Working paper 418



Developmental Revolution or Bretton Woods Revisited?

The Prospects of the BRICS New Development Bank and the Asian Infrastructure Investment Bank

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Abstract

This paper analyses the creation and potential operational scale of the BRICS New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB). The focus is on how membership, governance arrangements and the financial requirements inherent in the multilateral development bank (MDB) organisational model are shaping the trajectories of the NDB and AIIB. Choices made in these areas are already differentiating the two banks, with the AIIB appearing likely to achieve greater scale in development finance. The paper projects the financial capacity of the two new MDBs based on shareholder capital and likely financial performance, and considers a number of options for the NDB and AIIB to increase their operational impact.

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Table of contents

Acknowledgements ii

Abbreviations ii

Executive summary iii

1 Introduction 1

2 Background to Creation of NDB and AIIB 2

3 Initial Capital Structure 7
3.1 NDB: Equal Initial Capital Shares 7
3.2 AIIB: China's leadership role increases flexibility 9
3.3 Scale of NDB and AIIB Based on Committed Shareholder Equity Capital 9

4 Scenarios for NDB and AIIB Shareholder Equity Growth 12
4.1 Estimating NDB and AIIB Operational Scale 12
4.2 Exploring Factors Impacting NDB and AIIB Operational Scale 16

5 The Importance of Governance Arrangements 23
5.1 Governance at the NDB and Impact on Membership 23
5.2 Governance at the AIIB and Impact on Membership 26
5.3 Links Between Governance and Operational Effectiveness 27
5.4 Political leadership 28

6 Conclusions 30

References 32

Appendix 35

Abbreviations

AIIB	Asian Infrastructure Investment Bank
AfDB	African Development Bank
AofA	Articles of Agreement
AsDB	Asian Development Bank
BCIE	Central American Bank for Economic Integration
BoD	Board of Directors
BRICS	Brazil, Russia, India, China and South Africa
CAF	Andean Development Corporation
CDB	China Development Bank
E/L	Equity-to-loans
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IsDB	Islamic Development Bank
KfW	Kreditanstalt für Wiederaufbau (German Development Bank)
MDB	Multilateral Development Bank
MIC	Middle-income Country
NDB	New Development Bank
PBOC	People's Bank of China
PPP	Public-Private Partnership
ROE	Return on Equity

Executive summary

The recently announced creation of the BRICS New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB) represents a major shift in the global development finance architecture. Several emerging economies now have the confidence and financial wherewithal to create new multilateral development banks (MDBs) outside the Bretton Woods system that has dominated the decades since its establishment in the aftermath of World War II. A group of like-minded countries using resources to promote development projects throughout the world, via multilateral channels, should be a broadly positive move.

At the same time, it is not yet clear how the NDB and AIIB will differ from existing institutions, or what their scale is likely to be. Both banks will face many of the same challenges as existing development banks, due to the financial, political and development tensions inherent in the MDB organisational model. Based on political and financial commitments made to date, the NDB and AIIB are very likely to become functioning development banks in the coming months or years. Decisions made in relation to capital, membership and governance may, however, hamper the growth of the NDB in the short term. The AIIB appears better positioned to achieve greater scale more quickly, but its more inclusive membership structure may lead to replicating many characteristics (both positive and negative) of the World Bank and regional MDBs.

The initial capitalisation of the NDB was limited by the decision to give each founding member an equal capital share, rather than allowing differentiated contributions based on capacity. While understandable as a political statement of solidarity among partners, this means that the NDB's capital is smaller than it might otherwise be, due to fiscal constraints on the part of the smallest of the BRICS, South Africa. By contrast, the contribution to the AIIB's capital by China alone is equal to all of the NDB's initial capital, and the AIIB has a strong chance of obtaining considerably more initial capital from additional prospective founding members.

The projected loan portfolio capacity of the NDB is likely to be in the $45-65 billion range after ten years' of operation, while that of the AIIB could be in the $70-90 billion range. Due to the likelihood of receiving a AAA bond rating (because of the expected membership of several major industrialised economies), the AIIB has good prospects of growing more quickly than these projections, potentially reaching a portfolio of $100 billion or more by 2025 – one of the largest in the world, albeit a significant step below the size of World Bank's IBRD window. The NDB, on the other hand, will face more financial restrictions due to the likelihood of a lower bond rating, based on the sovereign ratings of the five BRICS nations.

The NDB Articles of Agreement (AoA) – negotiated by the BRICS nations and announced in July 2014 – in many ways follow the model of existing MDBs, which is surprising in light of the rhetoric about creating a new type of development bank. The BRICS have reserved considerable control over the new bank through voting rules, regardless of any other countries that may join. Other developing countries may see this as not unlike the Bretton Woods institutions, just with a different group

of countries in charge. Combined with what are likely to be higher loan costs than AAA-rated MDBs, such a governance set-up may be a disincentive for new countries to join. The result could be an NDB comprised of the BRICS and a group of lower-income countries, which could serve a useful role but not one that will have the kind of global impact the BRICS envisage. On the other hand, the composition of the countries that will run the NDB could mean that it will be faster and less bureaucratic than the existing MDBs, which may prove attractive to borrowers.

Under China's leadership, the AIIB is taking a different approach. Other countries have been actively lobbied to join, with the result that by 31 March 2015 almost 40 countries had signed its Memorandum of Understanding. Part of the reason for this success is that China will allow all these countries to take part in the negotiations on the AIIB statutes, and China has also signalled (at present only informally) that it is willing to share governance authority with other countries. This strategy is clearly more attractive to other countries than the NDB's approach. While bringing in a mix of industrialised and developing countries will give the AIIB strong standing in the international arena as well as capital markets, it also means that it will face the same pressures as many existing major MDBs to impose stringent requirements on its operations. This could, in turn, mean that the AIIB sacrifices to a degree its ability to differentiate its operational characteristics from existing MDBs.

Both the NDB and AIIB can employ strategies to further increase their scale and impact. Some of these options could be easier for the NDB and AIIB than for existing MDBs, as the new banks can be designed from the start with these approaches in mind and can also learn from the experiences of other MDBs:

- Focus tightly on infrastructure, which will allow the development of specialised practical knowledge of great value to borrowers.
- Adopt rigorously depoliticised and technical organisational culture and policies that will establish a strong reputation among borrowers, bond investors and potential partners.
- Leverage external resources as much or more than committing its own resources to maximise the developmental impact of the MDB's activities.
- Seek to leverage pools of resources and expertise from member countries through co-financing and other techniques.
- Generate a strong commitment among all shareholders through governance arrangements that grant meaningful voice and vote even to smaller shareholders. The commitment of all shareholders is key to avoiding the entrenched 'us against them' dynamic that hampers many existing MDBs.

1 Introduction

On 15 July 2014, the presidents of Brazil, Russia, India, China and South Africa (BRICS) formally agreed to found the New Development Bank (NDB), a new multilateral development bank (MDB). Then, in October 2014, China announced the founding of the Asian Infrastructure Investment Bank (AIIB), to be established by the end of 2015. The launch of the NDB and AIIB have captured global attention and headlines and are generally considered emblematic of the rising strength of emerging powers, and the parallel stagnation if not decline of the traditional western economic powers. Many see the NDB and AIIB as a direct challenge to the multilateral institutions of the post-war, Bretton Woods global financial order led by the World Bank, the International Monetary Fund (IMF) and regional MDBs.

Beyond the heated rhetoric, it is not certain how the NDB and AIIB will differ from existing development banks and how quickly they might become viable development institutions on a meaningful scale. The rationale for their creation is clear – huge investment needs in infrastructure, an inability of major existing development finance institutions to substantially reform governance arrangements, and a commitment by a group of emerging powers to work towards their own way to engage in multilateral development cooperation. The founders of the NDB and AIIB see the continued relevance of the basic MDB organisational model, and are constructing two new ones for their purposes.

At present, the two banks are still on the drawing board. The NDB's Articles of Agreement (AoA) still need to be ratified by the founding members (expected to be in early 2016, although there is some uncertainty about the timing), while the AIIB intends to negotiate its AoA between April and July 2015 and begin operations in early 2016. It is obviously premature to make any detailed assessment of their policies and operational characteristics. Decisions taken at this incipient phase regarding capital, membership and governance are far from definitive in determining the future of the two banks, but they may strongly influence their early trajectory in terms of scope and development impact.

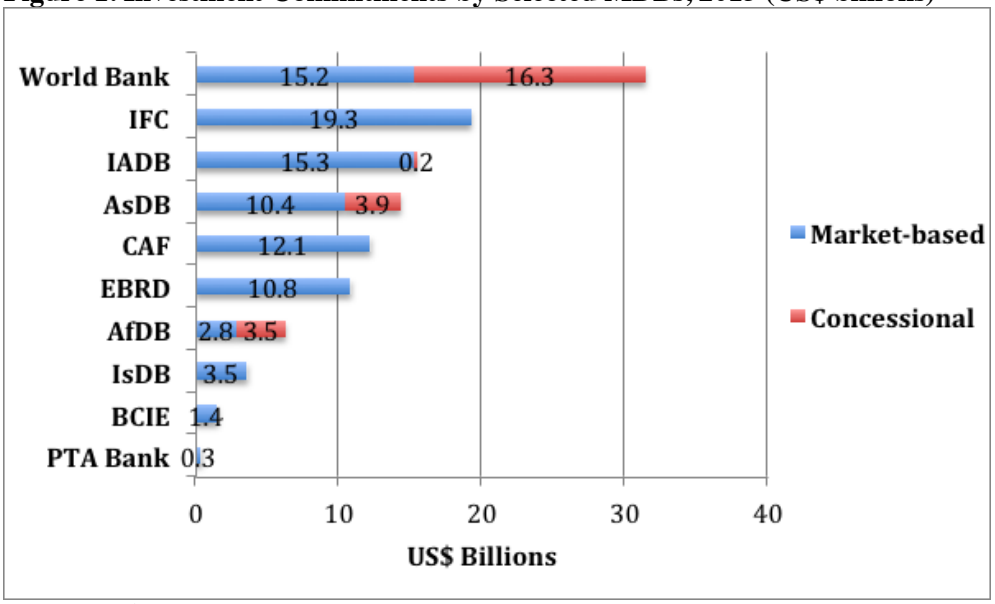
This paper highlights key issues related to finances and governance at the NDB and AIIB, based on available evidence and the experiences of existing MDBs. It aims to stimulate new thinking among founding country negotiators on how to proceed with designing and operationalising the new banks, and to give others in the development community a sense of their characteristics and scope. The paper does not seek to assess the geopolitical implications of the NDB and AIIB, but rather focuses on how they might evolve as development finance institutions over the next decade.

The paper is organised as follows. Section 2 briefly outlines the background to the creation of the NDB and AIIB. Section 3 analyses the banks' initial capital structure, while Section 4 models their potential operational scale based on this capital and considers options to increase it. Governance arrangements are addressed in Section 5, followed by the conclusions in Section 6.

