There is no mechanism or formal channel for communities and individuals affected by DBSA-financed projects to raise concerns and grievances. There is a fraud hotline but it is exclusively available to internal whistle-blowers. According to the DBSA officials that were interviewed for this report, the bank does sometimes receive complaints from individuals over unsatisfactory projects and the relevant social analysts are then assigned to investigate and submit a detailed report to management. It is not clear how remedies are delivered.

Project steering committees (with DBSA representation) have in the past served as a temporary platform for community interaction. As things stand, however, there are no explicit accounts of campaigns for greater inclusivity, accountability and transparency in DBSA work. There is no evidence that the DBSA is a target of civil society or NGO disaffection. This does not suggest its practices are entirely above reproach; it is just that there are no “activist” constituencies organised for the purpose of monitoring or petitioning the DBSA on specific issues that affect communities.

The DBSA has an indirect interface with communities through municipal projects that it supports. The DBSA only supports projects within the Integrated Development Plans (IDPs) of municipalities. These projects have been identified and prioritised with the target communities and have garnered the necessary community buy-in. There is a narrow scope for communities to reject delivery of municipal services; even where that is the case, the municipality, and not the DBSA, would have direct interaction with the community.

In 2012, the DBSA developed the Development Impact System (DIS) to assess and manage the impact of operations on communities. As development targets are established in advance, the DIS is intended to establish a baseline and measure the actual development against anticipated results. It is due to be rolled out in the current financial year. Once it is operational, all new DBSA projects will be loaded into the system and development impact reports will be generated electronically.

Finally, the DBSA uses some other activities and events to engage in debate and open up wider communication on its infrastructure policy issues, which are worth mentioning in the civic engagement discussion. These include the annual Knowledge Week which, according to the DBSA, allows main stakeholders to raise issues and to offer advice and guidance appropriate to the relevant department. The DBSA also hosts Infrastructure Dialogues, in partnership with the Presidency. All are aimed at broadening their reach to stakeholders and creating public awareness of the DBSA’s work.

### *Some Observations on Civic Engagement*

Civil society activism around DBSA operations in South Africa is low. Mobilisation of opinion on the bank’s operations and political pressure for greater civic engagement is very limited. There is virtually no serious constituency outside of government institutions that hold the DBSA accountable. For this reason, there has been little internal motivation to raise awareness of the DBSA’s operations to customers and targeted beneficiaries. In any case, such efforts are likely to be viewed by bank’s technocrats as creating the burden of an additional layer of reporting as well as sapping internal resources.

The reasons for the DBSA's muted levels of civic engagement are varied. One is conceptual confusion about what civil society entails, as the DBSA only speaks of community. Another is bureaucratic resistance to excessive civil society involvement in the bank's operations. This is especially true given the very technical and highly specialised nature of the bank's work. There is anecdotal evidence that the DBSA's top management dispensed with past practices that were geared towards "enhanced" civic engagement. The extent to which civil society engagement was integrated in a meaningful way in the bank's restructuring processes has been unsatisfactory.

The notion of "developmental" impact also suffers from conceptual confusion as it covers a range of interpretations, from the more expansive notions of the "developmental state" promoted by the government, to understanding development at a micro or project level. That makes it very difficult to discern the DBSA's developmental paradigm. It is at best nebulous, and a casualty of the failure to evolve a coherent and broadly accepted view of development thinking in South Africa.

As a state-owned agency, its mandate (and measure of impact) will vary depending on how the government of the day defines "developmental". For example, during President Thabo Mbeki's time, the DBSA was involved in defining aspects of the Accelerated and Shared Growth Initiative for South Africa (ASGISA), specifically the development and attraction of critical skills through the Joint Initiative on Priority Skills Acquisition (JIPSA), then headed by a DBSA official, Gwede Mantashe (now secretary-general of the African National Congress). Since Mbeki was fired, commitment to such programmes has waned and the DBSA's role has become ill defined.

