

Multilateral Development Bank Principles to Support Sustainable Private Sector Operations

The following paper identifies key principles for MDBs to work with the private sector, which was endorsed by the Heads of MDBs at their meeting on April 21 2012 in Washington DC.

By way of background, at their March 2011 meeting the Heads of MDBs decided to spell out a set of common principles that help MDBs to support the private sector in a way that is sustainable and ensures additionality of their operations. This work was motivated by the recognition that working with the private sector requires approaches that can be quite different from those supporting sovereigns. This distinction was becoming increasingly important as multilateral and bilateral institutions had been shifting a growing part of their operations toward the private sector.

An MDB working group chaired by the EBRD prepared the following paper, which identifies five common core Principles that guide MDBs' engagement with, and support of, the private sector. These are at the core of EBRD's operations: (i) additionality; (ii) crowding-in; (iii) commercial sustainability; (iv) reinforcing - and avoiding distorting - markets; and (v) promoting high standards.

EBRD President Mirow presented this paper to the Heads of MDBs last week, which endorsed it and approved its distribution to the Private Sector Roundtable, a broader group of multilateral and bilateral organisations working in the area of private sector development. The Heads of MDBs asked at the same time that the working group explore the interface between these Principles and MDB operations through the sovereign that impact the private sector (such as sovereign guarantees).

It is hoped that these Principles will guide any institution – be it multilateral or bilateral – in its approach to private sector development, so as to make it sustainable beyond the official sector's engagement.

April 27 2012

MDB Principles to Support Sustainable Private Sector Operations

Preamble

At their March, 2011 meeting, the heads of Multilateral development banks (MDBs) agreed to work on a set of general principles to support sustainable market

development and ensure additionality in their lending to private entities (“private sector operations”), and asked EBRD to lead an effort to identify these principles.¹ The task came against the background of a rapidly rising share of private sector operations in many MDBs’ portfolios and the realisation that MDBs’ approach to private sector operations can be distinct from the approach to public sector operations.

This paper confirms five common core Principles that guide MDBs’ engagement with, and support of, the private sector, so as to achieve development (transition) goals consistent with their individual mandates:

1. Additionality
2. Crowding-in
3. Commercial sustainability
4. Reinforcing markets
5. Promoting high standards

In confirming these Principles, the ad hoc Working Group convened to prepare this note,² which builds upon a recent joint report by 31 multilateral and bilateral development finance institutions, *International Finance Institutions and Development Through the Private Sector*, led by the IFC. That report took stock of International Financial Institution (“IFI”) contributions to the private sector, highlighted the main motivations for such support, demonstrated the increasing scale and strong impact of such operations, analysed their main features, and noted their success. Overall, the report clearly demonstrated the value of IFI investment in the private sector to stakeholders and the public.

Principles

The private sector is an important engine of growth and sustainable employment, and a critical part of the MDBs development mandate. MDBs are increasingly investing in private entities and projects in under-developed or under-served sectors where private sector gaps exist, for example due to country or project risks, institutional failures, information asymmetries, or other market failures. While these gaps may represent market failures, it is rare that there is no existing market of any kind, or no potential for a market-based private sector solution to partially fill the gap. The following common core MDB Principles to Support Sustainable Private Sector Operations are intended to guide the effective and efficient use of resources by MDBs in pursuing their mandates and development goals, to ensure that private sector operations (“PSO”) occupy the appropriate space relative to commercial finance, and to ensure that such operations maximize impact, and serve to reinforce rather than replace markets.

¹ For the avoidance of doubt, this work has been specific to private sector operations and is not intended to apply to sovereign lending operations by MDBs.

² The Working Group involved in preparation of this paper was supported by a background report commissioned from consultants John Howell & Co., based on consultations with representatives of AfDB, ADB, EBRD (chair), EIB, IDB/MIF/IIC, World Bank/IFC, CDC, DEG, EDFI, IDG, Norfund, and OEB.

