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Can development banks step up to the challenge of sustainable development?

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Executive summary

The great planetary challenges, be it the climate, loss of nature or human solidarity, call for concerted actions at all levels, on a scale commensurate with the problems. Yet, this transformative change, which requires mobilising actors across the board, cannot be achieved overnight. A transitional period will be needed to allow the actors to build socio-economic models attuned to this vision. While multilateralism is struggling to meet these challenges, public development banks – whether operating at sub-national, national, regional or international level – can cooperate and contribute to the search for economic and social models that hold promise for the future. … /…

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.../… Building on their dual role as a provider of public funding and an enabler to leverage private finance, Public Development Banks (PDBs) need to acquire the tools and indicators to help them select and support low-carbon initiatives as a priority. They need to put in place "sustainable development analytical tools" allowing them to select operations on the basis of criteria other than purely financial ones and, where necessary, propose long-term loans for high-impact operations. They must also ensure that none of their financing is likely to encourage activities at odds with the attainment of the Sustainable Development Goals, particularly those on climate and nature.

This policy paper explores the reasons why development banks can play a leading role in promoting the transition to sustainable development. It proposes five recommendations for decision-makers in order to help build the conditions for a successful transition.

- Streamline into financing decisions the imperative need to transition towards low-carbon, resilient and equitable socio-economic models, which assumes that each development bank acquire the necessary analytical tools and stand accountable for the impacts of its financing.

- Mobilise, encourage and draw on the private sector such that all stakeholders reach convergence on sustainable development. There is little point in a PDB refusing to finance a highly emissive or environmentally harmful project if another player then goes on to fund it. This mission is probably one of the most ambitious that the development banks can set themselves

- Use development banks to channel funds for transition purposes into projects, programmes and concrete actions forming part of national trajectories, consistent with the international agreements signed by governments.

- Support the emergence of responsible demand, given that the banks themselves are not the originators of projects. The environmental or social value of a policy, strategy or operation is the primary responsibility of the project sponsors themselves.

- Build a global and inclusive coalition of development banks, focused on the sustainable development transition and able to interconnect with other actors. Moving beyond isolated actions is crucial to tackling problems of global proportions. The world needs to have possible solutions in view as well as actors capable of embodying new forms of collective action, bolstering multilateralism, to give a breath of optimism and a positive momentum around sustainability.

Summary

Introduction

There are some 450 public development banks (PDBs) across the globe, present on all continents and operating within an international, regional, national or sub-national perimeter. They are independently managed and ensure the financial implementation of the public mandate entrusted to them.

Their rationale has been heavily debated. Is a state-owned development bank better able than a private bank to optimally allocate its available resources? The economic literature raises questions on what role the state should play in finance. In what way are development banks different? Can their very existence be justified?

Clearly, certain market imperfections greatly harm social balances and the smooth running of the economy. Persistent poverty and inequality, the need for affordable social housing and financing for farms or small businesses all justify proactive public policies across the world. At international level, financing for low-income countries, with only limited access to financial markets, justifies that transfer of resources should be implemented, in part, through development banks. The same holds true when it comes to financing for local authorities or support for foreign trade.

Yet, over the last twenty years, the nature of the problem has changed. Environmental and social awareness has brought to light the importance of externalities in investment and production processes. The United Nations' approval of the "Sustainable Development" concept at the 1992 Rio Summit, then of the Sustainable Development Goals (SDGs) in 2015, concretely signals the need to reason with a universal and cross-cutting approach, instead of prioritising the sole path of economic development.

While the world remains preoccupied by the persistence of poverty and inequalities, by climate change and the loss of nature, the Covid-19 crisis is a reminder that the problems are interlinked and that, most often, they call for a combination of local and global actions.

We are entering a period of transition, during which we must chart the critical path to ensuring that consumption and production modes are compatible with sustainable growth. What are the possible modalities and who are the agents of change able not only to ensure a coherence between investment choices and the crucial need for sustainability, but also to incite the international financial community to evolve?

This policy paper analyses the special role that development banks can play on this road to transition. It proposes that they take on greater responsibility in order to imagine their transformation through a mandate centred on the SDGs. It points up the societal responsibility of public development banks, currently insufficiently mobilised. It shows how the PDBs have key advantages allowing them to broaden their operating procedures to include a cross-cutting vision of their activities and impacts, as the SDGs presume. It proposes five operational recommendations for development banks based on their purposes, their mandates, their governance, their financial tools and their sectors of operation. Lastly, it underscores the interest of having the PDBs form a new global coalition.

1. Who are the development banks?

1.1. Definition of a development bank

In the world of public banks and specialised financial institutions, development banks hold a special place, particularly due to their emphasis on having development impact. By contributing to financing the economy, they represent a concrete component of public policy. They are referred to by the generic term “public development bank” (PDB), but these institutions are in fact highly diverse.

There is no clear-cut definition but we can point to the common characteristics of the members of this rather special banking family. Five criteria can be identified:

- **Legal:** The institution must have its own legal personality and separate financial statements, unlike public credit programmes or some governmental agencies.

- **Financial instruments**: The institution must use revenue-generating financial instruments such as loans, equity investments, guarantees and insurance, designed for clients whose business model ensures repayment.

- **Sources of financing:** aside from the grants or subsidies entrusted to it, the institution must be able to finance itself, above and beyond the periodic budgetary transfers from central government, unlike classical donor agencies.

- **Mandate:** This must be substantiated and backed by one or more public policies, linked to the national development plan- unlike the mandate of a commercial bank, whose main and often only aim is to maximize short term returns to private shareholders,- and for development banks underpinned by investment norms (development impact, profitability, risks, shareholder remuneration, etc.), which differs from that applied in the private sector.

- **Government support**: Government involvement can take various forms: one or several governments can create the development bank, owning part or all of the capital, and provide financial support or sit on the board of directors. This includes sub-regional or multilateral development banks owned by groups of states, independent subsidiaries of the public development banks themselves, or institutions owned by central banks or local governments.