Generally, community and civic engagement on the bank's part have predominantly been limited to corporate responsibility guidelines and social responsibility expectations, often undertaken for branding purposes. There is certainly a need to clarify the added value of civil society engagement beyond concerns over corporate responsibility. The bank needs a depth of commitment to environmental and social impact, and to go beyond the government's minimum expectations.

However, the DBSA's regulatory legislation and corporate strategies provide a foundation to formally recognise and engage civil society entities in its work. Despite this and its developmental mandate, and despite declarations about community interface in its projects, the bank's financial products and services appear to be its core business, with civic inputs kept on the periphery. A "project-based approach" to civil society interface is generally accepted as adequate, but this will not support the search for more meaningful forms of civil society engagement.

## **The DBSA and Investment Decisions**

In recent times, the DBSA has made poor investment decisions, and incurred losses amounting to US\$82.6 million in 2012 financial year. These were attributed to impairments on development loans of US\$163 million and revaluation losses on financial instruments of US\$40.3 million. This prompted it to consider reducing investment in the private sector. It is noteworthy that such a decision was not based on strategic developmental considerations but purely on financial returns.

The bank attributed its impairments mainly to non-public sector investments, particularly in the mining sector, which the DBSA explained as due to market volatility. The bank further stated

that, in response to these challenges, it would divert its focus predominately financing public infrastructure projects in the water, sanitation, energy, transportation and ICT sectors.

## **The DBSA and the BRICS Relationship: Inter-bank Lending and BRICS Development Bank**

South Africa's 2010 accession to the BRICS group (Brazil, Russia, India, China, South Africa) was celebrated within government and business circles as an opportunity to gain greater access to the major emerging markets as well as to attract investment from them. This also elevated South Africa to the company of increasingly influential economies. At the same time, the NGP Framework highlighted the government's intention to scale up investment in infrastructure by working closely with the DFIs and SOEs "to address backlogs in regional logistics, water and electricity infrastructure" (EDD 2010). The government had also considered the possibility of launching an Africa Development Fund to disburse large-scale infrastructure funding on the continent.

The Third Summit of the BRICS countries, hosted by China in Sanya in April 2011, was the first that South Africa attended as a full member at the invitation of Chinese government - a gesture that has since not been extended to other countries. Subsequently, South Africa was a founding member of the BRICS Banking Cooperation Mechanism Framework that was concluded there. This mechanism included the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) of Brazil, Russia's State Corporation Bank for Development and Foreign Economic Affairs (Vnesheconombank), the Export-Import Bank of India (EximBank), the China Development Bank Corporation and the DBSA. This was to serve as an inter-bank lending mechanism that would, among other things, provide mutual trade payments using local currencies instead of the US dollar. This was already a powerful statement of foreign policy.

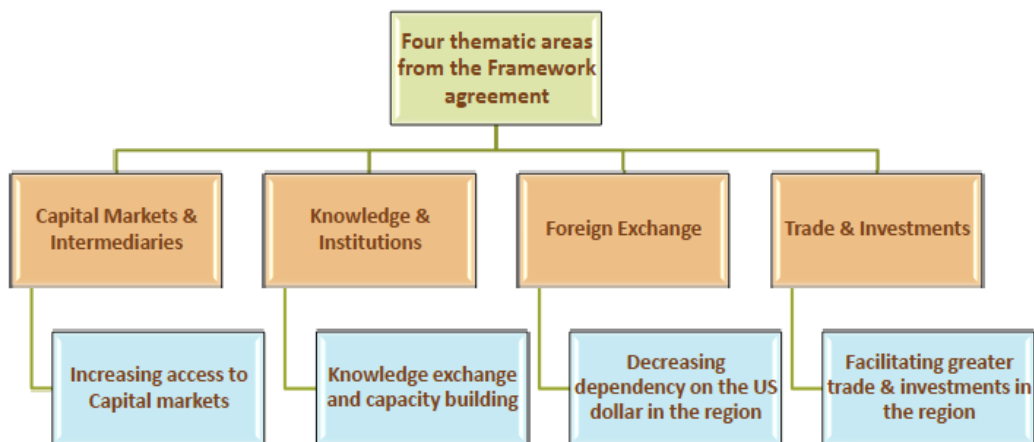
On the back of this framework, the DBSA also signed an agreement with China Development Bank Corporation (CDB) in September 2011 to work jointly on projects to improve South Africa's lagging growth and promote job creation. The agreement included the establishment of an initial facility of US\$2.5 billion for projects in transport, health care and education, water and human settlement. Both parties agreed to cooperate on various other initiatives including structuring joint venture arrangements between South African and Chinese enterprises, offering financing through credit lines, initiating syndicated loans, and co-financing. The non-financial aspects of DBSA-CDB collaboration include exchanges of professionals and knowledge.

