ISSUE 113 • APRIL 2016

PolicyBRIEFING

What Can the Asian Infrastructure Investment Bank Learn from Other Development Banks?

Global development has reached a critical turning point. In addition to achieving middle-income status, several recipient countries are now also becoming donors and lenders to other developing countries. China in particular has rapidly expanded its development finance programme and launched new multilateral initiatives. A key example is the Asian Infrastructure Investment Bank (AIIB), a new public development bank that although has developed economies, like the UK, as members, derives most of its capital from emerging or developing economies. The AIIB has a unique opportunity to learn from the positive experiences and mistakes of other public development banks such as the World Bank and European Investment Bank. It can also contribute to our understanding of development finance by bringing a different set of experiences and knowledge to those which underpin these institutions.

As its name suggests, the Asian Infrastructure Investment Bank (AIIB) has been created to help close the very large infrastructure financing gap in Asia, estimated at around US$600bn per year, or more once the challenge of climate change is taken into account. Climate change mitigation has created a pressing need for sustainable infrastructure. Renewable energy is at the heart of this. There is also the need to adapt to the changes to climate that cannot be avoided, which means 'climate-proofing' existing and new infrastructure facilities. While this imperative is clear, however, it should also be noted that sustainable infrastructure can be more expensive. Where this is the case, it will require some grant contribution from developed country donors for developing countries that have neither responsibility for creating the problem, nor the capacity to address it. Together, mitigation and adaptation costs may add 10–20 per cent to the infrastructure financing gap.

While the challenges of climate change were not known when today's multilateral development banks (MDBs) were established, the need to increase investment in infrastructure is certainly not new. For reasons such as the divergence between private and social returns, the scale of capital and time frames involved and technical, financial and regulatory risk (especially important in interregional projects), the private sector will generally not supply the socially optimal level of infrastructure investment. As a result, this has always been a core function of governments, and national as well as international development banks. Indeed, many of today's largest MDBs were, to a greater or lesser extent, established to increase infrastructure investment. The same is true for the AIIB.

The AIIB is therefore not starting from scratch, but has the opportunity to learn from the experiences of these institutions. Over the last half-century,

"Infrastructure investment has always been a core function of governments, national and international banks."

IDS

they have had to tackle many new challenges. The importance of ensuring that negative environmental and social impacts are minimised, for example, has become a crucial area for MDBs. Despite the progress that has been made in these areas, few would suggest that existing MDBs have successfully resolved all issues. As well as learning from these experiences, therefore, the AIIB has the opportunity to have a fresh look at the trade-off between those factors and the overall development impact of projects, including how these vary by country, sector and mode of intervention, and the need to increase the speed as well as the scale of infrastructure investment.

To begin a contribution to this process, this Policy Briefing explores what the AIIB can learn about infrastructure finance from the experience of the two largest MDBs: the World Bank and the European Investment Bank (EIB).

A brief overview of two of the largest multilateral development banks: the World Bank and European Investment Bank

When the World Bank and EIB were first set up, like other multilateral and regional development banks, they focused primarily on infrastructure. The World Bank focused first on European post-war reconstruction and later on infrastructure in the developing world, whilst the EIB provided for regional infrastructure, especially in poorer regions, to support trade integration.

In those initial phases, both institutions focused on specific projects or sectors. Later, the World Bank provided broader economy-wide programme lending, which often involved wide policy conditionality. The EIB, however, maintained its focus on infrastructure, expanding instead on its focus sectors, for example including health and education. By the 2000s, infrastructure still accounted for around half of EIB loans. Both institutions added sustainable infrastructure to their lending priorities.

Reportedly, EIB loans are processed more quickly than World Bank loans, which makes them far more attractive to borrowers. This seems related to their more narrow focus on sectors and projects, more rapid procedures linked to organisational structure such as the EIB not having a resident Board as well as reportedly more agile implementation of social and environmental standards, as well as no broad conditionality.

As regards climate change mitigation, though implementing environment standards at a project level is clearly important, it may be as or more important to help countries develop strategies to encourage a more sustainable development model, by helping fund renewable energy and energy efficiency.

Lessons from multilateral and national development banks

Sector investment and generating positive financial returns

When considering which sectors to invest in, it is important to choose those that maximise development impact *and* ensure sufficient commercial returns, since these enable a bank like the AIIB to maintain its capital and ideally expand it. The emphasis should be on maximising development impacts.

