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SOME IMPLICATIONS OF MULTILATERAL FINANCING TO THE PRIVATE SECTOR WITHOUT SOVEREIGN GUARANTEE

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Abstract: Direct lending by multilateral development banks to the private sector without sovereign guarantee raises two important issues. First, their presence in the financial markets alters the perception of risk, and that difference in perceived risk carries a market value; the question becomes who appropriates it. Second, by advising on policy matters related to activities that they are or may become interested in financing, or in which they have outstanding balances without sovereign guarantee, multilaterals put themselves in a conflict of interest that may affect their performance in informational and conditionality functions.

Keywords: multilateral, development, banks, finance, conditionality, sovereign

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1. Introduction

The International Bank for Reconstruction and Development (later the World Bank) was created in 1944 as an intergovernmental institution primarily to help finance the reconstruction of Europe after World War II, and with development as an "afterthought" (Lindbaek, Pfeffermann and Gregory, 1998). As the need for reconstruction financing went down development financing on a project basis increased and became its primary role. The World Bank charter prevents it from non-sovereign lending, so in 1956 governments created another organization as part of the World Bank Group devoted specifically to private sector financing, the International Finance Corporation (IFC).

The three main regional multilateral development banks (MDBs) –the Inter-American Development Bank, the Asian Development Bank and the African Development Bank–, created between 1959 and 1966, were also primarily designed to lend to the public sector with sovereign guarantee on a project basis.[1] In some cases –e.g., the Inter-American Development Bank– the founding documents did not exclude the possibility of carrying private sector risk in their portfolios, since the idea always included promoting the development of market economies, and thus private investment. These banks expanded on the basis of sovereign lending, which together with the backing from developed countries (DCs) contributed to obtaining the best possible ratings for their bonds in the international markets; in turn, they extended longer maturities and lower costs to less developed countries (LDCs).

MDBs provided not just financing, but also a bundle of services including project and policy advice. The potential conflict of interest between loan recovery and advice was at least mitigated, if not eliminated, by the sovereign guarantee. Repayment was certain, so there were no monetary incentives clouding the relationship between the provider and the recipient of technical or policy advice. The exception was the World Bank due to the existence of the IFC.

Some MDBs initially also included some sovereign-guaranteed project lending to private firms. Over time, the moral hazard associated with extending the sovereign guarantee to the private sector resulted in government losses, and governments and MDBs abandoned the experiment, thus this type of operations never developed as a significant part of their portfolios.

[1] In contrast, the European Economic Community created in 1957 the European Investment Bank, EIB, primarily for financing investment projects, public or private, with or without a sovereign guarantee (EEC, 1957, Art. 18). The youngest of the large MDBs, the European Bank for Reconstruction and Development (EBRD), was created in 1991 with a political agenda for private sector development (Stern and Lankes, 1998; Strand, 2003).

In the late 1980s, a combination of circumstances aligned to expand the traditional project-financing approach of MDBs. First, DCs and LDCs were struggling in the debt crisis, the former trying to help their financial intermediaries and reduce the risks to their economies, the latter trying to return to growth. Second, there was a reaction in DCs, and to a certain extent in some LDCs, against the results of public investment in areas where the private sector was expected to do better. Third, there was an active promotion of trade liberalization and a free market oriented approach to development led by some DCs and followed by some MDBs.[2] At that time, these DCs intensified their pressures for trade liberalization and a free market approach, offering governments the carrot of MDB-supplied freely disposable lending in exchange for adopting policy measures to implement the proposed model. The carrot greatly contributed to increasing the level of LDC "enthusiasm" for the promoted approach and the eventual stockholder agreement to incorporate the new lending instrument to MDBs.[3]

As part of the more market driven strategy, some developing countries started encouraging private investment, specially foreign investment, in areas that had been traditionally reserved to the public sector and financed by MDBs (e.g., utilities, roads). Foreign companies were willing to invest and private banks willing to finance these investments if they could mitigate some political and policy risks, and the MDBs were called in to do that. Last, but not least, some private and public LDC firms had started or were expected to start investing abroad, and saw the access to regional MDBs lending as a possible source of competitive advantage vis a vis well established firms from developed countries. Thus, pressures from developed countries for LDC privatization and for MDBs to incorporate financial services to the private sector without sovereign guarantee found a fertile ground. MDBs that had traditionally avoided taking private risk, were instructed by stockholders to do it in a manner that would complement, rather than compete with, the private sector. This new direction enjoyed the support of many economists working in development finance and related fields.[4] Today, several multilateral development banks (MDBs) have added to their portfolios private risk originating in direct lending to the private sector without sovereign guarantee and other forms of private risk like non-sovereign guarantees.[5]

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[2] See, *inter alia*, Williamson (1989).

[3] Previously, MDBs had lent primarily to finance specific investments.

[4] See, *inter alia*, de Larosière (1996), Stern and Lankes (1998), Lindbaek, Pfeffermann and Gregory (1998), Gurría and Volcker (2001). For a contrasting view, see Stiglitz (1998a). It should be noted that N. Stern succeeded J. Stiglitz as Chief Economist of the World Bank in 2000.

[5] *Inter alia*, the three large regional banks: the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank.

The incorporation of non-sovereign lending raises incentive-related concerns on MDBs that are worth exploring, since they affect their performance of essential functions.[6] First, their participation in the financing of projects or firms alters the perception of risk by participants in the financial markets. Those changes translate into differences in financial conditions expressing the market value of that risk difference. As expressed by IFC (1996, p. 83), “The special ‘comfort’ role played by multilateral agencies ... is largest in [difficult] environments; by sharing some of the political risks, they can help lower financial costs.” The issue then becomes the role of the MDB in determining who appropriates the market value of that “comfort”.

Second, by advising on policy matters related to activities in which they are or expect to become interested in financing the private sector without sovereign guarantee, or by having outstanding balances with the private sector without sovereign guarantee, MDBs put themselves in a conflict of interest and may see the perception of their role as policy advisors altered.[7] That, in turn, may affect their performance as providers of information on economic performance and designers and enforcers of conditionality (Rodrik, 1995), henceforth information and conditionality functions, in which these institutions are expected to enjoy a comparative advantage.

Sponsors expect that the MDB would mitigate political and regulatory risk not just by its presence, but also by approaching the government. Such expectation may lead to pressures on MDBs through government representatives pursuing their nationals’ private interests. The possibility that the MDB may be acting on behalf of these interests, rather than on the best interest of the borrowing country, contributes to the perception of conflict.