The Fifth BRICS Summit, hosted by South Africa in March 2013, took a decision to establish a BRICS Development Bank, which is expected to play a key role in financing infrastructure projects in Africa, as well as in other developing regions. South Africa has been actively pushing for the establishment of the BRICS Development Bank and has even offered to host this institution. It is also clear that the bank is not intended as a substitute for the work already undertaken by the World Bank and other regional development banks, but rather to function as complementary to these.<sup>3</sup> Some rhetoric from South Africa hints at a level of resentment towards the West, its ideologically oriented funding and its conditionalities. This perspective would cast the BRICS Development Bank as a counterpoint to Development Bank as a counterpoint to traditional Western financing.

<sup>3</sup> This was the consensus sentiment from the DBSA respondents interviewed for this research.

Policymakers from the BRICS countries believe that the bank will also help to boost growth and trade amongst the BRICS countries. China has US\$3 trillion in foreign reserves, and part of this could be harnessed for infrastructure investment in other developing countries. It is expected that a clear framework for the BRICS Development Bank will emerge at the Sixth BRICS Summit to be held in Brazil in March 2014. As the designated institution for South Africa's participation, the DBSA is likely to play an active role in this. The figure below sets out four thematic areas in the BRICS Development Bank thinking, and how the DBSA could possibly play a role.

**Figure 3: The DBSA relationship with BRICS**



DBSA's role is to facilitate the creation of the instruments and platforms that would be to the benefit of SA Inc in executing its role on the continent in infrastructure development and in the context of the BRICS opportunities being presented to both South Africa and the DBSA. This does not imply that the DBSA owns and creates these instruments themselves but rather **pursues coordinating the creation of such for South Africa Inc's benefit in general.**

*Source: DBSA Standing Committee on Finance - Corporate Plan 2012/13*

The DBSA's profile was significantly enhanced in 2012, when it was announced that it would represent South Africa in the BRICS multi-country development finance arrangements. The DBSA's participation is expected to enhance its capacity to mobilise resources for development and regional integration within SADC. Another implication of this is the likely expansion of DBSA operations that comes with BRICS membership.

Whereas its mandate was previously centred in South and southern Africa, the DBSA increasingly has a continental, multilateral and intercontinental remit. During the initial stages of the DBSA's engagement with BRICS, the bank's development planning division undertook significant research and policy analysis for the South African BRICS forum.

Accordingly, this work has largely informed South Africa's position in the BRICS and influenced the nascent BRICS Development Bank architecture on such issues as trade and governance, are central to the long-term sustainability of the overall arrangement (Ebrahim 2012).

Apart from the infrastructure-centred development bank, the BRICS countries have also established a contingent reserve arrangement to the tune of US\$100 billion aimed to reduce short-term liquidity pressures and ensure financial stability during times of exogenous shocks. This initiative is modelled on the Chiang-Mai Initiative that was launched in March 2010 and includes China, the Republic of Korea, Japan and the Association of Southeast Asian Nations (ASEAN) states. Their resources are drawn from a foreign exchange reserves pool worth US\$120 billion, of which China (including Hong Kong) contributed US\$38.4 billion.

## **The Industrial Development Corporation: Dual Commercial and Development Mandate**

The Industrial Development Corporation (IDC) is a national public company that was established under the Industrial Development Act, No. 22 of 1940. Its main purpose was to industrialise the economy (IDC 2012) and it helped to pioneer the synthetic fuels and chemicals industries in South Africa. The IDC became one of the core vehicles of state-driven economic development in the apartheid years, extending support to Afrikaner businessmen (Feinstein 2005). It took on even more importance as South Africa started to experience economic isolation and needed to become more inward looking for its development.