2 Background to Creation of NDB and AIIB

Since the World Bank was established in 1944, multilateral development banks (MDBs) have proven to be a useful specialised form of international organisation. At least 20 MDBs currently operate worldwide, including the World Bank, the major regional development banks, and several specialised or sub-regional banks (Figure 1). While the best-known MDBs include many developing and industrialised countries as shareholders – for instance, the World Bank and the Asian, African and Inter-American Development Banks – other less known MDBs have different shareholding patterns, such as the Andean Development Corporation (CAF), PTA Bank and the Islamic Development Bank (IsDB) (Figure 1).

Figure 1. Investment Commitments by Selected MDBs, 2013 (US$ billions)



Source: Annual Reports, 2013.
Notes: 'Investment' includes loans, guarantees and equity investments.
World Bank includes the IDA and IBRD; IFC – International Finance Corporation (part of the World Bank Group); IADB – Inter-American Development Bank; AsDB – Asian Development Bank; CAF – Andean Development Corporation; EBRD – European Bank for Reconstruction and Development; AfDB – African Development Bank; IsDB – Islamic Development Bank; BCIE – Central American Bank for Economic Integration; PTA Bank – Eastern and Southern African Trade and Development Bank.

A key characteristic of MDBs is that their main lending windows are for the most part self-sustaining and do not require regular budgetary contributions from shareholders beyond shareholder capital.[1] Resources are mainly raised from private capital markets and lent to borrowers at a mark-up sufficient to cover administrative costs. Because their credit rating is generally high and the cost of funding is therefore

[1] This refers to the non-concessional lending windows. Concessional lending – mainly at the World Bank and main regional MDBs – is funded mainly by donations from wealthy shareholders, as well as some contributions from non-concessional lending income.

low, even with the mark-up, MDB loans are still financially more attractive than most borrowers could otherwise obtain. Furthermore, many MDBs provide technical assistance and knowledge value-added along with finance – paid for mainly with an MDB's operational revenue – that many borrowers value.

The ability to leverage shareholder capital via private financial markets has allowed MDBs to raise impressive volumes of development finance. For example, the World Bank's non-concessional IBRD lending window cumulatively lent $586 billion between 1945 and 2013, based on total paid-in contributions from shareholders of only $13.4 billion. This combination of minimal cost to shareholders, significant financial leverage and knowledge-transfer capacity makes MDBs a valuable organisational model for achieving development goals. The performance of existing MDBs has varied widely, however, and is often perceived by some shareholders – notably from borrowing countries – as falling short of their potential. Many countries consider that the major existing MDBs are not adequately facing the challenges posed by the current state of the global economy, and hence could be supplemented by new institutions for at least two main reasons.

First, there is a massive need for greater volumes of development finance in many countries, particularly for basic infrastructure. Existing public and private sources have not been able to provide the type and quantity of financial backing and development expertise needed to fill huge infrastructure gaps around world. Estimates of future investment needs in developing countries vary considerably, from $1.3-1.5 trillion per year (Fey et al., 2010) to $1.8-2.3 trillion (Bhattacharya and Romani, 2012) or even $3 trillion (Bhattacharya and Holt, forthcoming).[2] Regardless of which estimate is considered most realistic, it is evident that current spending investment levels of roughly $1 trillion fall well short of needs.

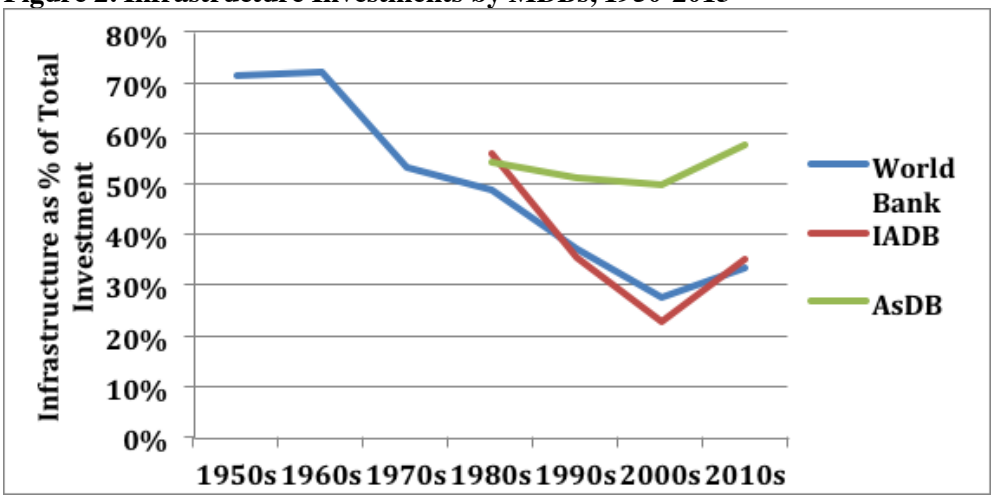
Increased private-sector investment in infrastructure is restricted for many complex reasons, but primarily due to difficulties pricing and hedging various types of risk in developing countries. MDBs are well placed to address these restrictions, as they combine the ability to take long-term risks with strong access to capital. However, MDBs currently account for only 10% of global infrastructure provision (Bhattacharya and Romani, 2012) (about $40 billion in 2013), and their investment in infrastructure has considerably declined as a share of total investment in recent decades (Figure 2).[3] By 2013, only 30% of total World Bank (IBRD/IDA) lending commitments was for infrastructure. Hence, it is evident that the NDB and AIIB can play a useful role in helping to close the infrastructure gap.[4]

[2] Estimates vary greatly depending on methodological approaches and how 'needs' are defined. See also World Bank (2013) and G20 Working Group (2013). Bhattacharya and Holt (forthcoming) offer a comprehensive review of estimation methodologies.

[3] Reasons include MDBs' decisions from the 1980s to focus more on social and governance lending, the increasing rigidity of safeguards and other bureaucratic restrictions imposed by non-borrowing shareholders, and limited flexibility for MDBs to accumulate and deploy capital for large-scale, transformative infrastructure projects. See Humphrey (forthcoming) for a fuller discussion of MDBs and infrastructure provision.

[4] See Griffith-Jones (2014) for a fuller discussion of this point in relation to the NDB.

Figure 2. Infrastructure Investments by MDBs, 1950-2013

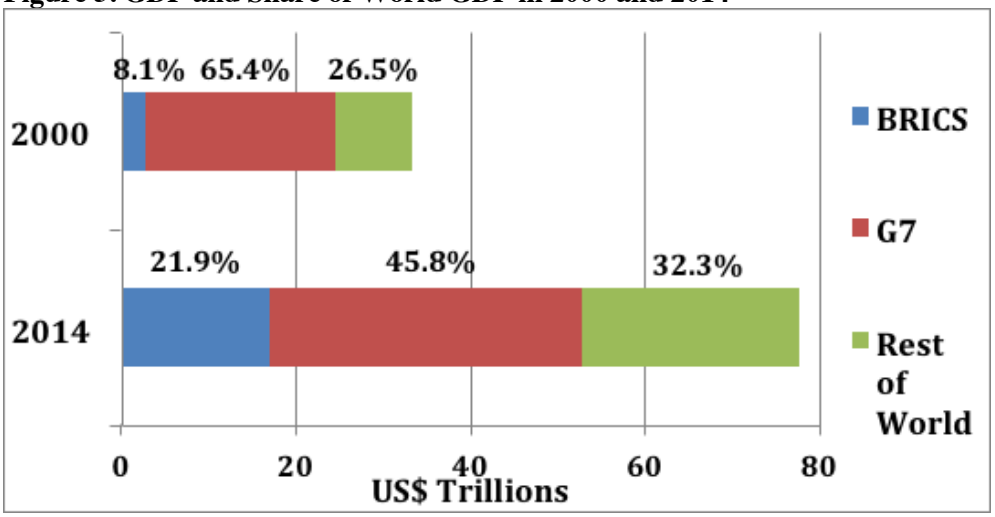


Source: Annual Reports.
Note: Includes concessional and non-concessional lending windows for all MDBs, excluding IFC.

Beyond the volume, the *type* of financing is increasingly important to achieve maximum development impact and to leverage much greater shares of private investment. Many development projects with potentially huge catalytic impacts cannot be financed by the public sector due to fiscal restrictions, and require financial support beyond traditional loans, such as loan guarantees, equity investments, project bonds, or loan syndications, as a means to attract private investors. Most MDBs were, however, designed to supply traditional loans to public-sector borrowers, and are facing major difficulties in adjusting their practices, due to both organisational path dependence as well as some shareholders' resistance to change. A new MDB can design an organisational structure, policies and culture more appropriate to providing sophisticated financing options, building on the lessons of more nimble MDBs with extensive private-sector experience, such as the EBRD, IFC and CAF.

Second, the governance arrangements at many MDBs – particularly the World Bank and the four major regional development banks – were designed as part of an economic and political global order that no longer exists. All of the major MDBs were created between the end of World War II and the end of the Cold War, when the USA, Japan and major western European nations dominated the global economy. Over the last 25 years, this panorama has shifted dramatically. Even since 2000, the combined GDP of BRICS countries grew by over 500%, compared to 64% for the G7, and their share of the global economy rose from 8% to 22% while the G7's declined by 20 percentage points (Figure 3).

Figure 3. GDP and Share of World GDP in 2000 and 2014



Source: IMF 2014.
Notes: Nominal GDP in current dollars is estimated for 2014.

The governance of the major MDBs has not kept pace with this shift in global economic power. At the World Bank, for example, the BRICS jointly control only 13.1% of voting rights despite their 22% share of the global economy. China has only a 5.25% voting share compared to Japan's 8.13%, despite the fact that China's economy is more than twice as large as Japan's. The situation is even more stark at the AsDB: Japan and the USA each have over 12% of voting rights (and jointly wield effective veto power), while China and India each have just over 5%. At the World Bank, AsDB, AfDB, IADB and EBRD, the G7 nations (and particularly the USA) have effective veto power over capital and governance rules. The traditional global economic powers have been incapable of and/or unwilling to reform existing MDBs to recognise the tectonic shifts in the global economy, and are at the same time unwilling to let rising economic powers contribute more capital as this would dilute their own voting control.

It should come as no surprise, then, that many fast-growing emerging powers consider the existing MDBs to be inadequate to address current development needs. At the same time, they perceive the MDB model to be useful for channelling finance and knowledge for the purposes of development. In the light of their growing global ambitions as well as considerable international reserves – much of which is invested in the bonds of governments that control the main existing MDBs[5] – they have as a result decided to create the NDB and AIIB. The new banks have the potential to achieve a number of positive and complementary aims:

- Leverage the savings of emerging economies for the purposes of global development, particularly infrastructure
- Serve as a forum for incorporating emerging economies into the multilateral system on their own terms
- Build MDBs more appropriately designed to address the financial, development and political realities of the current global context
- Provide stimulus to spur existing MDBs to overcome governance and organisational obstacles that have blocked reform

[5] For example, in April 2014, nearly $2 trillion of China's almost $4 trillion in reserves were invested in US Treasury bonds (Forbes, 2014).

While the creation of the NDB and AIIB is broadly a positive step for global development finance, it also entails some risks:

- The two new banks could potentially accentuate donor fragmentation, depending on the degree to which the NDB and AIIB are able and willing to coordinate with other sources of development finance in their countries of operation.
- Project quality, environmental and social protection, and financial oversight could be compromised if the new banks do not establish their own control systems in these areas.[6]

Bringing the new banks into operational reality will be a complex task. MDBs have struggled for decades to find the best recipe for promoting development within the restrictions imposed by the prevailing organisational and financial model. The following sections explore some of the issues that the NDB and AIIB are now facing, with a particular focus on finance and governance.