Some of these concerns were briefly captured in a report from the Task Force on Multilateral Development Banks (Development Committee, 1996, p.14): "There is a clear potential for conflicts of interest between sound policy advice to government and making investments as attractive as possible to private parties". The Development Committee (1996, p.14) further stated that “The EBRD approach” of limiting the conflicts of interest by “refraining from policy dialogue in macroeconomic matters and accepting the Bretton Woods

[6] As Stiglitz (1998b) reminded, “Advisers too are subject to incentive issues, and those who pay attention to their advice ... need to be aware of those incentives. The task of putting our advice on a more scientific basis ... may result in putting our own institutions and their incentives under closer scrutiny.”

[7] “A conflict of interest occurs when an individual or organization … has an interest that might compromise their reliability. A conflict of interest exists even if no improper act results from it, and can create an appearance of impropriety that can undermine confidence in the conflicted individual or organization. A conflict can be mitigated by third party verification or third party evaluation noted below – but it still exists.” *Wikipedia*: conflict of interest.

lead responsibilities in this respect ... would seem to make sense". It remains a political discussion whether in order to support private sector activities some MDBs should rely on other MDBs for macroeconomic and sector-policy dialogue. Such division of labor may make sense to the countries with a controlling role in the Bretton Woods organizations, but creating a *de facto* differentiation/specialization among MDBs has significant political implications for LDCs given differences in MDB constituency and institutional arrangements. Moreover, "refraining from policy dialogue in macroeconomic matters" would be far from enough. MDBs engage primarily on sector- and project-specific policy dialogue, the one with the highest probability of affecting project-specific medium and long run profits, and the IMF has expanded its role into areas of economic policy that go well beyond monetary and macro fiscal policies.

The Task Force on Multilateral Development Banks (Development Committee, 1996) also recognized that MDBs "enjoy privileged access to finance, regulatory authorities, and government decision makers; and they need to exercise care not to extend these privileges to particular private parties" (p. 12), and suggested that MDBs "need to train and motivate personnel for two very different types of activity" (p.14): providing policy advice to governments and making investments attractive to private parties. However, it did not discuss whether training was sufficient to counter balance the incentives introduced within the organizations by non-sovereign lending, neither did it address the conflicts of interest that non-sovereign lending creates for these organizations.

This paper aims at identifying and exploring the implications of two main issues arising from MDBs' lending to the private sector without government guarantee: a distributional effect arising from interest rate differentials attributable to MDBs participation, and some of the conflicts of interest for the MDBs brought about by their non-sovereign lending. It will refer almost exclusively to cases in which the government plays a significant role in assigning rights for private investors to participate (e.g., privatizations, concessions), since there seems to be very limited roles for MDBs non-sovereign financing in free-entry markets. For the sake of simplicity, only project financing by MDBs and private banks will be considered in analyzing these matters. The main arguments could be extended to include other forms of private risk.

2. Distributional implications

Private investors and financiers perceive that risks associated to a transaction are reduced by the participation of an MDB committing its own resources without sovereign guarantee.

Investors are more willing to commit equity and at lower expected profit rates, and financiers tend to grant better financial conditions (e.g., longer tenors and lower interest rates), in many cases even switching from refusing to lend to lending. Two main reasons have been invoked for explaining this perception of a lower risk due to the MDB presence. First, it is sometimes claimed that lenders would be willing to trust the MDB judgment (rather than their own) in assessing certain risks because of its more in-depth knowledge due to its continuous involvement with the government and its greater amount of technical resources. Also because they would save the costs of conducting similarly detailed assessments. In short, because on certain subjects the MDB would "know better", and reduce lending costs.

Second, and more important, investors and lenders perceive that by participating without a sovereign guarantee, the MDB reduces the risks associated to public policy changes that could negatively affect the project's overall financial profitability (e.g., regulatory risk). This would be due to three main reasons. First, an LDC government would be hesitant to inflict losses to a reliable long-term financial partner that often provides them with the best available financial conditions even in the most difficult situations. Second, because if such policy changes were to be considered, sponsors and financiers would expect the MDB to approach the government armed with the dissuasive power of its future lending power, thus reducing the probability of occurrence of such events.[8] Finally, because if measures affecting the project were adopted, financiers would expect them to be less detrimental to their interests if an MDB were one of the affected than if it were not involved. In short, because the MDB would reduce the expected loss.

It is not exactly the "sharing some of the political risks" (IFC, 1996) that is important, since the overall expected loss to investors and financier would be reduced just with a small participation of the MDB in total financing; in other words, within a wide range the risk reduction effect may not decrease with a smaller share of MDB financing. Therefore, from the point of view of the private financiers, the optimal MDB participation is the smallest necessary to generate the deterrence since it maximizes their expected private profit through lending.

MDB participation can be under many forms, and different forms offer investors and private financiers different risk mitigation benefits, and perhaps different extra profits. For

[8] "In cases when projects encountered difficulties related to government actions, sponsors particularly appreciated ADB's ability to access senior decision makers, in the role of an honest broker, to help resolve the problem.", ADB (2007, p. *viii*). Also see ADB (2007, pp. *iii*, 38) and IDB (2004b).

example, risks to private financiers are significantly lower when they lend jointly with the MDB, sharing their preferred creditor status. As explained by IFC (2009),

> "As a multilateral development institution, IFC enjoys a de facto preferred creditor status. This means that member governments grant IFC loans preferential access to foreign exchange in the event of a country foreign exchange crisis. Consistent with this preference, IFC loans, including the portions taken by participants, are exempt from country risk provisioning when applicable, and have never been included in general country debt reschedulings. Similarly, IFC has never been subject to mandatory new money obligations under general country debt reschedulings.
>
> As is the case for the World Bank and other multilateral development institutions, preferred creditor status is not a legal status, but it is embodied in practice and consistent universal recognition. It is granted by member governments of IFC and recognized by other creditors. It is also an important element in IFC's triple-A ratings. Due to mitigation of transfer and convertibility risk, capital markets transactions structured under the B loan umbrella can achieve a rating above the sovereign rating of the host country. The sovereign rating usually serves as the ceiling for the rating of a corporate in a country. Through the IFC umbrella, this ceiling can be 'pierced'.
>
> In times of a foreign exchange crisis in a country, IFC works closely with the World Bank to ensure appropriate treatment. There is no automatic cross-conditionality between the World Bank and IFC, but both institutions cooperate at the highest levels and work together to solve preferred creditor status issues. The institutions recognize that there is an overriding mutual benefit in protecting the status of the other institutions in the World Bank Group."[9]

Summing up, in the name of contributing to the implementation of the country's development policy, the MDB extends some risk reduction benefit to sponsors and other financiers for free just by lending alone. In the case of joint lending, the risk mitigation of the deterrence role increases significantly for the syndicate partners, since syndicated operations have special clauses that extend some of the MDB protection to the syndicated banks, in particular the preferred creditor status. This "comfort" provided by the MDB presence carries a market value (rent), the appropriation of which is determined primarily by the institutional arrangement governing the relationship between the government, the MDB, the other financiers and the private sponsors, with the consumers normally playing a more passive role. In order to illustrate the nature of the distributional issues raised by these MDB activities, the remainder of this section will discuss some simple possibilities and their alternative distributive effects.