Alongside the institutions that fall under the narrow definition above, many other financial entities fulfil public policy missions and could be included in the scope of our analysis. The recommendations and analyses in this policy paper also largely apply to them, given that the context of their activity is most often very similar to that of development banks, even though their financial logic is different. These entities with a public policy mission include among others:

- Universal state-owned banks with a business model based on a network of agencies, and which collect funds, manage accounts and offer retail services. Their activities usually involve them in the financing of infrastructure or companies, like their private counterparts.

- Some banks in which private interests have a majority stake sometimes carry out missions on behalf of state authorities.

- Sovereign funds whose budget allocation and mission are often organised within a full-fledged finance institution, but whose investment thesis is supposed to be identical to that of private funds.

- Special purpose funds financed by state actors for specific investments in companies or infrastructure projects. These are financing vehicles set up by states or PDBs to ring-fence a specific activity.

- Insurance companies and guarantee funds, whose intervention tools differ from those used by a development bank, but which can fulfil a very similar mission. The World Bank's Multilateral Investment Guarantee Agency (MIGA) is one such example.

- Government departments, which most often carry out missions akin to those of PDBs, financing development projects and providing loans if needed, but their governance and operating procedures are those of the state.

1.2. Panorama of development banks

An innovative and comprehensive database based on PDBs' annual reports and developed by the Institute of New Structural Economics (INSE) of Peking University in partnership with AFD has, for the first time, provided a complete mapping of these institutions. Analytical work is on-going to exploit this data and produce a PDB typology.

According to our earlier definition, there are around 450 public development banks around the world, with combined assets of some USD 11.2 trillion in 2018.

The PDBs operate on four geographic levels– sometimes simultaneously:

- Sub-national, to finance economic development on a specific territory, which may be a city, a national region or a federal state. Most often, these institutions fund small and medium-sized enterprises (SMEs) and are created by a local government that has a majority shareholding.

- National, at country scale, to carry out a specific mission to support a given sector or specific type of actor, or to support different sectors and missions.

- Regional or sub-regional, or else based on a specific criterion that may correspond to a geographical, religious or political preference.

- Multilateral, proposing their financing worldwide.

While the duration of loans granted by development banks is highly variable, it is on average far longer then that of commercial banks. Furthermore, there is often a lag between the committed amounts and disbursed amounts – in other words, between the financing decision and its financial execution. Asset turnover rates seem to be around 5 years (source: AFD database), though other sources give longer maturities. PDBs' annual disbursements can be estimated at USD 2,000 billion, equivalent to around 10% of global public and private investment.

Some salient facts from the database:

- National banks are in the great majority, with 329 institutions.

- In terms of geographical distribution, the number of institutions is relatively balanced between Africa (21%), America (22%), Asia (29%) and Europe (23%), but African PDBs are small in size and account for only 2% of total assets.

- At sectorial level, PDBs focus primarily on agriculture (9%), international trade (10%), social housing (6%), local government (3%) and particularly small and medium-sized enterprises (35%). However, most are generalists (38%) and finance all these sectors without exclusion.

- PDBs finance mainly private actors, although some also finance governments, municipalities or state-owned enterprises. Almost all the banks established by local governments focus on SME financing.

- Sub-regional banks are generalist multilateral banks, while 18 Development Finance Institutions (DFIs) specifically promote investment in SMEs worldwide.

- 39 development banks call on private equity, which signals that some private investors choose to participate in the activity of development banks.

- The three Chinese "policy banks" alone held USD 3,600 billion of assets in 2018, equivalent to 32% of the overall total for development banks.

- The German Landesbanks, which evolved from a specifically German system for savings and business financing, have often continued in the role of development banks. Others have become more commercial. Their combined assets total USD 1,180 billion (10% of total assets). We have nonetheless included them in our analysis.

- Taking only those institutions with assets worth over USD 3 billion, there are 138 institutions accounting for 98% of reported assets. At the other end of the scale, 65% of development banks are very small, accounting for only 2% of total assets. The size of the institutions thus varies greatly.

- No international development bank has a specific mandate to provide funding to local governments. A few national generalist banks do so, but given the extent to which sub-national actors are key to managing territories and the transition, this gap deserves to be pointed out.

- No international development bank specifically finances housing and only one is wholly dedicated to the rural sector (IFAD). Yet, these two sectors are crucial to promoting the transition towards sustainable development.

Facts and figures

- The earliest public development bank still operating is the Caisse des Dépôts et Consignations (France – 1816), followed by the Cassa de Depositi y Prestiti (Italy 1850)
- China Development Bank alone represents USD 2,355 billion of assets, USD 189 billion equity, USD 19 billion net profit
- PDBs in European Union countries, including their regional banks EIB and EBRD, together hold USD 3,950 billion of assets, i.e., 67% more than CDB.
- Various PDBs were created in 2019: International Development Finance Corporation (US-DFC); Banco del Bienestar (Mexico) ; Hellenic Development Bank (Greece) ; Romanian Development Bank (Romania) ; Banque Nationale d'Investissement de Guinée (Guinea).

2. Two centuries of history

2.1. The rationale for development banks

The appropriate scoping of the state's responsibilities in the financial and monetary realms is one of the subjects that sparks most debate among economists, though in-depth research on actual public development finance institutions has been fairly limited. Development banks have at times been stigmatised by free market advocates, while at other times, particularly during periods of crisis or war, there has been a call to reinforce them. Fortunately, we have now gone beyond this binary stance. We are better able to understand that everything boils down to context and the moment in history, as well as finding best ways for development banks to operate, complement, and collaborate with, the private sector, whilst maintaining their public purpose.

Historically, the establishment of public financial institutions has targeted a twofold objective.

