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# THE NEW DEVELOPMENT BANK AS AN ADVOCATE OF COUNTRY SYSTEMS

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## EXECUTIVE SUMMARY

The New Development Bank (NDB) locates the use of country systems (UCS) at the core of its operational policies. While facilitating infrastructure financing through country systems holds significant financial and non-financial benefits for developing countries, the experiences of other multilateral development banks (MDBs) have highlighted some key challenges: increased risks, weak country systems, questionable commitment of member states to the UCS agenda, procurement challenges and capacity-building constraints. By analysing the NDB's nascent approach to UCS and drawing on the experiences of traditional MDBs, this briefing offers recommendations to the NDB on how it can strengthen its UCS approach. It also raises pertinent considerations for the NDB, its member countries and others looking to join the bank as it considers expanding its membership.

## POLICY RECOMMENDATIONS

1. Member countries' PFM and ESF processes indirectly underpin the NDB's financial reputation. It is therefore vital that it supports member states where their domestic processes fall short. Where the NDB relies on financial intermediaries (FIs), adequate monitoring of FIs' and subprojects' compliance with safeguards is required.
2. Traditional quantitative methods of measuring equivalence and acceptability of country systems vis-à-vis MDBs' have proved cumbersome and expensive. The NDB, given its limited membership, should make use of in-country experts and staff to qualitatively assess country systems and identify shortcomings.
3. Discerning member states' commitment to the UCS agenda is vital. Country or regional offices can assist with building trust between parties to increase the uptake of UCS, provided they are adequately empowered.
4. Placing UCS at the centre of the NDB's procurement policy is encouraging. However, this should be supported by adequate post-award contract monitoring.
5. The NDB could cooperate with other development partners that have displayed a keen interest in strengthening the capacity of governments, while exploring avenues for financing such efforts.
6. Broader society plays an important role in keeping governments accountable to domestic PFM and ESF processes, which is important where MDBs relinquish more control to governments through UCS.

## INTRODUCTION

Infrastructure investments enable development by spurring job creation, trade and investment, and thus remain a core priority for developing countries. MDBs play a vital role in infrastructure development by providing finance for large-scale investments. In the past MDBs employed largely their own management systems to facilitate such loans, primarily to mitigate the financial, reputational or development risks that accompany these. However, all countries have public financial management (PFM) and environmental and social frameworks (ESFs) in place to mitigate such risks. Duplication of such management systems in MDB-financed projects are now recognised as hampering development efforts by increasing bureaucracy, time and cost of loans. This has prompted a shift towards greater UCS, whereby countries' PFM and ESFs are used to facilitate development finance.[2]

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The NDB, established by the BRICS group of countries in 2014, does not deviate from the traditional business model used by established MDBs: it leverages paid-in capital from its member countries on debt markets, allowing it to maximise these funds and extend loans at attractive rates to its members. However, the NDB's core objective is to increase the efficiency of development finance. In line with this objective, it has signalled that it will use country systems wherever it operates to facilitate development financing more efficiently. This approach is underscored by key policy documents released by the NDB, such as its ESF and procurement policies. While the NDB's approach to UCS is promising, this approach remains untested and only the implementation of projects will reveal the efficacy of its approach.

A discussion paper from the GEG Africa programme[3] explores the challenges faced by traditional multilateral development banks, in particular the World Bank and the African Development Bank (AfDB), in their respective UCS approaches.[4] While the NDB can learn from these experiences, it should be noted that the NDB differs from traditional MDBs in two important ways: it has a limited, exclusive membership with strong country systems and all its members have equal voting power in the institution. This briefing offers recommendations to the NDB on how it can enhance its approach to UCS within the context of these differences.

## THE NDB AS A PROMOTER OF THE UCS APPROACH

In assessing the NDB's approach to UCS, three cross-cutting issues become apparent. First, the NDB places nation states at the core of its engagements, rather than itself or other borrowers (eg, private clients). For example, its Articles of Agreement note that 'the Bank shall not finance any undertaking in the territory of a member if that member objects to such financing',[5] meaning that if a private borrower seeks to solicit financing from the bank and the country objects, the NDB will not proceed. In addition, it notes that '[t]he Bank, its officers and employees shall not interfere in the political affairs of any member'.[6]

Second, the NDB favours not only UCS but also 'use of *client* systems' (emphasis added). It extends loans to both sovereign and non-sovereign clients (eg, state-owned enterprises [SOEs] or the private sector), with a clear preference for employing borrowers' existing systems. While broad principles are identified, a great deal of autonomy is delegated to clients. On procurement, for example, the NDB suggests that 'rather than using formal competitive tendering [as is the case for sovereign borrowers], private sector clients may follow commercially acceptable procurement methods'.[7]

Third, there is a clear focus on capacity building and technical assistance evident in all bank policy documents. The bank's founding document, for example, suggests that to achieve its objective of mobilising resources for infrastructure and sustainable development projects, it needs to 'provide technical assistance for projects to be supported by the bank'.[8] Its procurement policy highlights capacity building and technical assistance in a similar fashion, while the ESF explicitly notes 'when the client has inadequate capacity to carry out necessary environment and social plans for a proposed project, the project may include component(s) to strengthen capacity'.[9]

Finally, the bank seems to favour a 'hands-off' approach in its lending activities. This is evident from its comfort with on-lending to financial intermediaries (FIs) in two of the projects that it already finances (to Canara Bank in India and BNDES in Brazil).