[6] This has been a frequent complaint of the US government in arguing against the creation of the AIIB, although its interim leaders insist that they will follow best global practices. See, for example, Reuters (2015).

3 Initial Capital Structure

MDBs are built on a foundation of shareholder capital. Ownership of an MDB is divided among member countries,[7] a condition of which is that they contribute capital resources. This shareholder capital forms the security upon which an MDB can borrow from investors, mainly international capital markets. The scale of shareholder capital is directly linked to the potential scale of an MDB's operations, and also to its governance. Hence, the choices made regarding shareholder capital have very important implications for the trajectory of all MDBs.

3.1 NDB: Equal Initial Capital Shares

At the time of the NDB's launch in July 2014, the BRICS countries announced that:

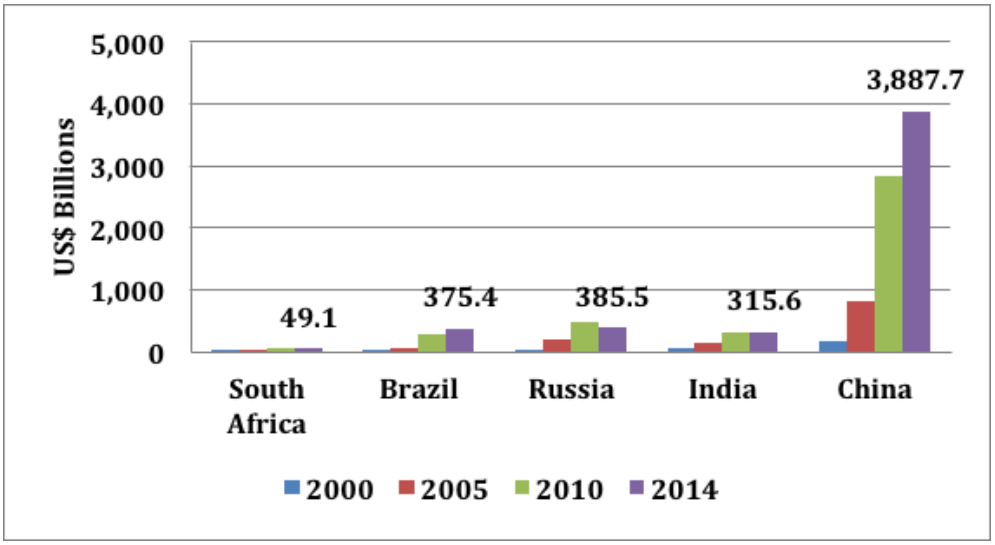
- Each of the five member countries would initially have equal capital shares and equal governance votes.
- The total initial capital of the NDB would be $50 billion, of which 20% would be paid-in capital.

The choice of giving each of the founding BRICS members an equal capital share is understandable and in many ways laudable. It is a clearly political decision to immediately differentiate the NDB from the Bretton Woods system, in which more economically powerful countries were initially allowed to contribute larger capital shares and therefore obtain greater control over its governance. The downside is that this does not recognise the vastly different scale of potential contributions by the BRICS countries, with China in possession of more than ten times the reserves of India, Russia and Brazil, and nearly 100 times those of South Africa (Figure 4). As a result, the scale of initial capital of the NDB is limited by the fiscal/reserve capacity of the smallest member – South Africa. Had the founders been permitted to contribute different amounts, the NDB's initial capital could have been considerably higher. Interestingly, this is the case for a reserve-swapping arrangement initiated by the BRICS in parallel with the NDB, to which China committed $41 billion, Brazil, India and Russia $18 billion each, and South Africa $5 billion.[8]

Figure 4. BRICS Countries International Reserves (2000–2014)

[7] It is possible, but uncommon for MDBs to have non-sovereign owners. Of the larger MDBs, only CAF has a small share of ownership by a group of private banks based in member countries. Several smaller MDBs are partially owned by other MDBs or government-owned entities, including the East African Development Bank, the West African Development Bank, and the PTA Bank.

[8] The reasons for the differentiated contribution approach with the reserve arrangement but equal shares for the NDB were not explained in the July 2014 announcement.



Source: Central banks of BRICS countries.
Notes: Includes gold, foreign exchange, and IMF reserves/Special Drawing Rights, based on data from end of each year. Number in chart refers to reserve position at 13 December 2014.

It is notable that for all the pronouncements against the Bretton Woods institutions, the BRICS have actually chosen a very similar model for linking capital and governance: each capital share translates into one vote. Alternative arrangements – some of which are in use at existing MDBs – could have connected shareholding and voting power in ways that permitted the founders (as well as other members who join later) to pay differentiated capital contributions, but still have a meaningful say in the NDB's governance.

One mechanism to give greater governance authority to members with fewer shares in an MDB's capital stock is to employ 'basic votes' or 'basic shares'. Under this arrangement, all members, regardless of their level of capital contribution, are granted an equal number of basic votes. In addition, each member is given further voting power in proportion to the capital contribution. Thus, the basic votes dilute the influence of capital contributions on voting power by giving more voting power to countries with smaller capital shares. Many MDBs use basic votes, notably the World Bank (IBRD), AsDB, AfDB, IADB and IsDB. It may be argued that this has not been sufficient to ensure more favourable voting arrangements from the point of view of developing countries, although the power of basic votes could simply be increased to achieve more voting power for members with few capital shares.[9] An alternative technique could be to grant full voting power for capital contributions up to a certain level, and then marginally decrease voting power for contributions beyond that level.

In Latin America, the Andean Development Corporation (CAF) has developed a method for balancing differentiated capital contributions with egalitarian governance involving three share types. All CAF member countries are eligible to purchase a single 'A' share, and can also purchase 'B' and 'C' shares according to their economic ability. While all shares confer a degree of voting power, A share votes are much more powerful on deciding key issues such as changes to the CAF AoA (requiring unanimity of A shares)[10] and changes to the capital structure (80% of A shares).[11] In addition, each A shareholder each designate one sitting member on the

[9] For example, IBRD allots 5.55% of total voting power to be divided equally as basic votes (IBRD Articles of Agreement, Article V, Section 3), while AsDB allots 20% (AsDB Articles of Agreement, Article 33.1).
[10] CAF Convenio Constitutivo, Article 15.
[11] CAF Convenio Constitutivo, Articles 14 and 17.

Board of Directors, while B and C shares vote to designate a total of four directors. This gives all members representation on the Board and a strong influence on operations, as the Board votes by majority of members present (with no reference to capital contributions).[12]

The NDB negotiators may well have thought through the choices on initial capital and governance, and rejected the options discussed above. The decision to have equal initial shares among the founders may have been considered more important in terms of political solidarity than the initial capital level, or it may have been an essential aspect of the negotiations among the BRICS to seal the agreement. Whatever the reason, the result is a bank with much less initial capital than might have been the case, thus limiting its development impact in the early years of operation.

3.2 AIIB: China's Leadership Role Increases Flexibility

The AIIB's initial capital structure remains as yet unclear. China initially announced that, like the NDB, the AIIB would have authorised capital of $100 billion, of which it would contribute $50 billion. How much of the remaining authorised $50 billion will be committed by the 39 other countries that had formally expressed interest in joining by 31 March 2015[13] remains to be seen. Much will depend on the fiscal situation of potential shareholders as well as the course of negotiations on bank governance and policies, but clearly the AIIB will start off with a greater capital base than the NDB – $75 billion seems a reasonable estimate, although the full $100 billion could be feasible in view of the interest expressed by potential members (including several major industrialised economies, which will strengthen the AIIB's credit rating).

The AIIB has not yet announced whether capital will be linked directly to voting, or if some type of basic vote mechanism will be used. Regardless, China has taken a relatively flexible attitude to how to divide up shareholding, which to date appears to be more successful than the NDB approach in terms of initial capitalisation. Both regional and non-regional countries may become members, although the latter are expected to be limited to an aggregate 25% total voting share. Regional member shares are to be allotted based on a combination of economic size (GDP) and fiscal capacity, while there are no defined criteria to determine the share size of a non-regional country, which appears to be negotiable.[14] The more rigid approach of the NDB –founded by only five countries all with the same shares, thus limiting capital to the lowest common denominator – is not being replicated at the AIIB and hence is not restricting initial capital in the same way. While China's capital share will be dominant initially, it has committed to reducing this considerably. This has been sufficient to allay concerns of other countries, judging by the number of prospective members.

3.3 Scale of NDB and AIIB Based on Committed Shareholder Equity Capital

The NDB and AIIB will get off the ground relatively slowly for two main reasons. First, only 20% of the capital so far committed to either bank is paid in cash and so

[12] CAF Convenio Constitutivo, Article 26.
[13] China has stated that all countries signing the Memorandum of Understanding prior to 31 March 2015 will be considered founding members and are eligible to participate in negotiations of the AoA.
[14] *Wall Street Journal* (2015); personal communication with potential member government officials. The Chinese government has not confirmed this publicly.

can underpin the expansion of the loan portfolio, while the remaining 80% is in 'callable' capital that will not directly underpin the loan portfolio.

Callable capital is used by most MDBs, but is not common in private financial institutions.[15] First employed with the creation of the World Bank, callable capital is a given amount of capital guaranteed by member countries to be paid to the MDB if 'called on' to meet financial obligations, for instance in an emergency situation. Its main purpose has been to give potential investors in MDB securities additional security (Mistry, 1995) and the overall loan portfolio and/or borrowing limits of many MDBs is linked by statute to its total (callable and paid-in) subscribed capital. Following this pattern, the NDB established a 1:1 limit on outstanding operations to total subscribed capital, while the AIIB has not yet decided on a statutory limit.[16]

The usefulness of callable capital has declined considerably in recent years as a measure of an MDB's potential exposure. From the 1980s, MDBs have gradually moved more towards the equity-to-loans ratio (or, in some recent cases, a more sophisticated economic capital model). Callable capital retains some use in helping MDBs achieve a slight uplift in their bond rating (discussed in Section 4),[17] but is no longer a relevant measure of the scale of an MDB's development operations. The $10 billion paid-in is the only capital useful to underpin the NDB's lending portfolio. In the case of the AIIB, as stated earlier, China has committed $10 billion, and with almost 40 other nations (including several OECD countries) likely to join, a total initial paid-in capital of $13-17 billion seems feasible.

The second reason that the banks will not have an immediate impact is that the initial shareholder capital will be paid in over several years. In the case of the NDB, capital will come in on a set schedule over seven years[18] following final ratification of the agreement by all BRICS countries (which had happened by March 2015). The AIIB has not yet defined a schedule for capital payments – China would certainly be able to pay in its capital more quickly, but may follow a schedule similar to the NDB to take into account the fiscal realities of most other potential members.

Based on a seven-year schedule following the same proportions for both banks, and assuming $10 billion paid-in capital for the NDB and $15 billion for the AIIB, and an equity-to-loans (E/L) ratio of 25% (see more on this issue below), it is possible to project a simplified growth of the loan portfolio (see Table 1).