The first is to channel investments into infrastructure or sectors that the government considers a priority (Diamond 1957). This was notably the case during the industrial revolution, which saw the creation of institutions such as the Caisse des Dépôts et Consignations in France (1816), the Cassa Depositi e Prestiti (1850) in Italy or the German Sparkassen (savings banks). Certainly, the 19th century was the cradle of national and specialised public banks. The driving idea was to support the construction of the infrastructure needed and rendered feasible by industrialisation (Mazzucato and Penna, 2018). In this, the founding role played by public development banks was what forged their basic identity, as they invested in new sectors or organised financial pools that opened pioneering outlets for investment, most often partnered by the private sector. In 1850, the French Caisse des Dépôts invested massively in the capital of the newly created railway companies. More recently, the Channel Tunnel – a project on the back burner since 1801 – saw the light of day thanks to the business plan promoted by the European Investment Bank for a consortium that included private banks, with political backing from the French and British governments, but no direct budgetary spending for the two states.

The second objective aims to overcome market imperfections, especially those linked not only to i) the various economic, environmental and social impacts accompanying any development project, also known as externalities, but also ii) to questions of coordinating and implementing public policy, and thus iii) to information asymmetries in some sectors, which leads to them being underfinanced (Armendariz de Aghion, 1999; Hausmann et al., 2020).

As a result, some projects judged to be economically, environmentally, or socially relevant by public authorities are not financed by private banks as the rate of return is considered too low compared to the risk. This is the case when it comes to financing an industrial and innovation policy, or some infrastructure.[1] These types of projects require long-term finance that the private sector is not always willing to provide, particularly when the risk involved stems from a governmental policy choice. It is also the case for sectors such as social housing for the most disadvantaged, in a market that is blind to the social consequences of inadequate access to decent housing. And again, for the small family farms that make up the economic and social bedrock of many countries, particularly low-income countries.

The role of the public sector in the financial system intensified during the reconstruction in the wake of World War II. This was a time of generalist multilateral and international banks – years marked by the state's growing role in regulating the economy both in the near term (Keynesian policies) and long term (planning). The International Bank for Reconstruction and Development (IBRD), later known as the World Bank, was created at this time and emerged as the financial pillar of a multilateral system that needed rebuilding, notably to assist those countries that had been ravaged by war. The German KfW was also established during this period (1948) funded by the Marshall Plan. In the post-war years, development banks were bolstered or created so that they could take over, at local level, the drive for industrial

[1] The French Caisse des Dépôts provided its first financing in support of territorial development in 1822 to the Port of Dunkerque.

investment (Diamond 1957). This was the case of the Industrial Development Bank of Turkey (TSKB), which the country set up in 1950 partnered by the World Bank.

Another reason for creating development banks emerged in the 1950s and 1960s, as governments were eager to foster regional integration. Solidarity between countries all holding stakes in the same financial institution unlocked powerful political and financial leverage. The existence of these banks enabled states to jointly raise capital, giving them the possibility to finance structural projects in a given sub-region. The objective of economic integration dovetailed with political ambitions, and proved to be a contributing factor to peace and security between neighbouring countries within the same geographical region.

This is the moment when regional banks appeared on the scene. The European Investment Bank (EIB – 1958) illustrates the success of this shared vision, which was highly effective both economically and politically. The pooling of European debt has long been operationalised through the EIB's debt issuance, and the bank is still one of the world's best-rated bond signatures, especially in times of crisis. It has played a major role in funding European infrastructure and innovation, as well as SMEs. It has increasingly focussed on financing the European Green Transformation.The Council of Europe Bank (CEB -1956), the Corporación Andina de Fomento (CAF -1970), the West African Development Bank (WADB - 1973), and more recently the Black Sea Trade and Development Bank (BSTDB 1997) also exemplify this kind of vision. The European Bank for Reconstruction and Development (EBRD) had been established to facilitate the integration of Eastern Europe and the promotion of democracy. Could it be that the extension of the EBRD's mandate southwards will delay the opportunity to build a full-fledged Mediterranean development bank able to embody the shared future of the two shores?

Mention should also be made of what characterised the years of African independencies, when the need for national financial institutions independent of the former colonial powers could only be met by the newly established governments (Duchaussoy 2017). The local financial sector was embryonic, having very few national institutions. In these circumstances, development banks had to support the autonomy of the newly constituted nations and fully contribute to promoting the drive for economic growth. The hundred or so African PDBs hold relatively modest assets, which raises the question of what critical or optimal size needs to be reached in order to play a real role.

2.2. PDBs' decline and revival as public policy instruments

After many years of a more Keynesian and plan-based vision, the 1970s and 1980s were marked by a challenge to government intervention in the economy. The world was divided by the political issues of the Cold War and ideological clashes often prevailed over economic considerations.

In the realm of finance, the general trend was towards liberalisation (cf. John Williamson and the Washington Consensus). The recommendations of the structural adjustment programmes implemented by the International Monetary Fund and World Bank pointed in this direction, although paradoxically the World Bank is itself a PDB. The shortcomings real and perceived, in the management of public institutions, be it governments, state-owned enterprises or public banks, brought on widespread distrust of public sector effectiveness, not only on account of suspected corruption but also because it was seen as a systemic failure. The private sector and rules of free competition were called on to take over. Financial regulations were revised and relaxed, state technostructures, including ministries, were bypassed and the market was seen as a more efficient way of optimally allocating resources. The move towards the privatisation of public banks, facilitated by management irregularities in some institutions (La Porta et al., 2002; Smallridge and de Olloqui, 2011), became common in many countries.

Public development banks were caught up in this movement and many were liquidated, restructured or privatised, particularly in Latin America and Africa. The World Bank[2] emphasized what was then perceived to be a failure. It concluded that poor governance was the major stumbling block in weak institutional environments. In less developed countries in particular, a consensus emerged that the context in these countries was not conducive to reaping the potential benefits of development banks.

At the same time, in Europe and particularly in France, Germany and Italy, the picture was less clear-cut. Certainly, in France, the experience of the Sociétés Locales de Développement (local development agencies) had ended in failure, bar a few exceptions. Yet, although state-owned commercial banks were privatised, some public development banks escaped this trend and their potentially structuring role continued to receive support and recognition. Several countries that had recently left the Soviet bloc created their own development banks in the 1990s, more often than not successfully.

