Key findings

# Matching risks with instruments in development banks

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THE VISIBLE HAND: Development Banks in Transition

**The paper explores how development banks (DBs) should deploy appropriate financial instruments to encourage real economic risk-taking, while minimizing financial engineering risks. It also explores comparative advantages of different financial instruments - such as loans, guarantees and equity - in tackling risks in normal times; it synthesizes common features of DB's responses to the Covid-19 crisis; and proposes future research directions.**

## Objectives and research questions

**This is an umbrella paper, partly with the aim of defining key topics for a future research program on business models of development banks.** The core question is how development banks should deploy appropriate financial instruments to maximize development impact.

## Methods

The paper has deployed three methodologies: conceptual analysis, interviews and statistical analysis. Conceptually, its builds on the existing literature to distinguish different types of risks. Empirically, the authors conduct interviews with practitioners from development banks to understand the rationale behind using different financial instruments and responses to the Covid crisis. Drawing on first-hand data collection of financial instruments by the Institute of New Structural Economics at Peking University, they identify empirical patterns of main financial instruments of 50 selected national DBs.

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## Results

Development banks' ideal outcome is to maximize development impact, whilst at the same time minimizing financial engineering risk. A direct loan or equity would likely maximize the development bank's policy steer to try to ensure maximum development impact, though it would use more capital.

The DB can, alternatively, use more complex financial instruments engineered or created to attract additional financing and add leverage. Yet, the use of such instruments may lead to too much risk being taken by the DB, including through contingent liabilities and reduce policy steer aimed at maximizing sustainable development impact.

Different financial instruments have comparative advantages in addressing market failures and mitigating specific risks:

- Subsidized credit is particularly useful when there is insufficient return on an investment to attract private investors, but has positive social or environmental externalities.
- Guarantees may be appropriate when used to address idiosyncratic risks when there is high risk aversion by private investors or lenders; and in times of high uncertainty, such as after the 2008-09 financial crisis, or during the Covid crisis.
- Equity could be particularly well suited for ambitious projects, such as the development of a new technology, which may have difficulty attracting private finance due to high uncertainty; an equity instrument would also allow the DB to capture the upside if the project is successful.
- During the first phase of the Covid-19 pandemic, there have been some common measures adopted by national and multilateral DBs, including: fast-track procedures to speed up transactions; provision of working capital for companies; standstill on existing loans; extended grace periods; and additional lines of support for the health sector and governments, especially local ones.

## Recommendations

➔ **Increasing the capital of DBs is worth pursuing**, both at national and multilateral levels, especially in Covid times, and given the major challenges for structural transitions to low carbon and more equitable economies.

➔ **When subsidies are used, they should be just sufficient to induce private actors to invest, without over-compensating the private investor.** One way to address this is through an auction, where the national development bank (NDB) might set an amount and give the project to the lowest bidder.

➔ **Development banks need to adapt their financial instruments** to tackle the changing demands from the real economy at different stages of development.



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**Access the research paper**

**MATCHING RISKS WITH INSTRUMENTS IN DEVELOPMENT BANKS**