Table 1. Projected NDB and AIIB Equity Capital and Portfolio (US$ billions)

Year	NDB Equity (Cumulative)	AIIB Equity (Cumulative)	NDB Potential Loan Portfolio	AIIB Potential Loan Portfolio
1	0.75	1.1	3.0	4.4
2	2.0	3.0	8.0	12.0
3	3.5	5.3	14.0	21.2
4	5.0	7.5	20.0	30.0

[15] It is similar conceptually to contingent capital arrangements, which are often employed in the private sector. However, contingent capital is usually in the form of debt that converts to equity under pre-determined circumstances, whereas MDB callable capital is essentially a promise made by governments.
[16] BRICS AofA, Article 20a.
[17] Although this 'uplift' has declined dramatically in recent years, as ratings agencies have decreased the rating credit they give to callable capital. For more on the methods used by ratings agencies, see Standard and Poor's (2012) and Moody's (2013).
[18] See Annex 2, BRICS AofA.

5	6.5	9.8	26.0	39.2
6	8.25	12.4	33.0	49.6
7	**10.0**	**15.0**	**40.0**	**60.0**

Source: BRICS (2014) for capital (equity) contributions; 2013 Annual Reports for MDB data.
Note: Loan portfolio growth based on an E/L ratio of 25%, with no reserve accumulation.

4 Scenarios for NDB and AIIB Shareholder Equity Growth

The $10 billion paid-in capital committed by the BRICS shareholders in July 2014 and the estimated $15 billion by AIIB prospective shareholders are only the initial contributions to the equity capital of each bank. Realistically, the NDB and AIIB will build equity capital through additional capital paid in by new members and accumulated reserves derived from net income generated by the bank each year. In addition, the banks could modify the E/L ratio from the one assumed in Table 1, which would lead to different potential portfolio and annual lending potential.

This section explores these different possibilities in an effort to produce a more realistic model of the potential scale of the NDB and AIIB. The model makes various assumptions to arrive at loan portfolio projections, which are discussed in detail. The first sub-section lays out a series of scenarios for the projected evolution of shareholder equity and loan portfolio, with a brief outline of key assumptions used to make the estimates. The second sub-section explores these assumptions in more detail, to better evaluate the challenges faced by the NDB and AIIB in expanding operational capacity.

4.1 Estimating NDB and AIIB Operational Scale

4.1.1 Modelling NDB Equity and Portfolio Growth

To project how the NDB's shareholder equity and operational portfolio might realistically evolve in the coming years, a model was developed to include several key factors.[19] The assumptions included in the initial scenarios are:

- *Paid-in shareholder capital* following the schedule outlined in the NDB AoA for the baseline scenario, and an additional $5 billion paid in from new members over five years starting in 2020 for an increased capital scenario. Achieving this increased $5 billion paid-in capital may be optimistic in the light of governance issues discussed in Section 5, but is feasible if the BRICS recruit new members in the coming months and years.
- *Return on equity (ROE) of 3.5% per year*, which is dedicated entirely to reserves and thus builds equity. This ROE level is the average of IBRD, IADB, AsDB and AfDB between 2009 and 2013 (see Annex 1). Returns are assumed to not start accumulating for two years, due to the time

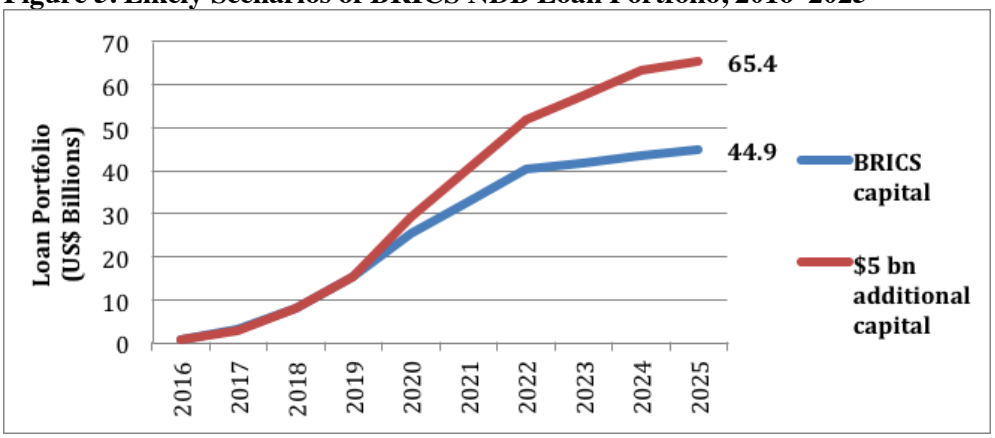
[19] Judith Tyson at ODI developed the model in collaboration with the author.

required for lending operations to be prepared and disbursed and begin repayment.[20]

- *Equity-to-loans ratio of 27%,* which represents the lowest (i.e. least conservative) level achieved by the IBRD, IADB, AsDB, AfDB between 2009 and 2013 (see Annex 1).
- *Steady demand for lending services* to use available equity capital. Demand will depend on whether borrowers consider the financial terms and any additional value-added offered by the NDB suit their development needs, which is not guaranteed but is assumed in this model.

Briefly put, the model adds shareholder capital paid in according to a set schedule and reserves accumulated annually under the assumed ROE to arrive at a total shareholder equity level each year. This is multiplied by an assumed E/L ratio to estimate the outstanding portfolio. Under these assumptions, the combination of paid-in equity and accumulating annual net income leads to a range of $45-65 billion in outstanding loan portfolio by 2025 for the NDB (Figure 5).

Figure 5. Likely Scenarios of BRICS NDB Loan Portfolio, 2016–2025

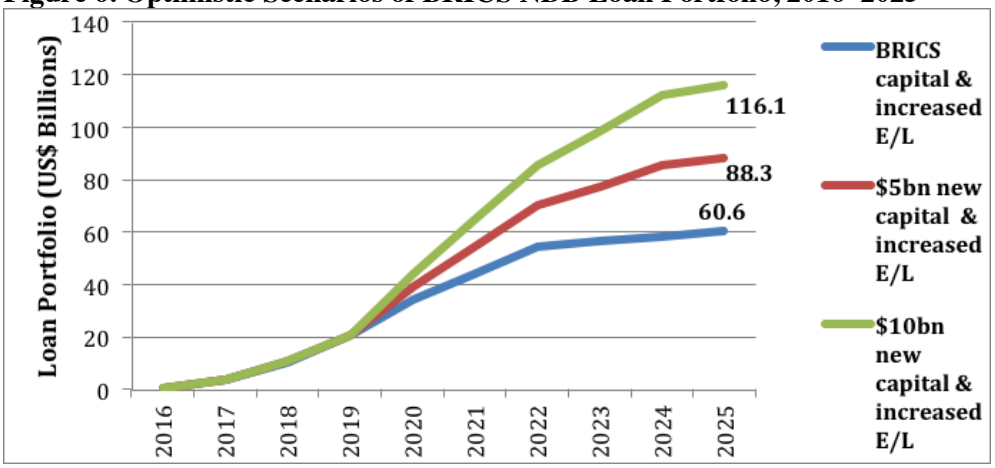


Source: Calculations by Judith Tyson, ODI

While the above two scenarios are optimistic about how the NDB shareholder equity and loan portfolio will evolve in the first decade of its operations, it could be argued that accelerated expansion will be feasible. The two main channels for achieving this would be an E/L policy of 20% and a faster increase in paid-in capital from new members (or an increase by the BRICS themselves). In the most optimistic of these possibilities (Figure 6), the NDB could within a decade build a loan portfolio of $116 billion, larger than any of the major regional MDBs, though still smaller than World Bank's IBRD lending window. As discussed below, these more optimistic scenarios are unlikely, due to financial and governance constraints.

[20] Two years is a highly optimistic assumption in view of the time required for the bank to develop its own systems, begin negotiations with governments and process loans (many of which are intended to be for complex infrastructure projects that require considerable planning). Nor does it factor in any repayment grace period, which is common to the other major MDBs (often five years).

Figure 6. Optimistic Scenarios of BRICS NDB Loan Portfolio, 2016–2025

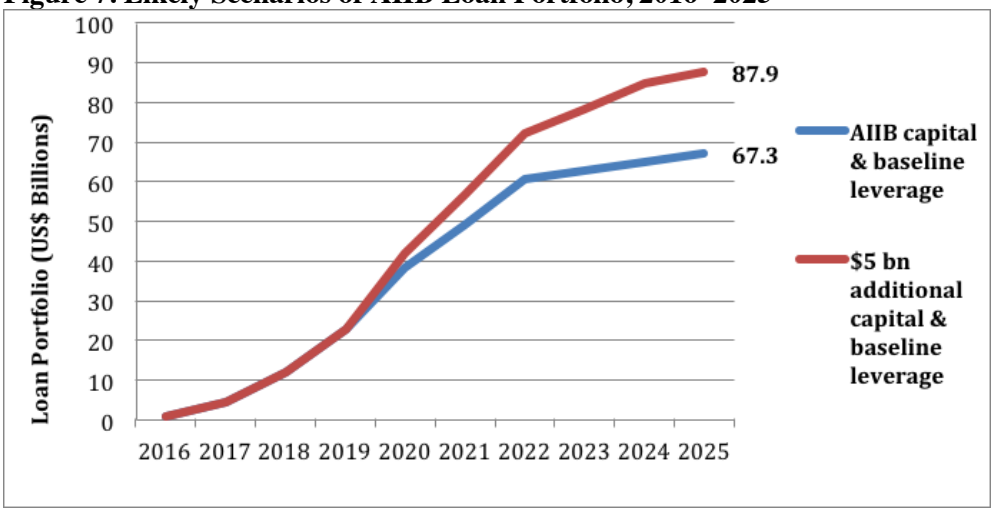


Source: Calculations by Judith Tyson, ODI
Note: Same assumptions as Figure 5, but using 20% E/L ratio.

4.1.2 Modelling AIIB Equity and Portfolio Growth

The same model was used to project AIIB shareholder equity and operational portfolio, based on the same assumptions for base-case scenarios on E/L (27%) and ROE (3.5%). The initial amount of paid-in capital for the AIIB was assumed to be $15 billion, rather than $10 billion for the NDB, given that China alone has committed $10 billion paid-in capital initially, and almost 40 other countries have signalled their interest in joining as founding members. Final shareholding will depend on many factors, but it seems reasonable to expect that half of the remaining $10 billion in authorised paid-in capital will be subscribed, thus arriving at the total of $15 billion. Assuming a seven-year payment schedule, the AIIB is projected to have an outstanding loan portfolio of $67-87 billion by 2025 (Figure 7).