The assessment of potential development impacts can draw initially on the experience of existing MDBs, for example by including a shadow price of carbon, as well as successful national development banks, such as the China Development Bank (CDB) and Germany's development bank KfW.

Ensuring projects can generate positive financial returns requires careful debt sustainability analysis to ensure countries can pay back loans. The World Bank's losses reflected in its Heavily Indebted Poor Countries Initiative provides some valuable lessons in this respect.

Choosing the right mix of instruments

One important criterion for choosing the mix of instruments is that they should facilitate rapid and significant financing of infrastructure. In a recent speech AIIB President, Jin Liqun, rightly emphasised the 'need for speed'. Another criterion is that unnecessary financial risks should not be created, and excessive unfunded contingent claims, for example via guarantees, should be avoided. This will reduce future losses. Rather than excel in 'financial engineering' as the private financial sector has, often resulting in excessive systemic risk, the AIIB should excel in actual engineering, especially in the earlier phase of its establishment.

"As well as learning from [MDBs'] experiences, the AIIB has the opportunity to have a fresh look at the trade-off between ensuring that negative environmental and social impacts are minimised, and the overall development impact of projects."

To fulfil these criteria, simple instruments such as 'plain vanilla' loans are most appropriate, especially for a new MDB, as they will allow rapid growth of lending to infrastructure, as well as minimise risks. If a new MDB such as the AIIB can establish a good asset book based on simple instruments, good repayment record, and strong decision-making process, it has the potential to achieve better rating than the average of its shareholders. This has worked well for institutions such as the World Bank and the EIB, who have maintained an AAA rating, whilst many of their shareholders have a lower one.

To achieve greater leverage over time, other instruments, such as guarantees to private investors and lenders, will need to be developed. Guarantees are safer if they are at least partly funded *ex ante*, and if the risks for which guarantees are provided are clearly capped.

While increasing the speed of transactions is essential, it is very important that this is not achieved at the expense of project quality, including from a social and environmental perspective. While these risks can be mitigated, for example by recruiting high-quality and experienced staff to the AIIB and by learning from the experiences, both positive and negative, of existing multilateral, regional and national development banks, it is important that they are actively addressed, by rigorous evaluation of commercial viability and development impacts.

Ideally, the aim should be to maximise the speed of operations without compromising on beneficial development impacts and the quality of social and environmental outcomes. This is a critically important issue for global development finance where the AIIB could bring real additionality. By commencing operations, the AIIB will automatically increase the *quantity* of investment in infrastructure. If it can also accelerate the investment process this quantity affect will be amplified, particularly if other MDBs learn from its innovations. If it can achieve this while also maintaining, or even enhancing the *quality* of projects, the positive development impacts will be huge.

Lending limits and leverage ratios

The World Bank has a 'statutory lending limit' of 100 per cent of total subscribed capital, retained earnings and reserves – a leverage of 1:1. In contrast, the EIB lending limit may not exceed 250 per cent of subscribed capital, reserves and retained earnings, implying a higher leverage ratio of 2.5:1.

A higher leverage ratio allows higher levels of lending, for any given level of total subscribed capital. For example, the current level of subscribed capital could only allow US$100bn total stock of loans for AIIB, but if leverage was increased, for example to 1.5:1, this could increase to US$150bn. Reportedly, such a higher leverage would not impair rating of a bank like the AIIB, but further research may be needed to ensure that is the case.

Knowledge bank

The World Bank's role grew from one that was just focused on development financing to becoming a knowledge bank that produced theory and policy applications for global development.

This knowledge is produced in different ways: research by the World Bank's own research department; applied analytical studies in operational departments; training programmes developed and delivered by the World Bank Institute and a number of further powerful global knowledge and policy networks, such as the Global Development Network (GDN), initially launched by the World Bank in 1999 before becoming an independent not-for-profit in 2001.

"Ideally, the aim should be to maximise the speed of operations without compromising on beneficial development impacts and the quality of social and environmental outcomes."

The AIIB offers the following potential advantages:

- specialisation in Asia and infrastructure development;
- openness and inclusiveness;
- high standards;
- innovation in voting rights, staff recruitment, and procurement;
- regional economic growth, integration and mobilisation of finance across borders;
- public–private partnership component;
- alleviation of geopolitical tensions and reconciliation of differences at the multilateral level.

Challenges for the AIIB include:

- balancing demand and standards;
- creating a fair governance structure;
- delineating China's role in the bank;
- establishing a cooperative relationship with existing MDBs;
- influencing the international governance regime;
- ameliorating safeguards problems among infrastructure projects.