The IDC was instrumental in developing a domestic industry outside of the mining sector in South Africa, which acted as an economic buffer to isolation for many years before it crumbled. Essentially, this created a new crop of industrialists, and set the economy on a manufacturing path with the state playing a catalytic role. It was a key pillar of apartheid's version of a developmental state for bolstering Afrikaner entrepreneurs and to serve as a bulwark against the English-centred Anglo-American Company (Lipton 1985).

Commercial activities such as the South African Coal, Oil and Gas Corporation (SASOL), Phosphate Development Corporation (FOSKOR), and Iron and Steel Corporation (ISCOR) were some of the entities that benefitted from the IDC's largesse. As Charles Feinstein points out, "The IDC operated like an industrial bank, providing capital for new firms, establishing new ventures in partnership with domestic or foreign companies, and launching new projects of strategic importance." (Lipton 1985).

Post-apartheid, the IDC was retained as a state-owned development institution, pursuing many of the same objectives, except that it had to advance transformation objectives: in particular, the empowerment of a new crop of black business players.

An important change however was the expansion of its ambit through an amendment to the Industrial Development Act in 1997. This extended its mandate to the rest of southern Africa, allowing the corporation to finance cross-border industrial development initiatives in the SADC region and support South African companies looking to expand geographically. This was done under the auspices of encouraging regional economic integration and also supporting the growth of new markets that South Africa would be able to enter and benefit from. The IDC's mandate was further expanded by another amendment in 2001 that extended the geographical area it could invest in to include the rest of the African continent.

The Industrial Development Amendment (IDA) Act, No. 49 of 2001, also tasked the IDC with supporting the country's black economic empowerment (BEE) agenda, that is, "to promote the economic empowerment of the historically disadvantaged communities and persons" through its business activities. The IDC is the key industrial development actor in the country and plays the dual role of being both a financing institution and development agency. Its main activities are to provide development finance, offer project development support and generate research and policy inputs.

## **IDC Governance and Stakeholder Relations**

The IDC is governed by the 2001 IDA Act. However, as a public entity, the IDC also has to abide by the Public Finance Management Act, JSE listing requirements and the Companies Act. It also utilises and implements recommendations from the King III report in its corporate governance. The IDC is a self-financing entity that generates its funds through its loan and equity investments. It also borrows from commercial lenders and other development finance institutions to help fund its activities (IDC 2012).

### *Stakeholder Relations*

The government is an important stakeholder due to its status as the sole shareholder. As a state entity, the IDC meets frequently with economic policy departments to ensure cooperation around development objectives and develop shared understanding. The board also presents itself before the relevant parliamentary committees. Existing clients and partners are engaged through official business channels such as meetings and other forms of direct communication in order to address any issues and keep up monitoring and evaluation activities to loan recipients. Employees are also considered key stakeholders and are engaged through internal processes as in any other organisation.

Although communities are perhaps the hardest to reach, particularly those with no direct links to the IDC through projects and investments, the IDC establishes project-specific meetings with community leaders in affected areas. The IDC also holds meetings with traditional authorities on land issues. Meetings with community representatives are sometimes undertaken via a contracted consultant. Generally, interaction with communities and the general public is done through media statements informing them of the organisation's activities. In a bid to raise awareness of its existence and functions, the IDC undertakes road shows from time to time.

It is important to note, however, that these forms of engagement are largely a one-way street. There is no mechanism for receiving inputs from the communities. In a fashion pretty much similar to the DBSA, the IDC does not require public input to determine policy or disbursements of funds to projects. It does not have any significant engagement with civil society and is largely immune from its influences. It operates like a private company while fulfilling its public mandate.

### *IDC Funding Model*

The IDC is a self-financing DFI and pays corporate tax according to the Companies Act, 2008. Its funds are drawn from borrowings, mature investments and its retained earnings.