Figure 7. Likely Scenarios of AIIB Loan Portfolio, 2016–2025

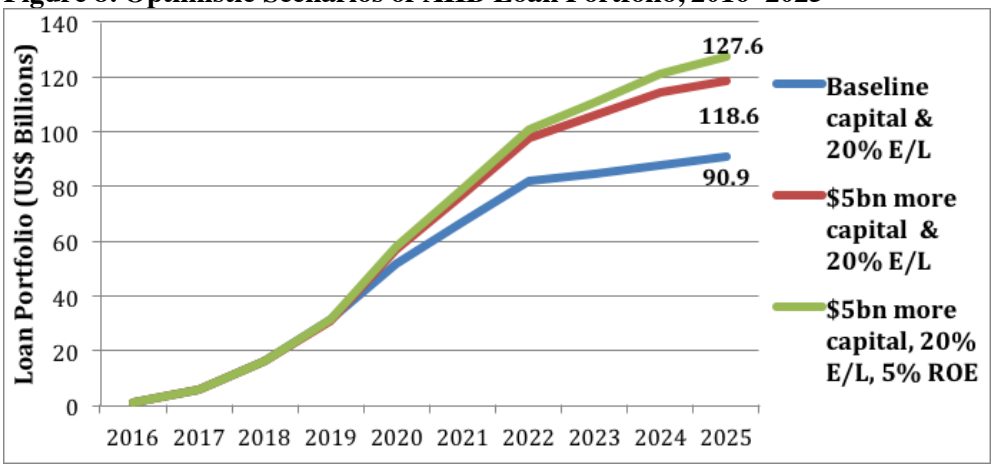


Source: Calculations by Judith Tyson, ODI

A further series of three scenarios were generated for the AIIB, using more optimistic assumptions than in the base case. These include baseline capital of $15 billion but increased E/L ratio to 20%; the same conditions, but with additional capital of $5 billion from new members; and the same conditions, but a ROE of 5%. As discussed below, the AIIB has a more realistic likelihood of achieving these optimistic scenarios due both to China's active efforts to recruit new members and also the

strong possibility of achieving AAA rating, which will allow greater financial flexibility (making it easier to generate higher ROE and lower E/L). Based on these scenarios, the AIIB could have an outstanding portfolio of $90-127 billion by 2025 (Figure 8).

Figure 8. Optimistic Scenarios of AIIB Loan Portfolio, 2016–2025



Source: Calculations by Judith Tyson, ODI

4.1.3 Summarising and Comparing to Existing MDBs

According to these projections, the NDB is likely to lift off slowly, with a potential loan portfolio of $25-30 billion after five years of operation and between $45 and $65 billion after ten years. This would be a welcome addition to the development finance landscape, but it will clearly not be a global game-changer in the short or even medium term. Rather, it will be on a similar scale to that of the AsDB in 2013, but probably below the AsDB's projected operating level in 2025 (Table 2).[21] The AIIB is also likely to begin relatively slowly (although the capital payment schedule has not yet been fixed), but shows more potential for scale due to the larger number of shareholders and also the potential for achieving a AAA rating. A portfolio in the range of $70-90 billion seems likely, with the potential to reach $120 billion or more. This would make the AIIB similar in scope to the IADB in 2025 – one of the largest in the world, but still significantly less than the World Bank's IBRD window.[22]

Table 2. Selected MDB Loan Portfolio in 2013 and 2025 (US$ billions)

MDBs	Equity (2013)	Loan Portfolio (2013)	Est. Loan Portfolio (2025)
IBRD	42.7	141.7	219.2
AsDB	17.1	53.1	73.1
IADB	22.6	70.7	120.4
CAF	7.8	18.0	28.5
AfDB	8.9	17.8	28.2

Source: Financial statements 2013 and author's projections

Notes: 2025 projections are calculated by accumulating reserves (equity) at the same rate as the 2009–2013 average for each MDB, and maintaining the same average E/L ratio over the same period. Neither potential shareholder capital increases or net income allocations to uses apart from reserves are taken

[21] MDB loan portfolio was calculated for 2025 to offer a more realistic comparison with the BRICS NDB in that same year (as opposed to comparing it to the 2013 size of the other MDBs, which is misleading). This table is not intended to represent precise predictions of the evolution of MDB portfolios.

[22] The EIB had an outstanding portfolio of nearly $600 billion in 2013 but works mainly in industrialised European countries and so cannot be directly compared to MDBs working mainly in developing countries.

into consideration, nor the planned $31 billion increase in AsDB capital from the reorganisation of its concessional window (AsDB, 2014).

4.2 Exploring Factors Affecting NDB and AIIB Operational Scale

This section looks in more detail at factors included in the model and considers options for the NDB and AIIB to increase operational capacity.

4.2.1 Equity to Loans

The equity-to-loans (E/L) ratio is a critical factor in determining the scale of an MDB's operational capacity. Put simply, for each dollar of equity capital, the E/L ratio determines how many dollars in development operations the MDB can have in its outstanding portfolio. Although MDBs also use more sophisticated measures to assess their capital adequacy, the E/L ratio provides a useful snapshot and is still used by many MDBs to limit their exposure to risk.[23] The E/L ratio for most MDBs is very high – over 30% in many cases, double that of most private banks – due to the insistence of non-borrowing shareholders and the expectations of bond-rating agencies.[24] The World Bank has come under pressure from shareholders to lower its E/L ratio and thus expand lending capacity based on existing capital, and recently announced that it will lower the floor of the IBRD's E/L ratio to 20% (down from 23-27%) (World Bank, 2014: 34).

In principle, the NDB and AIIB could deploy equity capital more aggressively than existing MDBs, and thus expand operational capacity. It would, however, be unwise to employ such a strategy at an early stage. The strength of the MDB financial model is its ability to leverage shareholder capital by borrowing on international capital markets. This, in turn, depends on gaining the trust of capital markets, which is not a given – a reality that many MDBs, including the World Bank, have had to learn.[25] For this reason, the NDB and AIIB will need to manage their finances conservatively, particularly in the early years, to establish themselves as sound investments for potential bond buyers. It will be essential for them to build strong access to capital markets at relatively low interest rates and long maturities in order to provide development financing on attractive terms.

Both the NDB and AIIB would therefore be advised to maintain their E/L ratios in the 23-27% range in the early years. Once they have a good reputation as a bond issuer, they may have the space to employ equity capital more aggressively—that is, extend more loans based on the same level of equity. This may particularly be the case for the AIIB, as it will have a larger array of country shareholders – including some AAA countries – right from the start. Moreover, China's very strong and vocal commitment to the AIIB may make markets more inclined to consider it a relatively safe bet, giving it more leeway to use its equity capital more aggressively. It will also be worth watching the IBRD's E/L in coming years following its stated intention to make more aggressive use of its shareholder capital, to see how its performance evolves and how markets react – a positive reaction could give the two new banks more room to deploy their equity.

[23] IBRD, AsDB, IADB and AfDB all use the E/L ratio as a formal measure, while others such as the EBRD and IFC have moved more toward a more sophisticated 'economic capital' approach.
[24] See Humphrey (2014a) for more on this issue.
[25] See Kapur et al. (1996) and Mason and Asher (1973) for the World Bank; and Humphrey (2014b) for the World Bank, IADB and CAF. CAF was created and is still governed by borrowing countries, and so has had to work very hard to obtain access to capital markets (it has an E/L currently of around 40%, which is very high). Also relevant is the case of the AfDB, which accepted non-borrower shareholders to obtain a AAA rating in the 1980s, but then was downgraded between 1995 and 2003 and is currently close to a downgrade. See Standard and Poor's (2012; 2014).

The NDB and AIIB may also be able to obtain access to sources of finance other than international capital markets. The sovereign wealth funds (SWFs) or central banks of its founding members as well as other countries may be a viable source of non-market finance. At the same time, SWFs and central banks have mandates to safeguard their nation's savings, and are therefore unlikely to take significantly higher risks or offer much better financial terms than private markets, at least on a sustained basis. It may be possible to offer the NDB and/or AIIB regulatory advantages that give privileged access to newer capital markets – particularly in China, similar to what the Chinese Development Bank has enjoyed for years.[26] However, as capital markets in China and other nations mature, investors are likely to seek the same sorts of assurance as investors elsewhere, and capital adequacy will be a critical element. Hence, it appears unlikely that the NDB and AIIB will have much space to take a more aggressive approach to capital adequacy for the first decade.

4.2.2 Return on Equity

Another potential avenue for increasing operational capacity based on a set amount of shareholder paid-in capital is to generate higher ROE. The model above used a set ROE of 3.5%, which as mentioned is the average for the IBRD, IADB, AsDB and AfDB between 2009 and 2013. By contrast, the IFC and EBRD have averaged ROEs of 7.5% and 7% respectively in the past five years. If the ROE can be increased, more net income will be generated each year that could be dedicated to reserves, thus more quickly building shareholder equity.[27] For example, an ROE of 7% increases the NDB portfolio capacity by about $9-18 billion by 2025, based on the five scenarios described above.

Overall, the possibility of generating ROE considerably above 3.5% would seem more likely for the AIIB than for the NDB, for reasons explored in the following sub-sections.

Lending margin: This is the spread between an MDB's cost of funding and the terms at which it makes loans for development projects. As most of an MDB's revenues are generated by the interest paid on loans, this is a very important component of ROE.

An MDB's cost of funding is largely exogenous, depending on bond buyers or other potential investors perceive the bank's risks. It is impossible to determine the financial terms that capital markets will offer to an MDB that does not yet exist. Based on the methodologies of the main bond-rating agencies, however, it is evident that the NDB will at best be in the 'A' range, and very possibly lower, due to the sovereign rating of the five BRICS countries.[28] China is rated AA-; Brazil, India, and South Africa at at the lowest investment grade rating, and Russia was recently downgraded to junk bond status. The NDB could improve its rating above that of its

[26] CDB bonds by regulation classified as risk-free by the commercial banks purchasing them in China's interbank market. Largely because of this, Chinese banks channel large volumes of savings to the CDB at low interest rates and long maturities (Sanderson and Forsythe, 2013). However, this regulatory status is due to expire at the end of 2015 (Standard and Poor's, 2013).

[27] The practice of building reserves from annual net income is not without controversy. Many borrowers from existing MDBs argue that they are increasing equity capital via their interest payments into net income and reserves, but do not receive the corresponding voting rights. Kapur and Raychaudhuri (2014) propose that borrowers should be granted greater voting power in recognition of their contribution to an MDB's overall functioning. The BCIE in Central America recently instituted 'E' capital shares along these lines – the only MDB to do so to date (BCIE, 2013).

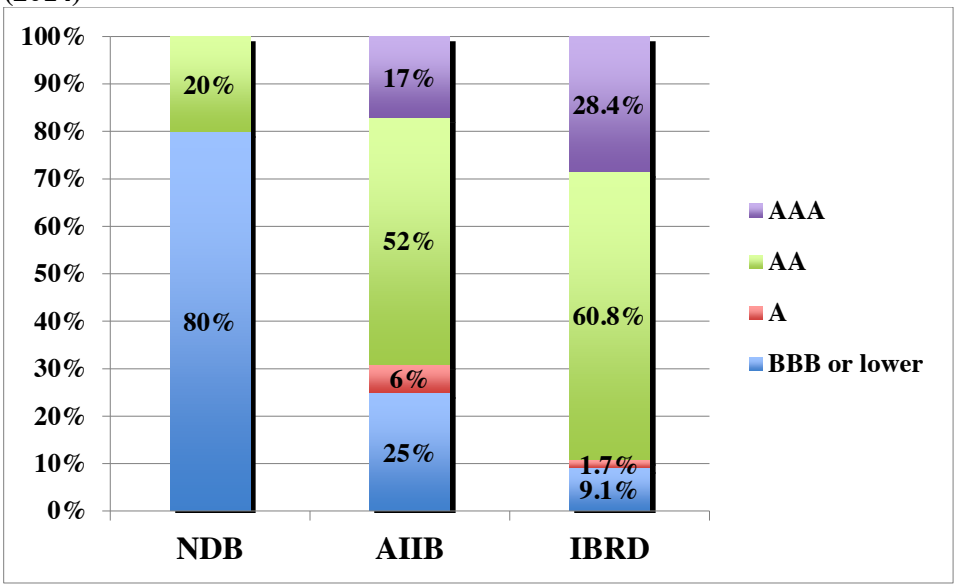
[28] See Standard and Poor's (2012) and Moody's (2013) for more on MDB rating methodologies.

member countries by demonstrating an outstanding repayment record and technical excellence, but this will only occur after at least a decade of operations, as the example of CAF illustrates.