In the wake of discussions on the new institutional economy during the 1990s and evidence that the private sector was blind to certain risks, it was effectively the 2000s and especially the major 2008 financial crisis that gradually shone the spotlight on the fragility of the private financial system and the positive state's regulatory role. The question of the countercyclical role of public banks became particularly key given the dearth of other actors capable of vigorously stimulating economic recovery.

The possibility of mobilising public development banks in this countercyclical role hangs on two specific features that universal banks do not have (Brei and Schclarek, 2015):

- The first is institutional: as the state is the shareholder of development banks, the need to safeguard the economy stands as a priority. The bank can be used to transfer resources to economic agents who can justify their need. The risk of moral hazard is lower than when

[2] The World Bank's 2013 report on financial development is symptomatic of this view (Global Financial Development Report: Rethinking the Role of the State in Finance).

private intermediation is involved, and the signal is useful for restoring market confidence.

- The second characteristic is structural: public development banks more often than not have balance sheets based on long-term resources (de Luna-Martinez and Vicente, 2012), which limits the risk of a maturity mismatch, unlike other financial institutions that also contribute to public policy objectives. Fanny Mae and Freddie Mac as well as Dexia3, privatised institutions that were PDBs at their inception, were caught in the crossfire of the 2008 financial crisis for this reason. By contrast, the PDBs were less hard hit as their business model does not require a fast turnover of assets. Most often, they lend over a duration that matches their resources and thus have no great need for short-term refinancing. In the event of market volatility, they are less exposed than others to the risk of illiquidity. This more stable balance sheet structure is clearly an advantage in periods of crisis, as it allows them to step in until market tensions ease.

All in all, development banks' business model positions them very differently from private banks. They have, of course, to factor in banking margins and risks that affect their financial equilibrium and sustainability. They remain governed by banking law or similar standards but, on top of this, they also have to meet the requirement of fulfilling their government mandate. They are expected to strike the right balance between operating equilibrium, risk management and allocation of their resources with a view to maximising the economic, social and environmental impacts of their financing. This robust financial stability and investment thesis fashions them into specific instruments able to play a government-defined role which differs from that of commercial banks across all financial systems. Redefining and amplifying this role in line with the Sustainable Development Goals could constitute a fresh rationale for their continuing and expanding trajectory.

2.3. The Covid-19 crisis and sustainable development

In peacetime years, there is almost no history of a decision leading to the lockdown of all "non-essential" economic activities in less than 24 hours, except for health services and distribution of food supply. Neither is there any prior example of what can ensure a successful recovery given the magnitude and depth of the present crisis. Governments and central banks, especially in developed economies, which have more fiscal space, have put in place large-scale financing measures and blown the cap on fiscal deficit ratios.

In these unprecedented circumstances, the mobilisation of governments and development banks has been exceptional, both in terms of speed and scale,[4] much more so than in 2008 when a

[3] The case of Dexia bank, a former public development bank, now privatised, that specialised in local government financing, is interesting on this count. Its liquidation (by orderly resolution) in 2009 owed nothing to the quality of its portfolio, which was excellent, but rather to the maturity mismatch of its refinancing.
[4] According to the International Monetary Fund, the G20 countries had already mobilised USD 10 trillion in July 2020, twice the amount that they had announced in March.
Source: https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19

wait-and-see approach had prevailed for several months. This attitude was, in fact, justifiable given that the 2008 crisis was endogenous to the financial system and spurred financial institutions, whatever their level of exposure, to relevant caution. In 2020, the crisis is purely exogenous and affects first and foremost the real economy. It stems from the policy decision to close borders, restrict economic activity and even confine whole countries. The consequences and risks are thus of a very different nature, and rebooting economic activities that were healthy pre-crisis depends over-archingly on the recovery of world trade, with each actor seeking to return to the pre-crisis situation as soon as possible. Unlike 2008, the current revival above all requires a particularly agile and dynamic financial system capable of generating the necessary liquidity. The public component, including PDBs, has thus been particularly in demand since March 2020, as confirmed by the numerous cases observed within the International Development Finance Club (IDFC – see box). This is also because the private financial sector has been unwilling to lend, unless strong public guarantees or co-financing with PDBs was available, due to widespread uncertainty.

An example of Covid-19 mobilisation is given by the members of the International Development Finance Club. The Club groups together 26 development banks from around the world, including some very large institutions such as the China Development Banks and the German KfW. More than EUR 30 billion were committed over a few weeks using a full toolkit of financial instruments: emergency loans, lowered interest rates, more flexible financial facilities, provision of guarantees, massive reallocation of funds, moratoria on repayments, etc. The main goal was to cover companies' cash flow needs and protect jobs in the economic sectors most affected by the slowdown in business: SMEs, transport, tourism, energy, industry, trade, services – but all sectors are potentially concerned.

The urgent need for a swift reboot of the economy has also opened the debate on the nature and quality of this reboot. Is it a matter of returning to the previous situation as quickly as possible? Before the Covid-19 crisis, many development banks had already engaged in joint discussions on methodology and operations aimed at enhancing the compatibility of their financing with the international agreements on climate and the SDGs, which their own governments had signed in 2015. The IDFC has set up several working groups to operationalise this alignment, while an international group of researchers has launched a series of studies on the inclusion of PDBs in the international financial architecture, the business model of PDBs, the characterisation of climate- and SDG-compatible financing, and systems of regulation, governance and adapted mandates.

In a context of climate change, nature loss and social inequalities, questions are being raised on the extent to which operations, albeit cost-effective, are of benefit to the whole community. Certainly, assessing other investment opportunities goes hand in hand with identifying related externalities. Whether these are positive or negative, as is often the case, taking them into account can quite radically change the view of a project. Good examples of this are given by projects that are justified economically but whose implementation nonetheless implies the destruction of a landscape or natural area. The INELFE project for the electrical interconnection between France and Spain is interesting from this standpoint. Following heated debates between nature conservationists and those defending financial priorities, most of the cable link was laid underground The need to strike a balance between these two stances led to justifiable interventions by the EIB (EUR 350 million) and the European Commission.