As it does not rely on state funding like other SOEs or DFIs, its own profitability becomes important to its continued ability to fund other enterprises. Over the past five years, despite the global financial crisis, the IDC has managed to increase its asset base and record profits. In the 2012/2013 financial year, it has recorded some losses on its income statements, although its balance sheet continues to grow (IDC Annual Report 2013).

The IDC provides loans to some enterprises while it is an equity partner in others. The nature of the IDC's involvement is determined by the specifics of the financing requirements and the nature of financial risks.

### *The IDC's Government / Political Mandate*

As a key industrial development actor, the IDC aligns its investments with priority sectors of the economy as outlined in national economic policy. Since 2011, its main guiding frameworks are the NGP and the Industrial Policy Action Plan (IPAP), which outlines key industries for investment and development to increase South Africa's manufacturing base and stimulate growth and employment. These two policy programmes are at the heart of government's move towards building a "developmental state", which is marked by state activism in the economy. Both the NGP and the NIPF outline key economic sectors that are of high priority to government and earmarked for support. The main criteria are job creation and value addition, which includes beneficiation (with respect to mining), increased value-added in manufacturing, and local sourcing.

Some people at the IDC sense that nationalism and an inward-looking approach lie at the heart of some of these strategic shifts. There are tensions over the IDC's expansive role in the African continent, with growing government pressure on the DFI to justify why it sees it necessary to invest outside of South Africa when the needs are greatest within.

This is aggravated by South Africa's policy approach that encourages inward foreign investment rather than outward investment in Africa or elsewhere, with the exception of infrastructure projects or those that source from within South Africa. Even domestically, the IDC has had to significantly re-align its priorities, which has meant discontinuing some projects it has traditionally funded, such as construction, transport and franchising. According to those working closely with projects at the IDC, the closure of some of these programmes created confusion for the IDC and represented a loss of creativity in funding programmes.<sup>4</sup>

The restructuring of the IDC mandate was also influenced by the effects of the global financial crisis on some companies in South Africa. The IDC was called upon to provide a lifeline to save some industries, including the clothing and textile sector, from collapsing.

Regarding bureaucratic and regulatory requirements, the IDC has to seek approval from the National Treasury for projects that are financed outside of South Africa. This is an administrative requirement whenever equity leaves South Africa for another country. With the establishment of Economic Development Department under Ebrahim Patel, the IDC is required to go through another layer of bureaucracy where approval is required by EDD before National Treasury makes its own determination.

<sup>4</sup>This is based on confidential interviews at the IDC, 13 September 2013.

The IDC finances new businesses and the expansion of already existing enterprises. Its financing criteria consider both financial viability and the potential developmental impact. The latter include the following:

- ⇒ the number of potential job opportunities
- ⇒ contribution to small and medium enterprise (SME) development
- ⇒ contribution to regional development, with regard to priority development areas (i.e., rural and peri-urban settings, the less economically active provinces, and the rest of Africa)
- ⇒ the potential for foreign revenues
- ⇒ within the scope of the priority sectors
- ⇒ the environmental impact and sustainability of the project (IDC 2013).

As the issue of environmental sustainability has become ever more streamlined into business activities, the IDC also requires that the enterprises it finances act as responsible corporate citizens. As a signatory to the Finance Initiative of the United Nations Environment Programme (FI-UNEP), the IDC has committed to including social and environmental risks and impacts into its decision-making processes (IDC 2012). Enterprises that receive financing are compelled to comply with environmental regulations and their social and environmental performance is audited during monitoring and evaluation activities.

## The IDC and the Green Industry

A lot of financing continues to flow towards sectors such as mining and manufacturing that are intensive users of carbon-based energy. Manufacturing makes up 44 per cent of the total loan book (IDC 2013, 96–97). The mining industry accounts for 30 per cent, with the top 10 business partners representing 62 per cent of the IDC’s portfolio at market value. Given the nature of the South African economy and the country’s mineral wealth, large investments in that sector are to be expected. The strategy to make ownership in mining more representative of domestic demographics also plays a role in the organisation’s willingness to finance BEE deals. The high investment rate is also due to the fact that mining is capital intensive and generally requires huge upfront investments.