Because of the relatively expensive funding costs compared to AAA-rated MDBs, the NDB will face some difficulties in loan demand, and hence in its lending margin. Many larger middle-income countries (MICs) – including the BRICS – can access capital markets on relatively good terms, and are therefore likely to find NDB lending terms unattractive. Even MIC sovereigns with more restricted access to capital markets are likely to be highly sensitive to the lending spread placed on NDB loans in deciding whether to borrow. The NDB will need to keep its lending margins down if it wants to build a diversified loan portfolio among sovereign borrowers – otherwise it may end up with a small, narrow and risky loan portfolio, which would have a negative impact on its bond rating.

The AIIB, by contrast, is reasonably likely to achieve AAA rating either immediately or soon after beginning operations, due to the presence of several highly-rated sovereigns that intend to support the bank as well as China's very strong commitment. The exact breakdown of shareholding has not yet been decided, but estimates based on the broad criteria laid out so far indicate that a substantial portion of callable capital will be AAA (perhaps 15-20%),[29] and half in the AA range (Figure 9).

Figure 9. Shareholder Rating of NDB (Initial) AIIB (Projected) and IBRD (2014)



Source: IBRD taken from 2014 Annual Report for voting shares; Standard and Poor's Sovereign Ratings for country rating. AIIB estimated as follows: 40% shares to China, 20% to non-regional countries (divided according to economic weight) and 40% to regional countries (divided according to economic weight).

For both the NDB and AIIB, focusing more on non-sovereign borrowers could allow them to charge a higher lending spread, as the private sector in developing countries invariably expects higher capital costs than the sovereign. Furthermore, MDBs lending to the private sector differentiate pricing according to the specific risk of the project and borrower rather than applying uniform pricing as with sovereign

[29] These include Australia, Canada, Germany, Hong Kong, Luxembourg, Singapore, Switzerland and the UK, all of which had expressed strong interest in joining the AIIB by the end of March 2015.

borrowers.[30] They can, therefore, price in risk more accurately and make better use of their capital base. The examples of the IFC and EBRD show that a AAA-rated MDB lending to the private sector can generate high rates of net income each year. Should the NDB and AIIB wish to move in this direction, they would do well to consider closely the examples of the IFC and EBRD. This approach would require a fundamentally different approach in many aspects of bank operations, and also a much greater ability to evaluate and manage risks.

Other Income Sources: Beyond lending revenue, MDBs have other potential sources of income generation that can strengthen ROE, principally development equity investments and treasury investments.[31]

While most MDBs have traditionally focused on lending as their main business, some increasingly take equity stakes as part of their private-sector operations. For example, equity investments formed about one-third of the IFC's overall development portfolio in 2013, and one-quarter of the EBRD's.[32] Equity investments can have a very strong development impact – obviating the need for a firm or project to take on debt and improving cash flow, giving a strong signal to other investors, and being able to be sold off to private investors when a project is established – and have the added benefit to MDBs of potentially generating considerable net income (mainly through capital gains).

The trade-off of equity investments is that they are much riskier, requiring an MDB to set aside a larger share of capital to back up equity operations compared to standard loans (75-100% of project value, compared to 20-40% for non-sovereign loans). Furthermore, equity income can be much more volatile due to the impact of market conditions, as exemplified by EBRD's equity income swing from a $400 million loss in 2011 to $460 million gain in 2012.[33] If the NDB or AIIB intend to engage in equity investment on a significant scale, they would be advised to dedicate considerable effort to draw on appropriate expertise to evaluate and manage project risks and begin relatively cautiously – the benefits may be large, but so are the risks.

Similarly, all MDB treasuries invest available cash in a variety of assets (based mainly on financial rather than development criteria), which generates a considerable share of net income each year. The potential return on investment varies greatly according to the overall interest-rate environment as well as on the investment strategies and requirements pursued by MDB treasuries. For example, while IBRD Treasury's investment strategies are generally conservative, they still generate an average of about $400 million and incur minimal administrative expenses (unlike development lending) as its cost of funding is extremely low. Due to its expected lower bond rating and higher funding costs, the NDB can expect lower returns on investment income, while the AIIB will probably have similar earning potential as other AAA-rated MDBs.

Administrative Expenses: An MDB's administration budget has a modest but still significant impact on net income and ROE. Existing MDBs range widely in administrative costs, from a high of 194% of net income for IBRD to a low of 27.5%

[30] Differentiating loan pricing to sovereign borrowers based on risk makes considerable financial sense, and has been proposed by MDBs (notably their treasuries), but has never been permitted due to political opposition among shareholders.
[31] MDBs can also generate income through fee-based advisory services as well as fees for administering trust funds for third-party donors. These form a very small share of income among existing MDBs, and are unlikely to play a significant role at the NDB or AIIB for years to come.
[32] According to 2013 Annual Reports.
[33] According to 2011 and 2012 Annual Reports.

of net income for EBRD (2009–2013 averages). The reason for the IBRD's very high administrative costs are relatively obvious: it has developed and maintained world-class expertise in an extremely broad range of development issues, data collection and provision of global public goods, most of which are paid from the administrative budget.

Due to the nature of both the NDB and AIIB – with a particularly strong focus on infrastructure, and no stated intention of engaging in all aspects of development – they will probably be at the lower end of the administrative expenses range (after the initial high start-up costs). As a borrower-run bank, the NDB is also likely to develop a leaner and more vertical administrative structure, more akin to CAF, which will also keep down staff costs.[34] The AIIB's situation may be more complex – although China would presumably prefer a leaner administration, the stipulations of potential non-borrower members related to oversight and review could lead to higher staffing costs. On the other hand, according to anecdotal reports, the AIIB intends to follow an organisational model similar to that of the EIB in that it will have a 'light footprint', without an extensive network of local offices, and will focus on working jointly with other development funders, particularly in the early years of operations.[35]

On the other hand, the complex characteristics of the major infrastructure projects in which the NDB and AIIB intend to engage would benefit from substantial investments in employing first-rate project staff (notably engineers and project-finance specialists) and dedicating administrative resources to project preparation and management, with a view to ensuring results of a high technical quality. One way to move in this direction without very high upfront staffing costs would be to co-finance projects led by other MDBs, and thus build expertise among NDB/AIIB staff.

4.2.3 Alternatives to Expand Operational Capacity

Within a given amount of shareholder capital, there are several options that can help it to expand operational capacity. All of these mechanisms are to varying degrees employed by existing MDBs, which offer useful lessons should the NDB and AIIB move in these directions.

First, the new banks can find a role in assembling different financial options and investors to take a project forward, and as a 're-packager' able to sell off development projects already underway to the private sector. This would enable the NDB and AIIB to leverage volumes of financing far greater than they could provide themselves, through loan guarantees, loan syndications or public–private partnership (PPP) arrangements, among others.[36] Many MDBs are attempting to move in this direction, but those most successful at it – the IFC, EBRD and EIB –were designed to work with the private sector. The more traditional MDBs, like the World Bank's IBRD/IDA and the main regional MDBs, were designed to offer standard long-term loans to the public sector, and have found it difficult to scale up alternative financial instruments. The NDB and AIIB may have an advantage since they can design

[34] A great many of the oversight levels and horizontal organisational structure derive from impositions by non-borrower shareholders. Borrower-run MDBs such as CAF tend to be much more vertically organized. See Humphrey 2015 forthcoming for a discussion of this in relation to CAF, IADB and World Bank.

[35] Personal communication with officials of potential member governments. Interestingly, unconfirmed reports suggest that the AIIB will not have a policy of linking staff recruitment to membership, meaning that it could employ citizens of non-member countries.

[36] On MDB financial instruments, see Griffith-Jones and Kollatz (forthcoming), and on the specific issue of public-private partnerships see Ahmad et al. (forthcoming).

appropriate administrative processes, financial policies and staff skills around these more sophisticated instruments from the start.

Co-financing arrangements with other public-sector actors are also a useful option for scaling up development impact, and can be structured in a variety of ways. MDBs have for years partnered with bilateral aid agencies, national development banks and each other to increase the impact of individual project investments, with considerable success.[37] This could be a strong option for the NDB and AIIB, particularly in view of the fact that the world's three largest national development banks – China Development Bank ($1.1 trillion in outstanding loans at the end of 2013), Germany's KfW ($596 billion) and BNDES of Brazil ($237 billion) – are owned by founding or prospective founding members of the NDB and AIIB.

Other types of co-financing beyond individual projects are also feasible. For example, the People's Bank of China (PBOC) has recently established a number of co-financing funds at several different MDBs, including IFC, AfDB, IADB and AsDB. These funds constitute a pre-committed pool of resources upon which the MDBs can draw (with the approval of the PBOC) to match their own project funding, thus increasing the scale of the MDBs' investment. The MDB remains fully in charge of designing and implementing the project through its own systems, while the PBOC earns a pre-set rate of return on its investments. The NDB and AIIB are likely to be able to create similar funds drawing on the resources of their founding members as well as official resources (e.g. SWFs, pension funds, central bank reserves) from other countries seeking low-risk investment and development impact.

MDBs can also obtain access to other resources in the same the way as all banks originally did: by accepting deposits. This is not common practice at MDBs, and is not undertaken by the World Bank or any of the major regional MDBs. CAF, however, has long accepted deposits as part of its liability strategy, and has found it to be a useful way to garner additional resources to its standard funding strategy. Most CAF deposits come from central banks or treasuries of member countries, as a way to manage their liquidity with an institution that they own and benefit from, rather than using a commercial bank. By the end of 2013, CAF registered deposits of $3.3 billion. Because of the short-term nature of these resources, it is important to avoid asset-liability maturity mismatches, which means they have only limited use in long-term infrastructure projects. Deposit resources can, however, be used for trade finance or other short-term credit lines (as CAF does), should the NDB or AIIB decide to engage in such activity. It should be noted that deposits would in effect be like giving a loan to one of the new banks (though in a different legal form), and thus the banks would face similar financial scrutiny on the part of depositing institutions.