1. Additionality

MDB support of the private sector should make a contribution that is beyond what is available, or that is otherwise absent from the market, and should not crowd out the private sector.

The shared principle of additionality often delivers, among other things:

- financing that is not provided by the market
- risk mitigation and/or risk sharing
- improved project design
- better development outcomes
- environmental, social, and governance standards

Additionality is an important aspect of determining MDB value-added in a private sector operation and MDBs should always seek to provide financial and/or non-financial additionality.

2. Crowding-in

MDB support to the private sector should, to the extent possible, catalyse market development and the mobilisation of private sector resources.

Further increasing the involvement of commercial parties in transactions alongside MDBs can be fostered by, for example:

- Limiting the share of MDB involvement in any given project, where possible, so as to make room for other sources of finance, notably from the private sector;
- Syndication of transactions, which both draws in private sector finance and provides market-tests for pricing and commercial viability;
- Utilizing guarantees, insurance, and other risk sharing instruments to mobilize private capital (equity and debt) by mitigating perceived political and credit risk for private financiers and sponsors, thereby leveraging the use of MDB resources;
- Demonstration effects when early MDB support for transactions can promote replication or participation by the private sector.

Private sector operations may be complemented by MDBs' contributions to improving the policy environment by removing barriers to private investment, through policy advice and technical assistance.

3. Commercial Sustainability

MDBs support of the private sector and the impact achieved by each operation should be sustainable, both during and after their involvement. MDB support must therefore be expected to contribute to the commercial viability of their clients.

Elements that contribute to commercial sustainability at the *project level* include:

- Considering the long-term viability of the enterprise and sector;

- Using appropriate market-referenced pricing, taking account of the risk characteristics of the private sector borrower, where such market references are available;
- Where pricing cannot be market-referenced, efforts should be made to ensure prices are reflective of risk, fully costed, and consistent with the development of market pricing;
- The operation or sequence of operations should aim to enable the recipient enterprise (or sector) to become commercially viable without the need for further MDB support.

Commercial sustainability of individual clients and operations is consistent with the MDBs' commitments to sound banking and with the need for them to earn an appropriate return on capital.

4. Reinforcing Markets

MDB assistance to the private sector should be structured to effectively and efficiently address market failures, and minimize the risk of disrupting or unduly distorting markets or crowding out private finance, including new entrants.

Interventions by MDBs at times deliberately try to change the ways that imperfect markets function. These interventions risk distorting a nascent market or forestalling or discouraging the emergence of private participants. These effects can be avoided by, among other measures:

- In cases where MDB private sector operation financing is used alongside concessional resources, ensuring that a net subsidy to the project or enterprise is justified, e.g. by a clear market or institutional failure or public policy goal that is best addressed through a subsidy;
- Ensuring that subsidies are transparent and targeted, and structured to ensure the potential for market distortion is assessed and the subsidy is phased out once it is no longer justified;
- Avoiding the introduction of rent-seeking opportunities;
- Supporting 'level playing fields' by providing an equal opportunity for funding to qualified companies on a non-discriminatory basis;
- Not tilting a market in favour of a single or small group of actors while recognising the benefits of 'first movers' in fostering innovation and motivating risk-taking, or promoting an activity in the face of un-priced externalities, e.g., low carbon activities.

5. Promoting High Standards

MDB private sector operations should seek to promote adherence to high standards of conduct in their clients.

The MDBs' own commitments to high standards are enshrined in their mandates and in their operational practices. Fostering the adoption of high standards by MDBs' clients is not only critical to the fulfilment of stakeholders' intentions but also to attract private investor participation and strengthen commercial sustainability.

These standards include, but are not limited to:

- Corporate governance
- Environmental
- Social and inclusion
- Transparency and integrity

Advocating and demonstrating such standards has been a fundamental aspect of the operations of MDBs and is often an important source of development impact and additionality.