However, the development of the “green economy” in South Africa is one of the priority areas for the IDC, with an objective to create a local value chain in the green industry in order to ensure its sustainability and growth. In 2011, US\$2.5 billion over 20 years was committed to support this development. The Green Industries Strategic Business Unit came into existence in 2011. It received impressive financing of US\$550 million in 2012 and US\$400 million in 2013 (financial years). In terms of loan extension in a single financial year, this dwarfs the other sectors.

Much of the funding already dispersed has gone to projects connected to developing renewable energies and pollution management. In the department of energy’s Renewable Energy Independent Power Producer Procurement Programme (REIPPP) process, 17 IDC-funded projects received preferred bidder status (IDC 2012). These were mainly in the areas of wind and solar power, and solar photo-voltaics.

In partnership with a foreign development institute, the IDC has also established the Green Energy Efficiency Fund (GEEF) worth US\$50 million, which will support businesses to invest in energy efficiency by providing free energy audits and project support for developing and implementing energy efficiency interventions. This initiative is specifically aimed at already existing enterprises and industries.

## The IDC and African Investments

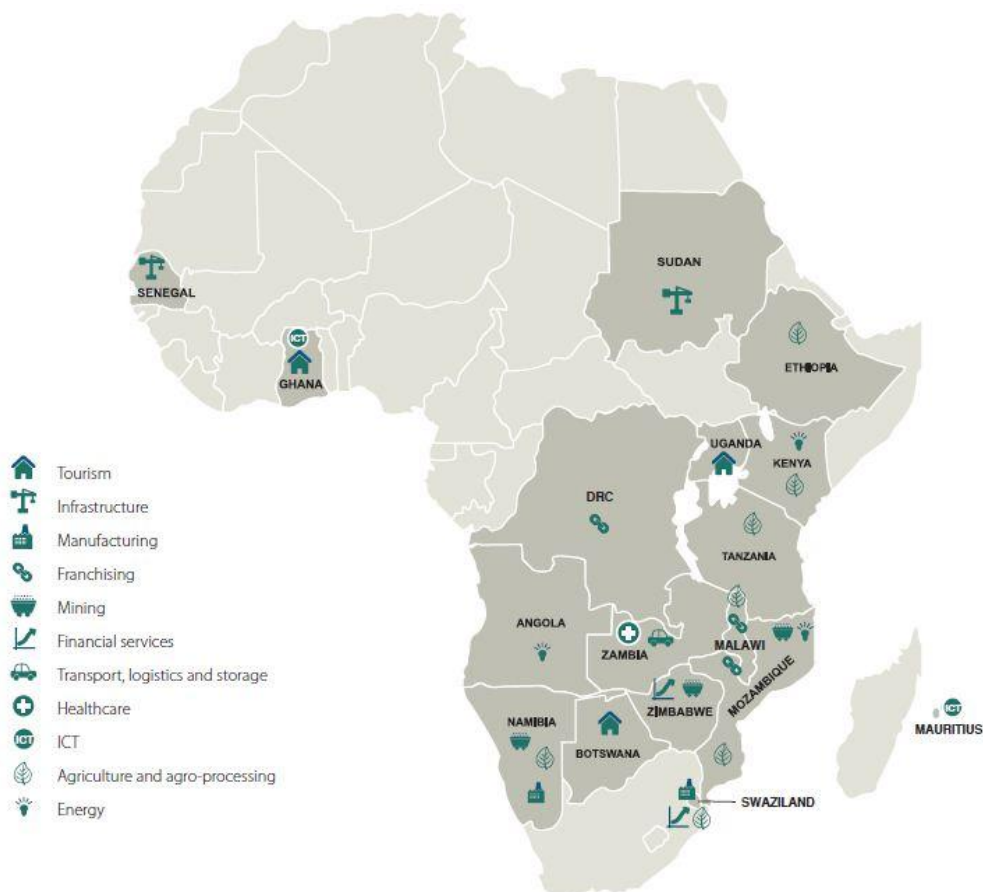
The IDC currently has 41 projects across 17 African countries, having approved around R20.1 billion in funding between 2001 and 2010 (IDC 2012). The rest of the African region currently forms of 16 per cent of its portfolio. Most economic activities are centred on the IDC's traditional arenas of mining and tourism, although it has started expanding into industrial infrastructure and agro-processing. One of the first and most successful ventures for the IDC has been the Mozambique Aluminium Smelter (Mozal) and the smaller Mozambique Cotton Textile Company (Mocotex).