Many are hoping that the economic recovery and the monies spent on it will provide the opportunity for a fresh start on new foundations. The PDBs are expected to be at the forefront of a "new finance" aimed at reconciling financial equilibrium, risk coverage and a resolute step in the direction of a sustainable and inclusive development model.

3. Development banks for sustainable finance

One prerequisite is, of course, the setting-up of a governance system and effective regulation of the activities of development banks. Here, no one-size-fits-all model exists, but the economic literature reminds us that, if directors are not relatively free from political interference in the financial and operational management of their institution, the risk of nepotism and abuses is high (see particularly Smallridge and de Olloqui, 2011). Having independent members on the board of directors is useful but, in all cases, it is crucial that regulatory and supervisory banking practices be aligned on industry standards. In some cases, exceptions to Basel III standards may be envisaged, to help PDBs fulfil their mandates better, provided they are justified and proportionate.

Once these fundamentals are clearly and firmly established, five structuring recommendations can be proposed, which could give development banks a leadership role in financing the transition without crowding out private financing.

- Mainstream the imperative to transition in financing decisions
- Mobilize and redirect private finance
- Use development banks to channel transition funds
- Promote the emergence of a responsible demand
- Build a new global financing architecture

3.1. Mainstream the imperative to transition in financing decisions

For governments that engage in the multilateralism dynamic and participate in the on-going transition, two points tend to gather consensus:

- The United Nations agreements on the SDGs and the Paris Climate Agreements represent a unified strategic horizon for all countries.

- The SDGs are a matter for all economic actors, at all levels, in all countries, whatever their level of income. The private sector, which determines and structures long-term economic growth trajectories, needs to become part of this dynamic. This is a prerequisite for the transition.

This new imperative for sustainable development requires a thorough rethink of the mandate and functioning of development banks (Clark et al., 2019; Griffith-Jones et al., 2020).

Since 2015, a growing number of development banks have already integrated into their evaluations the issue of the carbon emissions linked to the projects they fund. The multilateral banks and IDFC members have committed to ensuring that their activities are compatible with the Paris Agreement objectives. Many of these institutions are already working together or with the broader financial community to develop and compare the criteria and metrics that will guide their strategies, their analysis of counterparties and transactions, the proactive management of climate risks and the support for the economic transition.

Yet, much remains to be done. Although the climate question is pivotal, it is only part of the problem. Strictly speaking, no "climate project" can be effectively designed independently of its social and economic impacts. The relative failure of current policies to fight global warming – given that emissions continue to rise – is very likely because they have not adequately integrated the diverse dimensions of sustainable development.

Moreover, when crafting pro-poor policies, the questions of climate and nature are essential and must not be viewed as secondary, not only because the impact of global warming is felt worldwide but also because this warming, as well as natural resource depletion, is exacerbating the fragility of the most vulnerable populations. The challenge lies in ensuring consistency between investment choices and the imperative of sustainability – which is a major responsibility for development banks. This issue is particularly challenging in low-income countries, which have relatively low CO_2 emissions and high poverty rates. They are compelled to make trade-offs to ensure the investments crucial to their economic growth while, at the same time, giving utmost importance to climate change. To help alleviate their costs, when the investments are climate-compatible, they become eligible for grants from the international community.

The Covid-19 crisis reveals just how devastating the great planetary issues of climate and the loss of nature can be in a world that fails to prepare for them. It also shows that the economic and social consequences (resurgence of poverty, unemployment, exploding debt, bankruptcies, etc.) of a transition involving an annual 7% reduction in carbon emissions, for instance, have been vastly underestimated, were this drop in emissions to be achieved through a proportional drop in growth.

There is also a lesson to be learnt from the last twenty years of climate finance: the multiplication of commitments made in good faith and performed with due care, no matter who the actors may be, are unable to move the needle on the necessary scale. During the Covid-19 lockdowns, we saw increasing declarations to the effect that the "world after" would not be as before, that lessons would be drawn from the crisis, that we would have to "reinvent ourselves". Yet, in concrete terms, the stimulus measures implemented are primarily aimed at boosting consumption and pushing production back up to its former levels. It could be feared that the only goal is to reconstitute the "world before" – basically the only world that we know.

For financing systems, one of the challenges of the 21st century is to give a new direction to all financial flows to ensure their compatibility with the SDGs and their probable extension beyond 2030. A first step is doubtless for development banks, be they national regional or multilateral ,and whether they finance public or private projects, to have a simple and credible analytical tool to qualify the compatibility of their business with the Sustainable Development Goals, including climate. This could maybe also help to increase the number of operations partnered by the private sector (cf. *infra*), provided that a tried-and-tested method is able to qualify the sustainability of an investment and its contribution to achieving the objectives.

The main difficulty is linked to the multi-faceted character of the SDGs and their mutual coherence. It is indeed very difficult to determine whether an investment project or public policy programme is comprehensively positive for all 17 SDGs, but also and more importantly, assess to what extent the absence of one of the goals should be disqualifying. Their interactions are too numerous and often still largely unknown or poorly understood. Research work plays a decisive role in shedding light on this. Further questions arise concerning priorities – these are not identical for Mauritania and for Germany. The magnitude of the social or environmental damage potentially caused by an investment compared to the expected economic and financial benefits is highly specific to each investment, each context, each country.

Development banks are on the front line regarding these questions. They need to innovate and open up this difficult way forward. They must all acquire analytical "sustainable development" tools that are credible, sound and actionable.

In fact, there is hardly any other means to ensure that i) whenever possible, financing intiatives prioritise activities with direct or indirect co-benefits for climate or nature, ii) innovative operations are identified and hold top priority when the projects are able to trigger structural changes, be it on a small scale (pilots) or large scale, and iii) unlocking a small emissive investment or harming an unprotected natural space can be truly offset by the achievement of vital social progress objectives.

There is no one-size-fits-all approach to these questions. They need to be addressed by each development bank to make sure that its approach is tailored to its own constraints and to the development level of the country in which it operates. But all of them must ensure that each project includes an assessment of the externalities of the investment under consideration and what it could achieve or has to avoid, including any related aspects.