A final and more speculative option is to seek techniques to remove assets from the balance sheet with the help of interested external investors, thus freeing up substantial capital resources to be recycled into future development investments. For example, the Swedish government has recently held discussions with the AsDB on guaranteeing a portion of its loan portfolio, meaning that the AsDB would no longer need equity capital to back it up (due to Sweden's AAA rating).[38] Similar arrangements could be considered by the NDB and AIIB. A second option is securitisation – packaging loans and selling them to external investors. This is more complex for MDBs due to the nature of the loans and potential legal issues, and may not be feasible (to the author's knowledge, only the IFC has tried, and to a very

[37] Griffith-Jones (2014) also emphasises this point, using the example of the EIB's operations in Turkey.
[38] Based on an interview with the Swedish development agency SIDA, 1 October 2014.

limited degree). Nonetheless it may be worth exploring – if willing investors can be matched with a portion of an MDB portfolio, this could significantly improve the MDB's operational capacity without requiring further equity capital.

5 The Importance of Governance Arrangements

The governance arrangements of the new banks will be a major factor in determining which countries are willing to become members, their perceived international legitimacy and in their financial strength and operating characteristics. This section explores aspects of the governance arrangements at the NDB and AIIB. The emphasis is on the NDB, as it has already published its AoA and therefore these arrangements have already been set. The AIIB's statutes are to be negotiated among prospective members between April and July 2015, and as a result public statements offer only a sense of its future governance structures.

5.1 Governance at the NDB and Impact on Membership

The NDB AofA are very similar to the governance model used by the World Bank and the major MDBs. This is somewhat surprising in view of the rhetoric about building a new kind of MDB and of other governance arrangements its founders could have chosen. Not only does the NDB follow existing models, but it also enshrines a very strong degree of control by the BRICS countries, in some ways even stronger than the very MDBs that its founders have criticised. While this is to some extent understandable – the BRICS are rising economic powers intent on demonstrating their strength on the global stage – it could have unintended and possibly negative consequences for the NDB.

In terms of basic capital and voting structure, the BRICS opted for a direct link between shareholder capital contribution and voting power.[39] This is certainly the most obvious and clear option, but it enshrines the principle of linking economic power and bank governance and eschews more creative options such as basic votes, graduated voting power linked to shares or differentiated share types (as discussed in Section 3). The initial shareholding among the BRICS is exactly equal, but decisions on how to allocate future share subscriptions among themselves or to new members have no explicit criteria and are left to a decision by the Board of Governors[40] (over which the BRICS will have significant control, as noted below). The only criteria are that a non-BRICS country cannot have more than 7% of total votes and non-borrowers may not collectively have more than 20% of voting power.[41]

While the shareholding arrangements are not on the face of it problematic, more notable is the decision by the BRICS to lock in a minimum 55% majority of shares for themselves, regardless of any other changes to membership or share structure.[42]

[39] Based on an interview with the Swedish development agency SIDA, 1 October 2014.
[40] AofA, Art. 8a.
[41] AofA, Art. 8c(ii) and (iii).
[42] AofA, Art. 8c(i).

Some sort of guaranteed shareholding is not unusual among MDBs, but it has most commonly been employed by regional MDBs like the IADB, AsDB and AfDB to ensure a shareholding majority by countries in the relevant region. In this case, a small group of founding countries is ensuring by statute a majority of votes in a bank that is presumably intending to have a much larger membership.

This shareholding arrangement gives the BRICS control over most decisions made by the Board of Governors and the Board of Executive Directors, which will be taken by a simple majority.[43] On certain issues – such as modifying the AofA, changing capital structure and deciding county membership and capital subscriptions – a special majority is required, which consists of two-thirds of total voting power plus four of the five BRICS.[44] This gives a modicum of votes to non-BRICS shareholders on these issues, slightly diluting BRICS control. However, achieving two-thirds voting power would require only 12% above the BRICS' 55% (assuming that their shareholding is in fact lowered to that level – which can only happen if they agree), and the BRICS can easily veto any proposal to which they object.

The NDB's Board of Directors (BoD) will have ten seats, five of which will be reserved for the BRICS[45] – meaning that other countries will be grouped together as a 'constituency' and represented by one country on the BoD and voting for the entire constituency. This is a long-standing complaint against the World Bank, where countries feel that the constituency method of allocating seats on the BoD makes their voting shares meaningless – particularly because many constituencies are dominated by non-borrower countries and hence smaller borrower countries are powerless to wield their vote effectively.[46] The NDB does allow multi-country seats to split their votes according to the preferences of each constituency's members,[47]which is a clear improvement on the World Bank's arrangement. Nonetheless, lack of voice on the BoD may become an issue for those without a seat at the table.

Operational organisation further strengthens the governance authority of the BRICS. The NDB's president – who will manage the bank's day-to-day operations[48] and has the casting vote on the BoD[49] – will be chosen from the BRICS countries on a rotational basis.[50] The NDB will also have at least four vice-presidents, such that each BRICS country not represented as president will nominate one.[51] This is the only AofA of a major MDB that explicitly spells out its organisational structure to the level of vice-presidency, and suggests a degree of political interest that may not bode well for the bank's technical quality.

The importance of the vice-presidencies is emphasised by the establishment of a credit and investment committee comprising the president and all vice-presidents, with authority to decide on all loan and investment decisions below a certain level authorised by the BoD.[52] Such a committee is potentially useful in organisational terms as a means to streamline credit decisions, but the background of the vice-presidents will be critical. For the NDB to develop strong technical excellence in its projects, it will be incumbent on the BRICS to nominate vice-presidents with strong

[43] AofA, Art. 6b.
[44] AofA, Art. 7d, 8a and 44a.
[45] AofA, Art. 12b.
[46] For more on this issue, see among others, Woods (2001).
[47] AofA, Art. 6d.
[48] AofA, Art. 13b.
[49] AofA, Art. 13a.
[50] AofA, Art. 13a.
[51] AofA, Art. 13c.
[52] AofA, Art. 13b(ii).

technical skills (as is often the case at the EIB, for example). Should political considerations become paramount in loan and investment decisions, the NDB's legitimacy, reputation, and financial strength will suffer.

Overall, the fact that the governance arrangements of the NDB are so strongly controlled by the BRICS may dampen enthusiasm among other potential member countries. From the point of view of non-BRICS countries, the NDB may appear simply as another Bretton Woods-style MDB, but with the BRICS rather than the USA and other G7 countries in charge. These governance arrangements – combined with the relatively high expected financial costs and short maturities of loans compared to the major existing MDBs – could make joining the NDB less appealing for larger MICs. In the early years of the NDB, it is likely that new members will be smaller low-income countries (LICs) that are less concerned about governance arrangements, have more pressing needs to obtain new sources of financing, and are more inclined to join on the basis of political considerations in alliance with BRICS countries. On the other hand, the lack of major non-borrowing shareholders could free the NDB to create a much leaner, less bureaucratic and hands-off operational style compared to the major existing MDBs, which could be attractive to borrowers (Box 1). In addition, countries may wish to join in order to allow their national companies to compete for NDB contracts.[53]

A membership structure of BRICS along with predominantly lower-income non-BRICS countries could be a developmentally useful and relevant niche for the NDB, but it has a number of drawbacks:

- Financially, it would limit potential inflows of new shareholder capital, as LICs are less able to contribute paid-in capital due to fiscal limitations. Similarly, the loan portfolio of the NDB would be less diversified, smaller in scale and riskier, all of which would impinge on its access to capital markets.[54]
- Limited membership would restrict the NDB's ability to learn from best practices in different countries, develop world-class technical expertise in infrastructure, and serve as a knowledge broker – one of the most important roles played by MDBs.
- The international legitimacy and global impact of the NDB would to a degree be undermined with a narrow and unbalanced membership between the BRICS and a collection of much smaller and less economically powerful countries.

[53] AofA, Art. 21(vi). This stipulation restricting procurement to member countries is common in almost all MDBs.
[54] Interestingly, the AofA seem to show that the BRICS are aware of this. Arts. 19d and e provide for the NDB to lend to non-member countries in special circumstances. This could have been included to allow the NDB to build its loan portfolio despite a slower growth in membership.

Box 1. Administrative Process and Safeguards at the NDB and AIIB

One particularly contentious set of factors in the operations of existing MDBs are the requirements each project must meet on its path through the approval process and implementation, including various stages of internal review, quality control, environmental and social safeguards, procurement rules and financial management. Many if not most of these processes are driven by non-borrowing shareholders (often responding to pressure from domestic constituencies), while borrowers frequently complain that the bureaucratic burden is excessive.

As neither new bank has so far formalised policies in these areas, it is impossible to predict how this issue will be addressed. However, the differing membership of the NDB and AIIB may point to divergent paths, if as is likely they follow the pattern of other MDBs. Because the NDB is run by borrowing countries, project approval and disbursement may be considerably less bureaucratic and faster than at the major existing MDBs, and the NDB is likely to rely heavily on national systems rather than imposing external requirements related to environmental, social and procurement issues. In this area, the NDB may follow the direction of CAF or IsDB.

The AIIB, on the other hand, is likely to face tensions among members on these issues. Countries such as France, Germany and the UK are unlikely to move ahead with membership without strong assurances on quality control, environmental and social protection, and procurement rules. Anecdotal reports indicate that China has committed to providing these assurances. This then could lead to a bank with a similarly bureaucratic and lengthy project process to that of the World Bank – presumably not the type of MDB China is seeking to create. What sort of middle ground may be found during the upcoming negotiations remains to be seen, but it could result in a bank with systems more akin to the IFC or EIB – faster than the World Bank, but still with sufficient controls to satisfy non-borrower shareholders.

5.2 Governance at the AIIB and Impact on Membership

All the indications are that the AIIB will follow the same basic approach in terms of a direct link between capital and voting rights as the NDB, though possibly with some type of basic share arrangement adopted by many other MDBs. Other arrangements such as differentiated share types have not been publicly discussed, but are still feasible. Regardless, based on the initial authorised capital of $100 billion, China will be expected to start off with at least 50% of voting rights based on its $50 billion subscription. Whatever voting rules are put in place (special majorities, representation on boards, etc.), China is thus likely to have a very strong if not controlling voice in the early running of the AIIB.

China has reportedly indicated, however, that it is willing to reduce its shareholding to 25-30%, bringing the AIIB closer to the IADB model, where the USA has a 30% share. Further, China has said it is willing to forgo sole veto authority over key issues related to capital and membership (which the USA still retains at the IADB).[55] Thus, the AIIB's key founding country is demonstrating a willingness to step back from a majority role, which is likely to make membership more attractive for developing and developed countries alike (pending future decisions on specific governance rules). Should this hold true through the statute negotiations, it would contrast with

[55] *Wall Street Journal* (2015) and personal communication from potential member government officials. This has not been confirmed publicly by the Chinese government.

the NDB, in which the five founders have ensured their majority control in perpetuity.

A critical point on governance is that China has opened up the process of negotiating the statutes to potential members and encouraged many countries to join in, rather than the BRICS approach of deciding among a small group of countries and presenting the AofA as a fait accompli. As evidenced by the fact that so many countries have signalled their intent to join – including several major European nations as well as numerous MICs – this appears to have been a very successful strategy on the part of China to assuage fears of its dominance and to engender a sense of commitment and engagement on the part of other members.