When the IDC invests in other African countries, it works within the regulatory requirements of those countries. Where such regulatory requirements are weak or unclear, it adopts a higher South African standard. For example, it would voluntarily apply the Financial Intelligence Centre Act (FICA), which contains stringent measures to detect money laundering by verifying the identity of clients. It does this for the purpose of reputational risk (managing risk) and as a precautionary measure. The IDC also applies rigorous environmental impact assessments. There is a whole environmental assessment unit within the IDC.

Investments are generally assessed on a project-by-project basis. Country risk assessments are a standard part of IDC project evaluations. A high country risk could yield an unacceptably high price and lead to the project's rejection. Further, the IDC scrutinises the investors to identify and de-select politically exposed people: for example, those who are politically aligned or have political influence that grants them undue advantage. The IDC does not invest in a state-owned enterprise, but may invest in a special purpose vehicle for a particular project where the SOE may be an investor. This is to ring-fence projects from the potentially toxic (or political) effects of a SOE.

Despite some successes in the continent and the increase in the agency's financing, the IDC's investments in other countries are still very low in comparison to its South African financing. New African investments accounted for just 4 per cent of total financing in 2010/2011. This is understandable, given that its primary mandate is to support the industrial development of South Africa. However, given also the disappointing growth rates in South Africa and the difficulty in creating jobs, expanding linkages with other countries may be a strategy worth pursuing more aggressively in order to facilitate the entry of South African companies into more African markets.

Figure 4: IDC activities in Africa



Source: IDC Annual report 2012

## Conclusion

In conducting the research, it was challenging to identify key “push factors” that could place development finance institutions in a direct interface with civil society organisations. This is precisely due to the fact that these entities function more like corporations (more so in the context of the IDC) and disburse their funding indirectly (in the case of the DBSA). This lack of direct engagement can also be attributed to a generally weak constituency of advocates for certain standards on infrastructure development and other activities of DFIs. In the African continent in general – where South African DFIs are active – civil society tends to be weak.

Both the IDC and the DBSA have strong internal governance requirements for projects to be rigorously assessed for environmental and social impacts. What is on paper may look good, but actual implementation could fall short of international best practice, especially since platforms for engagement with the public seem non-existent. There is a welter of legislation and regulatory requirements within South Africa that establish a floor of norms for South African DFIs.

Considerations related to goodwill and reputational risk are also crucial in reinforcing commitment to high standards. In our view, this is unlikely to change with the advent of the BRICS Development Bank, although it would be extremely important for credibility that an independent monitoring and evaluating unit be created to assess adherence to international best practices for funding and executing infrastructure projects. This is a vital requirement given the wide perception that countries such as China and Russia have much weaker governance standards – especially on environmental safety, in the case of China.

There is clearly a repositioning of South Africa's DFIs to serve the domestic political mandate of upscaling public investment in infrastructure, broadening the participation of previously excluded groups in economic activities, and aligning more closely to the government's development priorities. South Africa's active role in the African continent, in particular in championing infrastructure development, further elevates the role played by the country's DFIs and gives them a much greater exposure to DFIs in other emerging economies.

With Africa's infrastructure development increasingly seen as a catalyst of growth and industrialisation, one could expect South Africa's DFIs to become more, and not less, involved in multi-country infrastructure projects and to execute their mandate alongside politically-driven initiatives. There will be a need to closely monitor the development of systematic social indicators in funding criteria. While there does not appear to be any reason raise a flag at the moment, the evolution of the architecture of the BRICS Development Bank needs to be watched, including normative convergence among the various BRICS DFIs and the actual modalities and criteria for project financing in developing countries in Africa and elsewhere.

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