Governments should ask all public development banks, to develop such methodologies, use them as concrete "echo chambers" able to mobilise research resources, and then catalyse other financial flows. The myth of market self-regulation has reached its limits. Setting a new course for the financial system can only be achieved through dialogue between public and private stakeholders – a far more substantial dialogue than is currently the case – under the eye of regulators likely to set the pace of the transition. The latter must be ready to impose precise and demanding standards should, as we see today, the changes advance too slowly when measured against the stakes.

3.2. Mobilise and redirect private finance

Among the needs to redirect global investment, the vast bulk of which is private, is the need to finance the various transitions. Today, this requires changing scale, especially when it comes to climate. Some preliminary remarks are useful:

- Markets are not efficient when it comes to giving the signals needed to channel private resources in the direction of the SDGs. In fact, markets pay little attention to the long term, sending no price signals on externalities and encouraging "free-rider" behaviour, particularly in fragile political and economic contexts.

- Private finance continues to invest heavily in the industries it knows well, even though some of these are contributing to climate change and the loss of nature. Investments in oil-related sectors are still very high, representing around USD 500 billion globally each year,[5] that is, triple the total annual amount of official development assistance (UDS 152 billon in 2019)[6].

- On the other hand, the flows of private resources required to finance the costs of transitioning towards sustainable and inclusive economies is far higher than current flows. The International Energy Agency estimates the energy transition alone will cost USD 44 trillion. This is beyond the reach of public financing alone, be it domestic or international. What's more, it would prove ineffective should private investors continue to pull in the opposite direction by financing investments detrimental to the SDGs.

- The 47 least developed countries, in particular, run a serious risk of being unable to finance this transition even though their populations are the furthest away from the SDGs. Even if financing were to be doubled, the amount of official development assistance mobilised would be incommensurate with their needs, estimated minimally at one trillion dollars a year.[7]

- Public debt levels, already elevated before the Covid-19 crisis, leave no leeway for the conjecture that, fiscality remaining unchanged, governments will be able to implement

[5] IEA (2019), *Oil 2019*, IEA, Paris https://www.iea.org/reports/oil-2019
[6] https://www.oecd.org/fr/cad/financementpourledeveloppementdurable/normes-financement-developpement/aide-publique-au-developpement.htm
[7] https://www.brookings.edu/blog/future-development/2019/07/29/how-much-does-the-world-spend-on-the-sustainable-development-goals/

the necessary transition infrastructure without a major redirection of private capital and adapted financial packages. One of the priorities that the Tharman report[8] underlines for its proposed reform of the international financial architecture is the mobilisation of vastly greater private investment.

These arguments are not totally new. The creation of many development banks in the mid-1970s, including Proparco, was based on this rationale. With the mobilisation of the international community around the SDGs, this line of reasoning is gaining strength and everyone agrees that what is crucial is for all stakeholders to fully take on board the pressing need for transition.

This means that potentially available private sector funds must be channelled into sustainable development. Development banks are well-placed to help this redirecting of private financial flows (Griffith-Jones et al., 2020). They are already often present in most of the financing rounds for large infrastructure projects and are in a position to bring their influence to bear. They need to strengthen their catalytic role through well-adapted financing methods and channels, in order to drive up SDG-compatible financing. In other words, what counts is not only that their own financing be in line with the requirements of the transition, but also that they try to bring all financial actors on board, so that a project that fails to adequately account for its social and environmental consequences finds no takers. More importantly, it is essential that projects contributing to a low carbon economy find sufficient funding.

To facilitate the mobilisation of private funds, the most common financial instrument is blended finance, which involves subsidising part of a private investment through grants or low-interest loans. Other frequent arrangements rely on trust funds, or ad-hoc mechanisms such as first-loss guarantees (e.g., for mezzanine finance). To be effective, development banks need to establish precise rules to prevent blending from introducing a competitive bias or, more importantly, from creating moral hazard by generating unjustified profit for private players.

Moreover, it is very difficult to put a figure on the level of subsidy that an investment requires to enable it to integrate a positive externality or cover a risk. This same question was raised by states with respect to the unfair use of ODA for commercial purposes. The rules of the OECD's 1978 Arrangement – which has since been regularly added to and updated – had attempted to establish a common framework to allay this concern. Different international actors have endeavoured to establish rules of conduct for blended finance (particularly the IFC and more recently the OECD via the Tri Hata Karana Roadmap) to limit possible criticism of moral hazard. The international debate is focusing on this question: beyond standards and regulations, how can investments be steered towards sustainability and, during an intermediary transition stage, how can those who take this direction be encouraged by financial incentives?

[8] Making the Global Financial System Work for All, Report of the G20 Eminent Persons Group on Global Financial Governance, October 2018

Given their knowledge of the economic realities of each sector, their experience gained from different operations and their close ties to government, development banks are probably the financial actors best-positioned to move this debate forward and systematise this type of intermediation. To do so, they must be able to make substantive financial commitments by having their capital increased by governments and leveraging their balance sheets,[9] in line with objectives that their shareholders need to set for them much more precisely and ambitiously.

3.3. Use development banks to channel transition funds

To accomplish their mission, development banks need to have a level of capital commensurate with their counterparty-risk-bearing capacity, while also ensuring that liabilities are backed by long-term resources. The failure of some development banks, regardless of the quality of their management, often stems from the conjunction between an unbalanced liability structure and an inadequately collateralised activity.

A prerequisite for their missions to succeed is government support, be it through loan guarantees, subsidised interest rates, tax breaks or maintaining a sound capital adequacy ratio. It could be thought that a mission broadened to include sustainable development financing presupposes extending the term of loans, as is often the case in the social housing sector. Loans with maturities of 30, 40 or even 50 years are justified if they promote solutions that prevent investments from being locked into highly emissive activities.

The question then arises of development banks' having sufficient capital, as well as access to grants or subsidies to support virtuous projects, or encourage non-virtuous projects to become so.

- Ethically and economically speaking, one rationale would suggest that, throughout their production cycle, companies pay and factor into their product pricing all related costs: not only the direct costs of inputs to production, such as labour and capital and taxes, but also the costs of all externalities, particularly if these cause environmental damage. Social responsibility and ethical treatment of employees are also found in most national labour legislations and should be imposed as a standard to be met.