The potential downside is that bringing in so many countries with contrasting interests could well make the process of negotiating statutes and basic policies much more difficult. For example, developed nations will have important demands on issues like quality control and project oversight that have led to the heavy bureaucratic burden faced by borrowers at the existing major MDBs. It is not clear if the AIIB will be able to find an acceptable middle ground of reduced bureaucracy while still offering assurances to non-borrower shareholders. This poses the risk of simply creating yet another World Bank-like institution, with similar virtues and flaws, but a slightly different membership structure.

5.3 Links Between Governance and Operational Effectiveness

Beyond attracting new members, governance arrangements will have a major impact on how the two banks operate. A fundamental problem plaguing the larger existing MDBs is an entrenched 'us against them' mentality among shareholders, with deep divisions and bitter disagreements mainly between a small group of large shareholders and everybody else. Smaller countries have little meaningful voice and vote, and as a result feel little sense of ownership or commitment to the MDB, and prefer simply to obtain whatever benefits they can from it while giving as little as possible. Larger countries, by contrast, fall into a dynamic of exercising power with a considerable dose of national interests in mind, and feel relatively entitled to impose their policy preferences on the MDBs.[56] The governance structure laid out in the NDB's AofA may contain within it the seeds of such a dynamic, and it remains to be seen what direction the AIIB's governance statutes will take.

If, on the other hand, the NDB and AIIB were to develop more inclusive governance arrangements (in the case of the NDB this could involve future modifications of the AofA, while the AIIB can design more inclusive governance from the outset), it could greatly benefit their legitimacy, operational smoothness and even financial solidity. For example, in Latin America, CAF has developed a highly egalitarian governance structure, and not coincidentally it has a perfect repayment record by sovereign borrowers – not one late payment in its entire history (Box 2). The reason is clear: borrowers are committed to the bank because they feel it is theirs.[57] This has a very positive impact on CAF's credit rating and cost of funding, which in turn lowers costs to borrowers – a virtuous cycle, with governance as a key component.

[56] See Humphrey (forthcoming) for an overview of the links between governance and operations at several existing MDBs.
[57] See, for example, LatinFinance (2005), where CAF President Enrique García explicitly linked the sense of governance stake by borrowers to the CAF's perfect repayment record.

Box 2. CAF and BCIE: Contrasting Lessons in MDB Governance

CAF and Central American Bank for Economic Integration (BCIE) are two MDBs created by five borrower country governments in 1970 and 1960 respectively. Owing to the nature of their shareholders, borrowers, and overall economic conditions, the MDBs operated on a very small scale in their early years, but began to expand in the late 1980s. The contrasting paths taken by each in their growth show how governance arrangements can exert an impact an MDB's effectiveness.

The BCIE began accepting members beyond the original five founders in the late 1980s as a way to boost shareholder capital and expand the bank. The founding members have, however, always maintained majority control over the BCIE, including provisions to ensure veto power over capital structure, changes to the AoA, and decision-making power on the boards of governors and executive directors. CAF followed a similar path initially, opening to new members in the late 1980s and also keeping control in the hands of founding members. In this case, however, CAF shareholders later took the decision to relinquish their veto over bank governance, and opted to allow all new members full and equal standing.

The divergent paths taken by each has been dramatic, and points to the relevance of governance in establishing a strong MDB (Table B2). CAF has grown spectacularly in terms of membership, lending and financial strength. The BCIE has advanced, but much more slowly, particularly in terms of expanding operations to non-founding members.

Table B2. CAF and BCIE: Various Metrics

	Borrowing Members	Shareholder Capital	2013 Loans	2013 Portfolio	Non-Founder Portfolio	Bond Rating
CAF	19	$3.9 bn	$12.1 bn	$18.2 bln	$6.5 bln	AA-
BCIE	9	$620 mn	$1.4 bln	$5.4 bln	$280 mln	A

Source: 2013 Annual Reports

There are many reasons for this divergent trajectory, but governance is a factor. For example, ministerial officials in charge of external cooperation in Panama and the Dominican Republic both explicitly stated in interviews that the BCIE's policy of requesting shareholder capital but keeping them as 'second class' members limited their desire to work with the bank. Panama stated that the BCIE has pushed it to take loans, but it had refused in part because of disagreements regarding governance. This limits the ability of BCIE to diversify and strengthen its lending portfolio, which in turn keeps its cost of funding higher and therefore loan costs higher, further limiting its usefulness as a development lender.

Source: Annual Reports; BCIE (2010); and interviews in Panama and Dominican Republic (2014) undertaken by the author as part of a consultancy for the IADB.

5.4 Political leadership

This paper does not focus on political issues, but rather more technical aspects of establishing the two new MDBs. However, the divergent trajectory of the NDB and AIIB highlights the fact that underlying financial capital, membership and governance arrangements is the key factor of political leadership.

The political focus of creating the NDB appears to be one of keeping each of the founding members on an equal footing. This is understandable and in many ways

positive, but may also have some negative consequences. For a start, as noted earlier, it has left the NDB with less capital than it might otherwise have, thus limiting its scale, at least initially. At a deeper level, it has left the project without a clear driver. The July 2014 agreement has not yet been ratified by member governments (which could be problematic in some of the BRICS countries, due to domestic politics), nor has there been any public movement to create incipient administration or name a provisional leader (which is up to India to chose).

The experience of the AIIB has been very different, with China actively leading the process in a very focused and strategic way. Immediately after the October 2014 announcement, China set up an interim secretariat and recruited a respected leader (Jin Liqun) and other staff to begin designing the new bank's infrastructure. China's foreign ministry has energetically sought new members across the globe and has done whatever necessary to assuage any fears they might harbour. This strong political and financial commitment – as well as the confidence to allow other countries into the process of designing the AoA and basic policies – is a strong signal that the AIIB has a viable future, and also a very positive indication of China's growing willingness to engage in the multilateral system.

The issue of political leadership may be a purely transitional issue for both banks, soon to be forgotten. But it is unquestionably making a significant difference in the speed with which the two banks are being created and their potential effectiveness in their early years.[58]

[58] Students of international political economy may find this comparison interesting evidence for the continued relevance of hegemonic stability theory – the notion that a single hegemonic country (China in this case) is essential to drive forward any real progress in international coordination.

6 Conclusions

The BRICS New Development Bank and the Asian Infrastructure Investment Bank together represent a bold step towards reordering the global system of development finance institutions. Emerging powers have no confidence that existing MDBs can be reformed to recognise their growing economic power, and are in any case insufficient to address the huge needs in developing countries. In broad terms, the creation of these new banks is a welcome move, and may mark the beginning of a new era in development finance and multilateralism.

At the same time, the NDB and AIIB are facing many of the same challenges faced by existing MDBs in relation to capital structure, membership and governance – challenges inherent in the MDB organisational model. Both banks have clear potential as viable development finance institutions, based on the political and financial commitments made to date. The new banks are, however, taking different approaches to their design and creation, and these approaches are likely to have far-reaching consequences for their operational capacity and effectiveness. Early evidence suggests that the NDB may face greater difficulties in achieving meaningful scale than the AIIB, at least in the short term.

Decisions taken by NDB founders regarding capital structure and governance arrangements may have unintended consequences that could restrict the NDB's scale and effectiveness, at least initially. Projections indicate a likely loan portfolio in the $45-65 billion range ten years after launching operations – relevant but fairly modest in relation to existing MDBs, and certainly not a global game-changer. The NDB's expected bond rating will restrict its financial flexibility and possibly limit demand for its services in some countries due to potentially higher loan costs. Lastly, the lack of clear leadership of the NDB (with five equal founding shareholders) may hinder faster implementation.

The AIIB appears better positioned for more rapid expansion due to greater flexibility regarding membership and shareholding, and is more likely to achieve AAA bond rating early on, thus increasing its operational scale and potential effectiveness. A portfolio in the range of of $70-90 billion is likely after ten years of operations, or possibly over $100 billion due to the greater financial prospects offered by obtaining AAA rating. This would make the AIIB one of the largest MDBs, second only to the World Bank. Vigorous leadership by China – in creating an interim secretariat, appointing key staff, and engaging in a concerted lobbying effort to persuade other countries to join – has also greatly helped the AIIB gain initial momentum and will serve it well as it moves forward.

Both the NDB and AIIB can employ several strategies to further increase their scale and impact. Some of these options could be easier for the NDB and AIIB than for existing MDBs, as the new banks can be designed from the start with these issues in mind and can learn from the experiences of other MDBs:

- *Focus tightly on infrastructure*, which will allow the development of specialised practical knowledge (project design, environmental

and social mitigation measures, financial structuring) that will be highly valued by borrowers.

- *Adopt rigorously depoliticised and technical organisational culture and policies* to establish a strong, positive reputation for the NDB and AIIB among borrowers, bond investors and potential partners (private or public).
- *Leverage external resources as much or more than committing own resources* as a strategy to maximise the development impact of their activities, with modest direct commitments providing a halo effect and attracting other more risk-averse investors. Create from the start appropriate organisational design, office systems, staff capacity and institutional culture oriented around more innovative financial options such as guarantees, equity, PPPs or syndication.
- *Seek to leverage pools of resources and expertise from member countries* through co-financing and other techniques with national development banks, SWFs or central banks, thus expanding operational capacity within the same shareholder capital envelope.
- *Generate strong commitment from all shareholders* through governance arrangements that grant meaningful voice and vote even to smaller shareholders. The commitment of all shareholders is key to avoid the entrenched 'us against them' dynamic that hampers many existing MDBs. Consider granting borrow country voting shares linked to the fact that their loan payments contribute to MDB equity via reserves, in recognition of their essential role in the MDB's financial strength.[59]

[59] See Kapur and Raychaudhuri (2014) for more on this. The BCIE in Central America recently instituted 'E' capital shares along these lines, the only MDB to do so (BCIE, 2013).

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Appendix

Appendix Table 1. Return on Equity, Various MDBs (2009–2013)

	AfDB	IBRD	IADB	AsDB	CAF
2009	4.9%	1.4%	6.3%	2.7%	4.9%
2010	4.4%	2.2%	6.0%	3.4%	3.2%
2011	3.4%	2.6%	4.2%	3.3%	2.7%
2012	3.7%	2.1%	4.4%	2.6%	2.6%
2013	3.1%	2.2%	3.7%	2.7%	2.6%
Avg	**3.9%**	**2.1%**	**4.9%**	**3.0%**	**3.2%**

Source: Annual Reports, 2009–2013

Notes: ROE calculated by net operating income (before mark-to-market valuations and board of governor-authorised transfers) as a ratio of total shareholder equity.

Appendix Table 2. Equity-to-Loans, Various MDBs (2009–2013)

	AfDB	IBRD	IADB	AsDB	CAF
2009	62.9%	38.6%	35.6%	36.7%	40.3%
2010	58.1%	30.7%	33.3%	34.6%	37.0%
2011	52.1%	30.4%	29.9%	33.2%	37.2%
2012	48.5%	27.3%	30.1%	31.1%	36.9%
2013	50.3%	27.9%	33.3%	32.3%	43.4%
Avg	**54.4%**	**31.0%**	**32.5%**	**33.6%**	**39.0%**

Source: Annual Reports, 2009–2013.

Notes: E/L calculated by outstanding loan portfolio (including guarantees and equity investments) as a ratio of total shareholder equity.



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