[9] EBRD (2009) provides a similar explanation.

Adjudicated contracts

Consider the case of a project that has been adjudicated by public bidding and is looking for financing. The financial projections underlying the bids would have assumed market conditions, since the penalties associated with non-compliance would have made it risky for the sponsors to assume different financial conditions. Moreover, MDBs finance only a fraction of all projects and would be expected to refrain from providing information regarding their interest to just some of the bidders in order to avoid creating asymmetries of information amongst participants.[10]

Suppose that *without* the participation of the MDB the market is willing to finance a certain project at a maturity M_{wo} and a rate i_{wo}. These would be the conditions assumed in the bid, and consequently would allow investors to obtain their expected rate of profit. If the MDB would finance the same project, its presence would also mitigate political and regulatory risk. Therefore, if the MDB financed at the same conditions (M_{wo}, i_{wo}) the sponsors would obtain such risk mitigation for free,[11] enjoying a rent attributable to the insurance-like functions of the MDB's presence and ensuing from its unique characteristics as an institution. Moreover, by mitigating certain risks for one investor (e.g. regulatory risks) the MDB could be also mitigating the same risks in that market for other investors, some of which could be investing on their own. The participation of the MDB thus becomes the collective interest of the investors, and particularly of those with less power to influence regulatory decisions.

The MDB presence also changes the financial conditions the market is willing to offer because it lowers the risk perceived by financiers, including the possibility of extending the preferred creditor status to co-financiers through a syndicated loan (IFC, 1996, pp. 59-60; Development Committee, 1996, p.13). Also, in some countries banks would not be required to comply with additional provisioning requirements (EBRD, 2009). As a result, and for the same maturity to keep it simple, but *with* the MDB, the market would be willing to offer a lower rate of interest i_{wi}.[12] The present value of the interest cost differential may be interpreted as the market value of the "comfort" (and cost savings) for the financiers.

[10] Some information could be provided *ex-ante* to all bidders if the objective were to transfer the rents to the country receiving the project. See below.

[11] The market value of the comfort, it is argued, should be weighted against the higher transaction cost of dealing with the MDBs due to organizational constraints and environmental and social concerns. See IDB (2004).

[12] Note that financial conditions (M_{wo}, i_{wo}) and (M_{wo}, i_{wi}) correspond to the without- and with-the-MDB situations (comparative statics), rather than the before and after situations.

The MDB plays an important role in determining how the comfort rent is distributed among the parties involved. The following examples are intended to illustrate the alternatives and their distributional implications:

1. Lend the total required amount at prices higher than those without the MDB ($i_{MDB} > i_{wo}$) so as to appropriate the market value of the reduction in the perception of risk by the sponsors ($i_{MDB} - i_{wo}$) and by the financiers ($i_{wo} - i_{wi}$).[13] By so doing it would minimize the effects of its participation on market incentives.
2. Lend the total required amount at prices without the MDB ($i_{MDB} = i_{wo}$) and appropriate the market value of the reduction in the perception of risk by the financiers ($i_{wo} - i_{wi}$). By so doing it would be granting the comfort for free to the sponsors.
3. Lend the total required amount at conditions without the MDB and then seek the participation of other financiers by selling shares in the loan at a price reflecting the situation *with* the MDB (i_{wi}), thus appropriating the market value of the "comfort" to the lenders.
4. Lend a portion of the required financing at conditions without the MDB (i_{wo}), thus extending some level of comfort to private lenders for free (margin that may be appropriated by lenders or sponsors), but not sharing its preferred creditor status.
5. Lead a loan syndication at (i_{wo}), but charging the syndicate banks, in addition to the syndication fee, an initial fixed amount equal to the present value of the flow attributable to the $i_{wo} - i_{wi}$ interest rate differential for the life of the loan, thus appropriating the value of the "comfort" to the lenders.[14]
6. Transfer to or share with the other financiers the rent by charging the sponsors conditions without its presence and offering loan shares at interest rates i_s higher than those with its presence ($i_{wi} < i_s \leq i_{wo}$).
7. Transfer or share the rent with the project sponsors by charging the project conditions cheaper than those without its presence ($i_{wi} \leq i < i_{wo}$).
8. Finally, the MDB could also seek to transfer the rent to the government (e.g., by increasing the market price of the concession) or to domestic consumers (through rules that lead to reductions in output prices), but this option may prove difficult once the contract has been signed.

[13] By mitigating certain risks for one sponsor, e.g. regulatory risks, the MDB could be also mitigating the same risks for other investors and financiers, who thus avoid paying for the "with the MDB" umbrella. The participation of the MDB thus also becomes the collective interest of sponsors, and particularly of those with less power to influence regulatory decisions.

[14] This is different from and in addition to syndication fees, which compensate for syndication services.

The first two alternatives are normally not open to the MDB since it is not expected to compete with commercial financing, but rather to mitigate risk and bring in private financing.[15] It should also be noted, that granting financial conditions below those without the MDB (i_{wo}) plus the market value of the comfort to the sponsors raises concerns regarding the development of capital markets,[16] since such conditions would reduce market incentives for developing the financial instruments suitable to these investments. These concerns would be greater if MDB financial conditions were at or below those without the MDB (i_{wo}), since private financing would be displaced.

In the preceding cases, the role of the MDB would not be to make the project possible, since the market would finance it, but to perform informational and distributional functions in the markets.[17] First, it would reduce the perceived risk by committing its own resources without sovereign guarantee. Second, it would play an important role in distributing the market value of the MDB comfort. Third, it may contribute to creating a record of financial transactions expected to improve LDC future access to financial markets.

The difference between the interest rates involved for identical maturities provides a market-based evaluation of an MDB's financing of adjudicated contracts. For example, the difference between the *without*- and the *with*-the-MDB situations would provide the market-based assessment of the MDB's ability to reduce perceived risk to the financiers (but not that of the sponsors); the greater (smaller) the difference between i_{wo} and i_{wi} (for a given M_{wo}), the more (less) important the presence of the MDB in reducing risk perception.

Therefore, when the MDB is asked to finance after the contract has been adjudicated, and there are no possibilities of transferring rents to the country or the consumers, in order to avoid transferring rents to the sponsors it should aim at pricing above the market without the MDB ($i_{MDB} > i_{wo}$). If the MDB is leading a syndication, it should aim at $i_{MDB} > i_{wo} > i_s = i_{wi}$, where i_s is the rate enjoyed by the syndicate banks. In other words, the private financiers should appropriate no part of the MDB-presence rent. When trying to transfer part or all the rent to the government or the consumers, the MDB would aim at rates below i_{wo}, and the difference $i_{MDB} – i_s = i_{wi}$ would be smaller the greater the part of the rent it intends to transfer to the government or the consumers.