- Another vision can justify providing a subsidy or benefit to a private company, as long as this yields a benefit for the community as a whole. The subsidy in a way "buys" a positive externality. This approach is adopted, for example, by the Global Environment Facility (GEF), the Green Climate Fund or the European Commission subsidies. These subsidies supplement and bolster an operation financed at near-market rates, thus ensuring its feasibility via specific financing for the environmental component.

[9] The leverage effect is the amount of additional lending permitted either by increasing equity capital or by receiving budget allocations from government.

Absent the market, the fair "purchase price" for a social or environmental benefit is hard to determine. Assessing the appropriate level of a grant or subsidised interest rate that can be optimally given to a private enterprise for a specific operation thus remains complex, both theoretically and methodologically (cf. *infra*).

It requires having the capabilities to distinguish between limitations that can be overcome thanks to concessional financing and those that are in any event unsurpassable. When this involves subsidising an environmental or social externality, it also requires being able to put a "price" on what the subsidy makes it possible to offset. Currently, the fact is that very few quantitative methods dispose of the necessary elements for calculating the right level of subsidies to apply .One important and valuable exception is using the shadow price of carbon to evaluate projects, as well as having a commercial evaluation, as the European Investment Bank does; such a practice could be generalized to other PDBs.

In light of this, there is a certain consensus around the idea that a subsidy backed by market financing can "buy" three types of services:

- Promoting an "inclusive service" component, such as opening up access to a service that is unaffordable for poor consumers at a market price.
- Gaining a collective advantage for the community by preserving a common good that has no market price (climate, nature, conservation of a landscape, etc.). This may involve promoting an SDG that is difficult to operationalise in a specific context.
- Enabling the implementation of an investment offering high economic and social utility, but whose risk/return profile is unacceptable to private investors, particularly in fragile or crisis countries.

These questions are crucial for a successful transition. Development banks, operating in close contact with the economic realities of their country, very likely have interesting answers, at least answers that are relevant for governments.

They bring three credible elements to the debates on the whether or not it is justifiable to grant subsidies or reduced interest rates through their intermediation:

- Their mandate is based on the understanding that market imperfection exists, whether this impacts housing, SMEs or financing for the poorest countries. If an additional dimension relating to the environment or climate is integrated, this is but another brick in an edifice already designed with this imperfection in mind, and is thus relatively easy to integrate.
- Although providing a grant to a company may raise questions of equity and moral hazard, this is not so for a public entity as it is not driven by profit. Certainly, it is healthy and necessary for development banks to balance their accounts. It is just as healthy and necessary that government or the international community give them the means to

finance all kinds of positive externalities resulting from their clients' operations. If this involves creating a market bias in favour of this vision, development banks are effective tools, wielded by the state and suited to acting as executing agencies, at least during an initial pilot phase before such mechanisms are extended to the private sector. .

- All countries and sectors have their own specificities. Faced with the very different economic realities of countries, national or sub-national development banks know better than anyone what constraints apply to local economic agents. A "tailor-made" response is possible, provided that the bank itself has access to the necessary support funding.

In exchange for this government support, development banks must stand accountable. Their contribution to sustainable development must be auditable. Financial innovation must also step up to the mark, particularly through investments in impact funds, results-based aid or guarantees.

3.4. Promote the emergence of responsible demand

Development banks do not originate projects, they finance them. This means that they count on the capacity and motivation of project sponsors and owners to design sustainable projects. However, PDBs can provide technical assistance or funding to generate desirable projects, or even design missions key for a sustainable economy, which will prioritize particular areas of investment.

In reality, there is a relatively broad spectrum of initiatives ranging from private enterprises following a "traditional" model to those working to integrate their externalities into their business model. For some, the prime objective remains financial profitability, and factoring in the transition, or even simple CSR criteria, is a constraint.[10] For others – ground-breakers that need to be identified and supported –, an investment project is always designed bearing in mind the whole gamut of impacts of their operations, and profitability is but one factor among many.

- Innovations, whatever qualities they may have, are still "laboratories". They are certainly relevant, but very few go to scale.

- For many countries, catching up the infrastructure deficit remains a non-negotiable priority, as it is their prime lever for development. The "silk road" promoted by China is based on this premise. Social externalities, such as environmental impacts, of this type of large-scale investment are systematically underestimated, especially with regard to more emotional or political concerns.

- Even though the conversation is becoming increasingly focused on the need for sustainable development and the opportunities it offers, many small businesses still view it as a constraint on their growth. They continue to perceive the reconciliation of

[10] Added to this are questions of taxation and distortions to competition linked to the diversity of social and environmental standards across the world.

financial, social and environmental agendas as purely theoretical, costly and far-removed from their everyday reality.

Sustainable development is a complicated, cross-cutting notion that is hard to mainstream in financing decisions. It is even more so for entrepreneurs, who are focused on product design and their market trends. In the current context, is there a critical mass of businesses and projects ready to take up the challenge of sustainable production? In the vast global fabric of SMEs, how can we kindle and support the mobilisation and motivation required to ensure that investments take sustainability issues into account?

This key question runs up against the fact that the support tools, advisory assistance and “non-banking” services that development banks could offer to their clients are insufficient to generate this type of demand on a massive scale. Considerable progress has been made, but purely and simply abandoning certain economic activities sparks the fear of social chaos. Such is the case of coal production in countries like South Africa and Poland, since their energy mix and employment are closely tied to this sector.

This implies that investors must build up their capacity to identify possible options, clarify and spell out long-term objectives, then translate these into a sequence of investments that all underpin concrete steps in the right direction. Admittedly, entrepreneurs’ motivation alone will not suffice. Failing public financial support and without technical and financial assistance, the transition will remain problematic.