Policy recommendations

- **Remain focused on infrastructure for the time being:** The examples of the World Bank and the EIB show that the AIIB's and the New (BRICS) Development Bank (NDB)'s initial focus on infrastructure will pay dividends, particularly in the face of existing and enormous needs in Asia, estimated to reach US$600bn a year.
- **Focus on sustainable as well as inclusive development:** With the AIIB and NDB being the first major multilateral development banks created when climate change has finally been acknowledged as a major issue to be addressed internationally, the banks have an opportunity to pioneer the design and funding of positive strategies that support sustainable and inclusive development, for example around renewable energy or labour-intensive technologies/sectors.
- **Conditions based on projects and sectors will strengthen relations:** The new banks' conditions, which are linked to projects and sectors, and are not economy-wide conditionality, will facilitate allowing countries' policy space. However, country creditworthiness must be carefully assessed, to prevent AIIB and NDB losses.
- **Borrowers will welcome AIIB intention to accelerate speed of transactions while not compromising the quality of projects:** When it comes to accelerating the speed of transactions, the AIIB can learn from the experience of the EIB and national development banks such as the CDB. It is crucial that this is not achieved at the expense of the quality of projects, and that social and environmental safeguards are not compromised. One solution could be to rely more on borrower countries to ensure standards, increasing efficiency and speed, but also building country ownership on these issues.
- **Use 'plain vanilla' loans and avoid complexity and opacity:** Instruments used should be 'plain vanilla', that are simple to facilitate speedy loans, as well as limit future risks to the AIIB and NDB. Complexity and opaqueness breed risk of future losses.
- **Increase ratio of total loans to total subscribed capital (leverage)** if AIIB wants lending to be quickly ramped up, and if capital itself is not increased. This needs, however, more study and consultation, for example with rating agencies.
- **Establish a knowledge bank around all aspects of infrastructure and its financing:** AIIB should consider establishing itself as a centre of world excellence on all aspects of infrastructure and its financing. This could later lead to new and broader development knowledge creation, building on its experience and that of its members. The knowledge bank would complement, rather than compete with that of the World Bank.
- **Opportunity for China to demonstrate commitment to transparency and openness:** New multilateral initiatives – such as the AIIB, NDB and the One Belt, One Road (OBOR) initiative – will serve as key opportunities for China to demonstrate its commitment to increased transparency and openness. While the China-led AIIB might not radically alter development finance, it would directly impact multilateral engagement. The bank's 57 founding members thus can play a central role in the future of global governance regimes.

IDS Institute of Development Studies

UKaid from the British people

IDS Policy Briefings are published by the Institute of Development Studies and aim to provide high quality analysis and practical recommendations for policymakers on important development issues.
To subscribe: **www.ids.ac.uk/idspolicybriefings**

Institute of Development Studies, Brighton BN1 9RE UK
T +44 (0) 1273 606261 **F** + 44 (0) 1273 621202 **E** ids@ids.ac.uk **W** **www.ids.ac.uk**
twitter.com/IDS_UK #idspolicy facebook.com/idsuk

Further reading

Griffith-Jones, S.; Xiaoyun, L. and Spratt, S. (2016) *The Asian Infrastructure Investment Bank: What Can It Learn From, and Perhaps Teach To, the Multilateral Development Banks?*, IDS Evidence Report 197, Brighton: IDS

Griffith-Jones, S. and Kollatz, M. (2015) *Multilateral Lending Instruments for Infrastructure Financing*, Infrastructure Finance in the Developing World Working Paper Series, Seoul and Washington: GGGI and G-24

Gu, J. (2015) *China's New Silk Road to Development Cooperation: Opportunities and Challenges*, Centre for Policy Research series on Meeting the Challenges of the 2030 Agenda: Alternative Forms of Development Cooperation and the United Nations, Tokyo: United Nations University Centre for Policy Research

Credits

This *IDS Policy Briefing* was written by **Stephany Griffith-Jones**, Emeritus Fellow at IDS and Financial Markets Director, IPD, Columbia University; **Jing Gu**, Director of the Centre for Rising Powers and Global Development; **Li Xiaoyun**, Professor at China Agricultural University and chair of the China International Development Research Network (CIDRN); and **Stephen Spratt**, IDS Fellow and leader of the Green Transformations Cluster. It was edited by **Emilie Wilson** and was produced as part of the IDS Rising Powers in International Development programme, supported with UK aid from the UK Department for International Development.

AG Level 2 Output ID: 545

ISSN 1479-974X