[15] For example, World Bank Group policies "…mandate that, in working with the private sector, it needs to limit its own participation to the minimum required to secure satisfactory financing from private risk-taking sources." World Bank (2009, p. 4).
[16] See, *inter alia*, Honohan (1995). World Bank (2009) discusses the development of the markets for guarantees and its effects on the World Bank Group.
[17] There may also be contributions to the project itself.

Finally, financing provisions against potential losses in non-sovereign operations is another reason that calls for pricing above that without the MDB (M_{wo}, i_{wo}). By doing it, the MDB prevents the financing of losses with the sovereign part of its balance sheet.

Before adjudication

So far, only cases of adjudicated contracts have been considered. The options available to the country and the MDB increase when the bidding has not yet taken place, particularly if the MDB would agree to transfer part of the rent to the government or to the consumers served by the project. For example, possible access to financial conditions with the MDB could be made known to *all participants* beforehand with the expectation that these conditions would be reflected in bids prices.[18] Bidding rules would then determine the share of the rent that would be transferred to the government or to the consumers, or whether part would be retained by the project sponsors. Note that this approach allows the MDB to attempt transferring the comfort rent to the sponsors through the bidding process while still lending at without the MDB conditions. Thus market incentives are less affected and the MDB keeps the option of not sharing the comfort rent with co-lenders by offering them an effective rate equal to that with the MDB (i_{wi}).

However, with this approach the risks increase as well. If sponsors decided to price the bid assuming with-the-MDB financial conditions, they would take the risk of not obtaining it later and having no risk mitigation for political and regulatory risk and higher financial costs (depending on the MDB ex-ante information on whether with or without financial conditions would be charged). The government may be affected by delays from having to restart with the second place bidder. Therefore, the design of the bidding should minimize these costs to the sponsor and facilitate and expedite the continuation of the process. On the other hand, if sponsors would not take risks and assumed no MDB participation, winning would imply that they end up appropriating most of the rent. Finally, and as previously noted, financing at conditions with the MDB reduces financial incentives to the development of financial markets.

Another approach would be to request proposals with prices for the contract quoted as ex-ante defined functions of financial conditions and MDB participation, so that any lowering of financial costs and/or MDB participation would be transferred to the government and/or

[18] That need not be exclusively in the form of financial conditions, but also as, for example, procedures to elicit the participation of commercial banks in a syndicated loan under the MDB lead, the resulting financial conditions of which would be offered to the project company. However, since the financing is not obtained until after adjudication, the magnitude of the effect is uncertain.

the consumers through higher prices for the contract and/or lower prices for the output. To become operational, this alternative may require a flexible negotiation mechanism so as to allow the best offer to negotiate with the MDB, retaining the option of switching to the second bidder in case the MDB would find the proposal not eligible for financing. This approach would increase costs every time there is a rejection. Alternatively, the authority may preselect a small subset of bidders for a second round used exclusively to negotiate with financiers once details of acceptable contracts are known to sponsors and likely financiers (less uncertainty). In this case the MDB should be willing to offer financial conditions (including rejection) to all preselected bidders, which would also increase MDB costs presumably to be paid by sponsors. These costs may be significant when proposals entail costly studies, as in the case of project alternatives with significantly different environmental effects.

If the project were to sell its output in a competitive market; that is, if there were competition *in* the market rather than *for* the market, transferring the rent to the government, or to the consumers through output prices, may prove to be impossible. Since access to the output market would be free, the output price would be market-determined by marginal producers paying market conditions without the MDB for their financing. In such a case, avoiding a transfer to the sponsors would dictate that the MDB charges to the project conditions without its presence (M_{wo}, i_{wo}), thus initially capturing the rent attributable to the difference between the two interest rates. Even then, conditions (M_{wo}, i_{wo}) would include, at least initially, a subsidy for other market participants as long as the presence of the MDB mitigates regulatory risk at no charge. Granting such "comfort" to all participants has been considered by MDBs a reason for financing the initial stages of developing markets that allegedly would otherwise self develop at a slower pace and with higher learning costs (e.g., electricity generation).

Whether the MDB transfers the rent to the country or to the consumers, or it attempts to retain it by charging conditions without its presence, could depend on its policy towards high-risk countries. Prospective investors in these countries may have no access to financial markets, or the conditions of such access may be so onerous that they become prohibitive. This latter case opens the possibility of providing some level of subsidy to high-risk countries in order to make financial conditions more affordable. The subsidy could be financed with part of the "comfort" rents captured by lending at higher prices in the relatively more developed markets, thus instituting a transfer from low- to high-risk countries, effected by means of the financial conditions charged to lending where prices are determined by competitive bidding procedures. This approach would avoid relatively more developed countries the disincentives on financial sector development of below-market financing, reserving the subsidy for cases in which financing without the participation of an MDB would be simply impossible.

3. Institutional implications

General

Reducing risk to the investor, rather than lending, is the most important role asked from MDBs in the financing of private investments without sovereign guarantee. On the one hand, their participation may be interpreted as a radical form of Rodrik's (1995) suggestion that "... private creditors might question the quality of the monitoring and conditionality exercised by multilateral agencies if these agencies did not back up their recommendations with their own resources". In the case of lending without a sovereign guarantee, the value of the MDBs' signaling (Claessens, 1995) would be increased, since they would be perceived as putting their *non-guaranteed* money where their mouth is.

On the other hand, and contrary to sovereign-guaranteed loans, non-sovereign lending may also be perceived as carrying the wrong incentives for institutions that perform informational and conditionality functions. Policy changes may not only carry positive developmental effects, but also affect the commercial profitability of firms with which the MDBs have outstanding balances. As a result, these institutions put themselves in a conflict of interest, affecting their credibility in claiming that their policy advice is free from any financial interest.[19] By trying to reduce investors' risk by committing their own resources without sovereign guarantee, MDBs put themselves at other risks.

It might be argued that the credibility of the advice stems from a cadre of international civil servants loyal to the peoples of the borrowing countries, loyalty that would preclude conflicts of interest from affecting their performance. In other words, international civil servants would be expected to conduct their work as carrying a mandate from the people of the borrowing country even when it meant to contradict the positions of other MDB members, and many of them do carry their professional work under such principle.[20] However, MDBs chief executive officers are elected or appointed by governments, as are the members of their boards of directors, making MDBs political institutions subject to the direct

[19] In commenting Rodrik (1995), Calvo (1995) indicated that "Private sector lending is highly desirable, but making it a central objective of multilateral institutions may jeopardize their role as honest brokers", but did not elaborate on the implications of more limited private sector lending for the functioning of these institutions.