This role of disseminating good practices, of “show-casing” and funding projects with environmental externalities, supporting clients through an approach conducive to sustainable and inclusive development and exploring financial models tailored to the business of originating sustainable development investments should come within the scope of responsibility of 21st-century development banks much more clearly and ambitiously. The current ODA rules governing the bulk of state subsidies for international cooperation should be thoroughly reviewed so as to include incentives to redirect financial flows into sustainable development. For the time being, the rules are a hindrance as they confine the measure of how states and their PDBs’ perform solely to the banks’ volumes of financing. The momentum for such change could come from the national PDBs that do not abide by these rules and to which concessional resources could be usefully channelled (cf. *supra*).

3.5. Build a new global financing architecture

The current political climate is marked by the resurgence of nationalism and questions of security. Several elections, including those in the world’s largest democracies, have shown that inter-governmental cooperation is not to be taken for granted and that an inward-looking attitude based on national identities or security is an option. Of course, this would hardly be compatible with building global cooperation on the various transitions, as this presupposes trust, cooperation and time.

Global governance of the transitions is not yet stabilised; the example of climate and the United States' withdrawal from the Paris Agreement prompt caution as to the possibility of concretising a consensus. As is often the case, the political thrust will come from citizen mobilisation and actionable solutions concretely financed and implemented. This is the field of the public development banks, and first and foremost the national PDBs.

We have now travelled one-third of the way between the agreements signed in 2015 (climate and SDGs) and the 2030 Agenda deadline. And in terms of results, particularly in the wake of the Covid-19 crisis, the major objective of poverty alleviation has lost vast ground in many countries. Likewise, the climate objective to settle humanity onto a 2°C trajectory seems difficult to achieve politically, socially and economically in present-day circumstances. As for biodiversity, 22% of known species are threatened with extinction under pressure from habitat destruction, overexploitation of natural resources or pollution.

The magnitude of the changes crucially needed to bring a solution to our problems sometimes has us believe that "we will never make it", given the necessary step change in our habits, efforts, and even in what we have to give up. Tocqueville, although he lived before this period of climate change, considered democracies to be short-sighted and incapable of averting long-term dangers (https://jancovici.com/recension-de-lectures/societes/de-la-democratie-en-amerique-alexis-de-tocqueville-1840/). Could it be that this grim future is unstoppable?

A great many surveys, however, indicate that a new roadmap for the transitions is mustering broad grassroots support from the general public, and that the Covid-19 health crisis has further bolstered the learning process and raised conceptual awareness and forward-looking attitudes. SDG financing necessarily means rethinking the international finance landscape and perhaps even its very architecture. Currently, this architecture locks the actors into fixed roles, each acting according to their own logic. Yet, multilateral banks, special international funds (eg Green Climate Fund, Global Partnership for Education,), national development banks, aid agencies, foundations, ONGs, cities, regions or federal states, private firms must now all have a common "radar screen", in the form of the SDGs, to guide their financing decisions.

Development banks can collectively organise themselves to act as this powerful new vector for financing the transition. They need to build an offer that can link up the great planetary questions and their operational responses.

To do so, the development banks need a global platform on which they can collaborate and coordinate their efforts internationally. The global architecture of development financing must be reinforced and converging methods and visions adopted (cf. *supra*).

A first indispensable step is to establish this coalition. It will allow these newly revealed actors to prove their effectiveness and enrich the content of international negotiations. Their added value will be that their commitments are anchored in highly actionable and concrete applications. Basically, this means doing banking differently.

- The first subject tackled by this coalition will likely be to develop a service offered to governments in order to channel the resources injected by the monetary authorities in the wake of the Covid-19 crisis towards transition solutions. These resources must translate into sustainable projects, distributed fairly across countries. This implies that the PDBs in high-income countries step up their financing mechanisms so that development banks in countries lacking such mechanisms can access a share of these resources.

- These financing initiatives must be in line with the sustainable development paths defined by governments. A coalition of development banks can create this actionable plan linking the decisions taken in international fora with local solutions.

- A key related subject involves ensuring that bank staff are trained and deepen their knowledge of the issues, methods and analyses required to integrate a broad range of impacts when studying an operation. A good example of this is found on the climate issue within the IDFC, where banks are improving their practices through peer exchanges. A coalition can organise these types of exchange, scale them up and finance them. The processes for discussion, experience-sharing and cross-comparing situations are perhaps some of the most powerful drivers of change.

- Development banks in low-income countries, particularly in Africa, with shallow financial systems need to have the benefit of a special solidarity from the larger, older and more financially sound banks. For the development banks whose mission is to finance international development, they can set up specific financial tools conducive to strengthening the paid-in capital of the smaller and more vulnerable banks. Long-term credit lines, Tier 2 funding (i.e., included in the bank's regulatory capital under Basel III), bond issue guarantees, grants for technical assistance and training, and equity investments are some of the financing instruments that can be used.

Conclusion

Based on the above and on the latest expert reports, various conclusions can be drawn.

- Governments must make sure that their PDBs meet four key conditions to ensure the effectiveness of the financings they mobilise: a credible "sustainable" development strategy; independent high-quality governance to be carefully respected as this is a guarantee of the institution's financial sustainability; a level of capital aligned with increases in their risk-taking, and new challenges; and alignment with their national climate plan.

- The imperative to transition plunges us into a world that is no longer unequivocal, a world that has to deal with the complex impacts of any investment project. Mainstreaming criteria and analytical tools based on the SDG roadmap in the project appraisal cycle is a prerequisite for success.

- Public development banks can amplify their dual function as a provider of public funding and an enabler of private financing through blended finance or support for impact investments. Their leverage effect must be scaled up and maximised.

- At international level, the global and regional PDBs must support and strengthen national PDBs through a better understanding of how the latter operate. They must use their intermediation more systematically to give these national PDBs easier access to local markets and concessional financing, provided that this delivers benefits for the climate and the other SDGs. They must also transfer their expertise so that these national development banks can act as effective relays for implementation of the key agreements signed between governments.

By synergising international, multilateral, regional and national levels and by highlighting how the interests of countries – and their citizens – dovetail with the preservation of the planet, development banks can make a difference. They have the potential to form an alliance that, at scale, will make it possible to finance the economic actors and actions of the transition.

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