[20] They may pay a cost for their integrity. For anecdotal evidence see Wade (2001).

pressure of governments (borrowing and non borrowing), some of which carry a heavy weight.[21] Moreover, MDBs have powerful incentives and instruments to influence the decisions of its professional staff including monetary and other incentives, such as promotions and the renovation of temporary contracts. While there exist institutional arrangements within the MDBs for appealing arbitrary personnel managerial decisions, the effectiveness of internal conflict resolution arrangements is not up to the task when considering the political and financial importance of the issues at stake. Incentives inside the organization tend to shape the professional conduct of its members, including the traits sought in new recruits, as well as the evolution of those characteristics over time. The result would be MDBs with a more limited "degree of autonomy from the governments that own them" (Rodrik, 1995), and therefore less able to perform their essential functions.

It may be argued that as long as non-sovereign operations are only conducted under the non-objection of the host country, the government has the option of keeping the MDB out the conflict of interest if it so desires. However, there would be a penalty attached to such option, since market participants would interpret it as a hidden agenda against particular interests. The role played by MDBs non-sovereign lending affects the costs associated with options for the host country.

Aware of the effects of conflicts of interest on the quality and perception of its policy advice, some MDBs initially attempted to institute a "firewall"[22] between their public sector functions and their non-sovereign private operations intended to provide clearly defined roles for each group and operational independence of one group from the other. But imaginary walls are penetrated by the effects of incentives generated within the organization, leading to different views of their essential functions and of the ethical implications of being placed in a conflict of interest, thus generating internal conflicts affecting the performance of the organizations in both their sovereign and non-sovereign lending activities.[23] Even successful "firewalls" do not resolve the problems; they just displace the conflict further up in the hierarchy where technical considerations play a lesser role. Ironically, as we shall see later, MDBs changed directions completely towards the opposite approach of forcing a consensus between their public and private sides in a strategy that would guide both groups in their

[21] On the role of the larger DCs in MDB decisions see Andersen, Hansen and Markussen (2005), Fleck and Kilby (2005), Kilby (2006, 2008), Strand (1999, 2003a, 2003b), and references therein.
[22] "In business, a … firewall is an information barrier implemented within a firm to separate and isolate persons who make investment decisions from persons who are privy to undisclosed material information which may influence those decisions. This is a way of avoiding conflict of interest problems.", *Wikipedia*.
[23] See, *inter alia*, ADB (2006, par. 30 and recommended actions 10 and 11) and (IADB, 2004, p. *vi* and par. 3.40).

actions. Conflicts of interest do not disappear by this type of consensus, but by one leading to eradicating the source of the conflict. More on this in Section 4.

Conditionality

The incorporation of policy based lending to help implement the “Washington Consensus” (Williamson, 1989) in the late 1980s and early 1990s challenged MDB claims of being independent advisors in both program design and execution. At the time, many considered it a blow to MDB independence. Rodrik (1995) seemed to look at the bright side in saying that: “… as long as multilateral agencies retain some degree of autonomy from the governments that own them, their interaction with recipient countries, while official in nature, can remain less politicized than intergovernmental links.”

Non-sovereign lending added a new dimension. Common financial interests with private firms brought new outside pressures into MDBs decision-making different in nature from those originating in bidding disputes or intergovernmental political disagreements. They originate in the profit motive (Sen, 1983), be it the MDB’s own[24] or through its commitments to private sector partners, and add to the perception of conflicts of interest in the provision of information and the design and enforcement of conditionality, thus eroding the autonomy in the performance of these core functions.

It is not obvious that developing countries perceive or should perceive MDB's economic advice as independent of their non-sovereign lending. The policy dialogue for the design of conditionality might be clouded by suspicions on who is ultimately trying to impose conditionality on whom, and for what reasons. The argument that MDBs should “put their money where their mouth is” leads to questions whether “they may be putting their mouth were their money is”. The conflict of interest, one with a firm grounding in financial incentives, complicates the design and implementation of policy measures originating in the policy dialogue.

During defaults, however, the situation may be turned around. By having losses from non-sovereign lending at stake, MDBs become more vulnerable themselves during negotiations, and governments might use these MDB potential non-sovereign losses as leverage to their advantage, which may result in short term political gain but not be the best long-term interest of the people they are expected to represent. Thus, non-sovereign lending

[24] In the case of MDBs, it would be more in terms of lending volume and avoidance of losses, than in profit volume.

hinders the legitimacy that may be attached to MDBs' "ability to impose effective and credible punishment in the case of default" (Calvo, 1995).

Problems with the design and implementation of conditionality are not limited to countrywide issues such as the independence of monetary policy, fiscal reform, or trade liberalization. They also arise at the sector and project level. MDBs ability to facilitate the successful completion of investment projects that are important for the government gives them leverage for negotiating sector-wide conditionality; for example, an MDB may consider that legal, regulatory or other changes should be undertaken before calling for bids. More recently, MDBs have been involved in more detailed features of market functioning, in particular risk-level and risk-distribution aspects. Such would be the case, for example, of market participants perceiving project risks originating in specific regulations followed by the MDB getting involved in improving the "rules of the game". Finally, closer to the project level, the MDB may consider in the best interest of the country that certain rules governing the bidding and adjudication processes should be observed, rules that would also help provide contracts satisfying minimum conditions to be eligible for MDB financing.

All these activities, however, become problematic for the MDB and the country once the MDB starts carrying private risk in their portfolios. On one hand the MDB is helping design the rules that govern profitability and risk allocation among parties, while on the other it may become affected, then or in the future, by such actions. By advising the government on such issues while doing non-sovereign lending to the private sector, the MDB puts itself in a conflict of interest situation. So, is the MDB advice then guided by the best interest of the country or by the best financial interest of the MDB?

Rent transfer

Similar problems arise when the MDB tries to perform distributional functions associated to the "comfort" rent discussed in the preceding section. The government and the MDB may consider using a price formula to transfer to the receiving country all or a significant part of the market value of the "comfort" through prices; it may be a formula aimed at capturing the "comfort" rent for the sponsors', or a price formula aimed at lowering the price of the goods or services to be produced. In all cases, the MDB may have to be involved in the design of the bidding rules, the draft contract, and perhaps even in negotiations, thus increasing the instances in which it could be involved in conflicts of interest.

These activities lead to other risks to the MDB that would increase at least the perception of conflicts of interest. First, there could be pressures from the government representing the sponsors trying to tilt the distribution of risks in their favor. Second, bidders may interpret MDB involvement as an assurance that the financing would be granted, leading to less attention than desired being paid to those aspects of the bid that determine the non-commercial risk profile of the project. Finally, after adjudication there could be more reasons for the host country to pressure for a successful closing, since the participation of the MDB increases the value of the contract for the country (either via transfer to the government or to the consumers). The result could be an MDB pressured by all three parties to finance something that it should not, and lead down the road to complicated conflict of interest situations.

Fiduciary implications and transparency

An agent bank has fiduciary responsibilities towards the other participating banks (Qu, 2000; Langer, 2009). As a result, when the MDB leads or becomes the agent of a loan syndicate its fiduciary duties to the other members may conflict with its fiduciary duties towards the government and the people of the borrowing country. This situation may affect the willingness of the government to grant the MDB access to confidential information that would have otherwise been shared. For example, a report by the General Accounting Office of the United States (GAO, 1996. p. 35) indicated that responsibilities of the International Finance Corporation (IFC) as a lender of record "include monitoring the project/borrower, [and] informing banks about any material developments", and it may be very difficult to monitor the project/borrower in isolation of, for example, sector policy developments in which the World Bank is frequently involved. While the conflict cannot be eliminated, the fiduciary obligations to the private financiers should be made public by the affected organizations for the duration of the contract.

There is a second, more general reason for concern. Agent banks have a fiduciary obligation "to act in the best interest of the person to whom a fiduciary duty is owed" (Langer, 2009), that is, the other members of the syndicate. A more stringent rule is that "…no person in a fiduciary position may enter into any engagement in which his personal interest conflicts, or may possibly conflict with his [fiduciary] duty."[25] As a result, any action from the agent-MDB that "may possibly" adversely affect the performance of the loan may be considered a breach of duty. It follows that the agent, in this case the MDB, should refrain for providing advice that may affect the profitability of the borrower, even if such advice is in

[25] Quote from a judgment, see Qu (2000, p. 90n).

the best interest of the country. At the very least, there are incentives for the MDB not to test the courts and stay away from the possibility of breaching its fiduciary responsibilities.

The counterpart to the risk reduction function of the MDB is an increase in the average risk of its own portfolio. Losses originating in non-sovereign lending could lead to cross subsidies from the sovereign side unless banks made adequate provisioning financed from non-sovereign net income. Therefore, financial results of non-sovereign operations and the implications of losses to the cost of sovereign operations should be known to the affected parties: stockholders and taxpayers financing the repayment of the loans. These issues call for separate accounting by MDBs of sovereign and non-sovereign operations as if there existed two separate organizations, and transparent reporting of such accounting as part of their fiduciary responsibilities.[26] No such reporting was found in the MDBs' websites consulted as part of the writing of this paper.

Other institutional implications

Private firms often attempt to influence MDB decisions through their government representatives pursuing their nationals' private interests when MDBs conduct their traditional activities of sovereign project finance. A frequent origin is procurement disputes, which resolution is governed by tested rules. If a conflict of interest appeared it would rarely affect the MDBs' ability to perform informational and conditionality functions. There are also attempts to promote national interests at a sector or thematic level, which run much closer to the core functions and sometimes create at least the perception of a conflict of interest.

The scope of possibilities for private-firm attempts to influence MDB decisions through their government representatives increases with non-sovereign-lending. Investors and financiers try to use the presence of the MDB for their private benefit, lobbying their country representatives to influence, through the MDB, government decisions affecting the project. In the case of government actions more specifically affecting the profitability of the project, investors may also appeal to MDB's concerns regarding the repayment of the loan; in this case it would be to executive officers reluctant to preside over financial losses and may come from the investor directly or through a government representative.[27]

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[26] For MDBs that conduct sovereign and non-sovereign operations to the public sector (e.g., non-sovereign municipal finance), accounting should separate non-sovereign public from non-sovereign private as well.

[27] "… there is considerable potential for the MDBs to catalyze privately led project finance – based on their knowledge of the policy and institutional environment, their technical and financial competence in infrastructure, and *their ability to help governments commit to appropriate policy because of their interest in*

MDBs need a "degree of autonomy from governments that own them" (Rodrik, 1995) to exercise their development functions. Non-sovereign lending reduces that autonomy, thus increasing questions on whether MDB advice is guided by the best interest of the country or by foreign policies aimed at protecting the private interests of foreign nationals. To be able to provide effective policy advice MDBs also need that such policy advice be and be perceived as been independent from its own financial performance, and that LDC-government policy decisions be and be perceived as been independent from their potential financial effects on the MDB.

4. The MDBs self-evaluations

To see the extent to which the main conflict of interest discussed in this report –that is, performing informational and conditionality functions when having a financial interest– is explicitly discussed in MDBs own reports, we conducted a limited empirical research. We looked at evaluations of non-sovereign private lending dated after year 2000 and published in their websites by four MDBs: the African Development Bank (AfDB), the Asian Development Bank (ADB), the Inter-American Development Bank (IDB), and the World Bank (WB).[28] These evaluation reports may benefit from some greater independence, better coverage in terms of number and scope of operations, and include the opinion of a wider spectrum of agents in their preparation. No attempt was made at reviewing evaluations of individual operations.

The initial approach was to search the documents for the string "conflict", record the number of instances that the issue discussed was a conflict of interest, and then identify within this last group the paragraphs referring to the type of conflict of interest we are interested in. Other parts of the documents where the subject was likely to appear were also read. While some discussion of conflicts of interest that did not use these specific words to describe them may have been omitted, the findings suggest that the coverage was sufficient to provide a good idea of the organizations' more public views on the subject.

The numerical results are presented in Table 1. The *Total* column registers the number of times we found the string 'conflict'; while the *Other* column contains the number of times there were references to conflicts of interest different from the one we are interested in. There were three evaluations conducted by the ADB (2001, 2007, 2008), two by the IDB (2003,

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maintaining the support of the official financial community.", Gurría and Volcker (2001), my italics. Also see ADB (2007, p. *viii*), IDB (2004b) and IFC (2009).

[28] We would have also liked to shed some light on the pricing and its distributional effects, but did not find publicly available data that would allow such analysis.

2004), and two by the World Bank (2006, 2009). No evaluations of this type were found in the AfDB website under the category "Private Sector Development", but there were other documents that could conceivably discuss the issues: 1) a policy on guarantees (AfDB, 2003?); 2) an evaluation on the process and portfolio performance of private sector operations (AfDB, 2004a); 3) an evaluation of the AfDB as a development institution during the period 1996-2004 (AfDB, 2004b); and 4) a strategy for private sector operations (AfDB, 2007).

African Development Bank

The AfDB documents reviewed do not refer to conflicts of interest arising from private sector operations. Surprising, since the AfDB VIII replenishments included specific directives on private sector development: "(i) Focus on improving economic environment, regulatory framework, and further unrestrictive microeconomic policies. Addressing legal and regulatory reform, financial sector reform; trade and price liberalization; (ii) Assist RMCs in building the entrepreneurial capacity of indigenous and grassroots organisations via training and technical assistance; (iii) Collaborate with other organisations such as IFC, African Project Development Facility and the Foreign Investment Advisory Service." (AfDB, 2004a. Annex A). The policy on guarantees (Afdb, 2003?) and a more recent update of the strategy for private sector operations maintain such role for the Bank (AfDB, 2007; e.g., par. 3.5 and 3.10).

Table 1. MDBs own views

Source	Conflict		
	Conflict of interest		Total
	Type discussed in this paper	Other	
AfDB			
AfDB (2003?)	0	0	0
AfDB (2004a)	0	0	0
AfDB (2004b)	0	3	37
AfDB (2007)	0	0	2
ADB			
ADB (2001)	0	0	6
ADB (2007)	0	14	15
ADB (2008)	0	17	18
IDB			
IDB (2003)	0	0	0
IDB (2004)	9	0	12
WB			
WB (2006)	8	0	9
WB (2009)	7	15	27

Note: Only conflicts of interest clearly referring to the type discussed in this paper have been included in the second column. In the case of the World Bank Group documents, only conflicts directly involving the Bank, rather than just MIGA or IFC, have been included in the first column.

Asian Development Bank

The three ADB evaluation reports examined, while aware of many conflicts of interest within the organization, did not address the ones discussed in this report. One of the reports (ADB, 2007) addresses the difficulties found internally in the "cooperation of public and private sector operations", mentions that other international finance institutions have changed their organizational structures towards a matrix approach, and notes that such an approach "requires a movement away from binary concepts of public and private sector towards a continuum between sovereign and non-sovereign guaranteed operations." (par. 147).

In contrast, the organization's early strategy for lending to the private sector (ADB, 2000) refers unequivocally to conflicts of interest arising from providing "policy advice to government on an issue in which it has a financial interest related to an existing or prospective private sector investment"(p. 37, Box 4). The report then states that

> "… the framework [to deal with the conflict] must not rigidly separate advisory and investment staff or unduly restrict the flow of information. Otherwise, the benefits of closer coordination will be lost. The concerned departments and offices should be responsible for identifying potential conflict of interest in their projects and bringing this to the attention of senior management as necessary." (p. 37, Box 4)

At the operational level, however,

> "ADB will need to enhance and institutionalize partnerships between public sector operations staff and PSO staff to achieve synergy across the organization, while keeping in mind the possibility of conflict of interest (*Box 4*). Networking and sharing of professional expertise will be encouraged. Disincentives to close collaboration will be removed." (p. 35)

The approach is clearly one of aligning staff on particular transactions expecting that somehow senior management officials are able to come to a decision that prevents the effects of such conflicts.[29] A curious approach, since the effects of these conflicts of interest in people's conducts would be expected to increase as you move from the more technical to the more political layers of the organization.

Despite the initial concerns, it is clear from the report that the ADB sees no problems in working on both the public and the private side of a transaction:

> "Investment opportunities may also be created by considering the private sector alternative to a government-proposed investment project, as was the case with the Colombo port project approved in 1999." (p. 14)

The report indicates that this particular project was later financed by the ADB.

A later update of the strategy (ADB, 2006) does not discuss conflicts of interest, but addresses again the conflicting views and incentives within the organization, and in order to "ensure collaboration and greater productivity" proposes that ADB adopts

[29] The document also summarizes World Bank/IFC conflict of interest rules.

> "… a system whereby both RD [regional departments] and PSOD [private sector operations department] teams are each given full credit for joint transactions (although single booking by ADB in external reporting), including cofinancing." (par. 70)

The ADB approach seems again aimed at smoothing the operational cycle by aligning incentives and combining human resources on an operation by operation basis, but the Strategy does not discuss the effects of the proposal on the organization's informational and conditionality functions. The proposed solution might indeed succeed (or have already succeeded) in aligning staff incentives and obtaining the desired behavioral changes, but it does nothing to prevent the conflicts of interest in which the institution puts itself, and that underlie the different views by the staff. These conflicts remain active and affecting the performance of core functions of the organization, although perhaps hidden to the naked eye behind the effects of incentives on staff behavior.

Inter-American Development Bank

The IDB is aware of one of the main conflicts of interest arising from its non-sovereign lending to the private sector, that between the roles "of 'political and regulatory risk mitigator" for private companies and lenders, and "impartial advisor" to the government" (IDB, 2004, par. 3.40). An important piece of information provided by this report is that "…a sizable percentage of the Bank officials (38%) and PRI [the non-sovereign private sector] staffers (32%) surveyed during the evaluation think that this type of conflict exists" (par. 3.40).[30] The report also recognizes that

> "Though in theory it ought to be possible to improve synergy between the different parts of the Bank the absence of a common diagnostic and shared vision is an impediment to such coordination …" (p. *vi*)

The IDB is also aware of the incentives to the organization created by the possibility of financial losses: "Backed up by solid guarantees, the Bank's fiduciary role has taken precedence over the risk of directly dealing with arbitrary acts" [of governments affecting sponsors]. While the consequences of these findings on non-sovereign lending occupy an important part of the report, the analysis of its causes and of the effects on the core functions of the organization do not receive much attention.

[30] Since "PRI staffers" are "Bank officials", the percentage of non "PRI staffers" would be higher than 38%. Unfortunately, there seems to be no Internet access to the survey data and its more detailed analysis.

Given the different staff views regarding non-sovereign lending to the private sector, the report recommends the preparation of "private sector strategies" to "organize work around a common vision". Then,

> "Once a concerted vision had been worked out for each area of action, with due regard to regulatory framework, private sector presence, and capital market maturity, a work program or framework agreement could be devised for all parties' activities in which both PRI [the non-sovereign private sector] and the rest of the Bank could operate independently." (par. 4.22)

It seems to suggest that once a consensus is reached, conflicts of interest would be avoided by the "independent" operation of the different units within the borders demarcated by the strategy. The report does not discuss that bureaucratic agreements cannot avoid conflicts of interest –which often lay at the heart of the lack of consensus–, analyze the experience with firewalls as tools to prevent conflicts of interest, or discuss the effects of a firewall on the perception of such conflicts by borrowing countries. Nevertheless, faced with the reality that true consensus may be hard to obtain, the report goes on to recommend that

> "Where two markedly different visions persist a single vision should prevail. The simultaneous operation of "twin visions" hurts the Bank's external image and impairs dealings between the different parts of the institution. It would be preferable for PRI [the non-sovereign private sector] or the Bank's public sector area to be exclusively 'in charge' of a sector/country than to have two sides of the institution putting out contradictory messages." (par. 4.22n)

This recommendation suggests that in order to prevent hurting its external image by internal conflict, the organization should proceed along a path with conflicting interests that impairs its information and conditionality functions. Aware of the inevitability of the conflict, the evaluators seem to be indifferent between the alternatives to conduct the process and opt to put the core functions at risk.

The World Bank

The World Bank first evaluation (2006) only refers to IFC conflicts of interest between its advisory and risk-taking functions (e.g., p. 18), but not to conflicts for World Bank development activities. However, the report does say that IFC provided technical assistance and advisory services "directed at private sector clients–for example, to build their capacity to engage in policy dialogue with the government." (p. 11), while World Bank (2009, p. *xii*) recommends "establishing more systematic links between advisory services and the deployment of Bank Group PRM [political risk mitigation] instruments and other products".

The second evaluation (World Bank, 2009) makes few but clear references to the conflicts of interest discussed in this paper,[31] which are best presented by the Bank's Administration in its response to the evaluators comments:

> "The infrastructure area is in fact a good example of WBG [World Bank Group] coordination on advisory and financing services. IFC's investment team, which is separate from the advisory team, can offer a financing package to the winning bidder subject to satisfactory due diligence. Such a package could include WBG guarantee products as appropriate. Advisory teams working with government clients will, as a matter of course, need to advise a government on the best options for ensuring a successful and competitive bid, for a concession, build-operate-transfer, or other structure. Those options may lead to recommendations that either indications of interest from potential financiers (IFC or others) or of availability of political risk reduction mechanisms (WBG or others) be included in bidding information packages to increase the prospects of the government achieving its objectives. Governments are of course always free to reject such recommendations. Given the possible appearance of conflicts of interest, potential conflicts arising from such recommendations are fully disclosed to clients and mitigating measures as per WBG Conflict of Interest policies are put into effect if the governments choose to follow such recommendations." (pp. *xix*-*xx*)

While the consequences of the conflict of interest for the World Bank policy and conditionality functions are not discussed, the procedures are. Once a conflict of interest is detected, policies aimed at reducing its effects are put in place (including disclosure to country authorities), but the process continues expecting that procedures would avoid the effects of the conflict. It is clear from the above paragraph that the World Bank Group believes that conflict-of-interest procedures are sufficient deterrence for the incentives generated by non-sovereign lending inside the organizations involved, and that such procedures are completely aligned with compensation and promotion incentives.[32] The report does not discuss the implications of these procedures for conducting the World Bank's most important development functions.

The official reports reviewed for this section show that most organizations are aware of the conflicts of interest discussed in this paper. The review also shows that they provide a rather limited view of these conflicts, practically no discussion of their more serious implications, and no proposal to eradicate them. Conflicts and incentives permeate

[31] Greater attention is devoted to conflicts affecting IFC and the Multilateral Investment Guarantee Agency (MIGA).

[32] The World Bank Code of Ethics explicitly accepts that different parts of the Bank or of the Bank Group may work on separate sides of the same transaction: "This responsibility [confidentiality of information] is particularly critical when different institutions or departments of the World Bank Group are advising separate parties to the same transaction." (World Bank, 1999, p. 12).

throughout these organizations, and absent a candid discussion and a political resolution of the issues, they manifest as limited or incorrect understanding of the matter.

5. Conclusions

Reducing the perception of risk, rather than lending, is the most important role required from the MDBs non-sovereign financing of the private sector. In carrying it out, MDBs see their roles as independent technical advisors adversely affected, since the independence of their advice might be disputed given incentives involved in their non-sovereign activities. The ensuing effects on credibility weaken MDBs in their functions of providers of information on economic performance and designers and enforcers of conditionality.

There would normally be rents attributable to this risk reduction role of the MDBs, who would be expected to either capture them, or transfer them on to the country or the consumers, rather than passing them to sponsors or lenders. Transfers to the country or the consumers reduce incentives to the development of financial instruments and may require the MDB involvement in bidding processes, raising conflicts of interest between their roles as development advisors and financiers without sovereign guarantee.

Non-sovereign lending raises additional concerns about the risks originating in board members acting as conduits of the private interests of firms from the countries they represent. The existence of these pressures may be perceived as, or result in, the MDBs having to balance different interests, thus further diluting the value of their development functions.

MDBs have a fiduciary responsibility towards the governments that own them and, more important, to the people who repay the loans. This fiduciary responsibility calls for a full, transparent, and separate accounting of non-sovereign operations, as well as full disclosure of any covenant potentially affecting the complete independence of the MDB in deciding the use of the information it gathers in the process of conducting its development activities.

There are several channels in MDBs to transfer incentives faced by high management into incentives faced by technical staff, including their compensation and promotion. These incentives affect staff performance and the traits sought in new recruits, as well as the evolution of those characteristics over time. Anytime there are reasons to believe that non-sovereign operations put the MDB in a conflict of interest, there are reasons to wonder about the true motivations of its advice. This erodes the trust on which the policy dialogue with counterparts in developing countries needs to be based, and the legitimacy that may be attached to the enforcement of conditionality. The longer these incentives to staff are in place, the greater the effects on the organization.

MDBs seem to be aware of at least some of the problems, but the published reports reviewed for this study are incomplete and superficial in their analysis of the conflicts and their bureaucratic symptoms, and do not include an in-depth discussion of staff experience and the incentives running inside the respective organizations. Surprisingly in the case of reports from evaluation offices, only one includes the opinion of staff on conflicts of interest and none informs on whether the issues have been discussed with borrowing member countries. However, this may be more a reflection of institutional incentives than of professional awareness.

The discussion of the effects of non-sovereign lending on the core functions of MDBs is essential to LDC high-level government officials in order to layout the rules of engagement with MDBs for lower-level officials, since they need to know the incentives affecting their interlocutor before asking for, or listening to, policy advice, or negotiating conditionality.

It is also essential for MDB stockholders, particularly LDC stockholders, since these issues originate in their decisions as “owners”. Diluting or renouncing the responsibilities involved in the provision of technical advice and the design and enforcement of conditionality while conducting non-sovereign lending converts the MDBs in insurers and financiers of the private sector based on the political power granted by abundant low-cost lending with a technical content to be suspected. If that were the road chosen, consideration should be given to an alternative source of technical advice based on an institutional arrangement that LDCs can trust. In such a case, wouldn’t it be more efficient to completely remove non-sovereign lending from existing MDBs?

Finally, facing the issue is crucial to MDBs themselves for a better understanding of their nature, the incentives faced as organizations, and the effects of these incentives on the performance of informational and conditionality functions, the independence of which is crucial to their development role. It is by discussing these issues with stockholders and sharing the information with the people of the respective countries that a consensus over the desired nature of these institutions could emerge.

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