## Public financial management

The NDB, as an emerging organisation, is yet to release comprehensive details of its UCS approach for all PFM functions. The bank has thus far dealt most comprehensively with its approach on procurement, a key PFM function. Again, it is clear that the procurement framework sets out broad principles to which a country must adhere, rather than strict criteria. The principles promote economy, efficiency, value for money, fit for purpose, competition and transparency.[10]

Nevertheless, as with any financial institution, the NDB maintains a number of safeguards to mitigate financial, reputational and development risks. These include an assessment of the procurement system and alignment with the broad principles set out in its procurement policy, the strength of the institutions within these systems, the capacity of the domestic market to supply goods and services, and the strength of governance. Divergence from UCS to mitigate these risks includes, among others, that the 'NDB may require clients to include specific provisions that may be at variance with the country procurement system'.[11] The NDB also draws on the list of companies barred from engagement by other FIs (Agreement of Mutual Recognition of Debarments) to avoid engaging with companies that have been flagged for misconduct.

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## Environmental and social framework

The NDB has a strong mandate to promote sustainable development, prioritising economic, environmental and social considerations equally. Its Articles of Agreement note that it should 'contribute to an international financial system conducive to economic and social development respectful of the global environment'.[12]

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In line with this directive, the NDB's current ESF outlines broad principles for its operations that seek to manage environmental, social, operational and reputational risks.

While many activities are delegated to countries under the NDB's ESF, the bank still maintains key responsibilities, such as screening projects for compliance with NDB policies, undertaking a due diligence review of borrowers' ESF, establishing the financial feasibility of projects, monitoring clients' compliance with ESF throughout the project cycle, building capacity and sharing knowledge. Borrowers are responsible for undertaking environmental and social impact studies, conducting domestic consultations with affected communities, developing and implementing mitigating plans to counter adverse effects, and maintaining a grievance mechanism.

The NDB's current ESF has been praised by a coalition of civil society organisations (CSOs) for its 'laudable principles for social and environmental performance, including sustainability, inclusion, and climate change'.[13] However, some of the key shortcomings perceived by these CSOs include the lack of clear definitions in its policies defining 'strong' country systems and the inadequate integration of gender considerations into its policies. Furthermore, the NDB's ESF requires its borrowers' systems to only be 'consistent' with its policies rather than 'complying' with them, perhaps leaving too much room for flexibility in an already broad approach.

## Key considerations for the NDB

At the bank's second board of governors meeting (March 2017), the terms and conditions for adding new members were approved, with the final criteria for selecting new members expected in the third quarter of 2017.[14] As the NDB looks to expand its membership, it is likely to face a number of challenges, in particular concerning UCS. Firstly, it is likely that the NDB will be unfamiliar with new member states, especially given that the bank is staffed almost exclusively with nationals from the current five member states. Secondly, while the founding members ensured that the UCS approach was a foundation of the NDB, signalling their clear buy-in, this might not necessarily be the case for new members. Thirdly, in the face of maintaining a 'lean' organisation, the NDB may be confronted with capacity constraints in rolling out its UCS approach. This may prove especially challenging in the initial consolidation phase of the NDB.

Perhaps most importantly, many of the considerations noted above, such as membership expansion, capacity and technical assistance, will influence the cost of the loans the NDB can extend. This concern is compounded by the fact that some South African SOEs contend, for example, that they can raise capital more cost effectively than any MDB on the domestic market.[15] Hence loan pricing will be an important consideration for the NDB going forward.

## CHALLENGES TO GREATER UCS AND REMEDIAL ACTION BY THE NDB

Traditional MDBs have found, as they implement and scale up their UCS approaches, that a number of issues can be challenging. These include:

**Risk mitigation**. By using country systems, MDBs face increased financial and reputational risks while the possibility of inadvertently causing adverse development impacts is greater. Country systems, which may be more susceptible to financial mismanagement or abuse, stand to disadvantage both MDBs and countries.

UCS is a core part of the NDB's operational strategy, and strong PFM and ESF processes indirectly underpin the credit rating received

Risk mitigation is especially pertinent for the NDB as it seeks to obtain an international credit rating. While domestic credit rating agencies in China have praised the institutional strength of the NDB, and rated the institution highly, having strong risk mitigation strategies is vital for maintaining not only a high credit rating but also the financial viability of the institution. UCS is a core part of the NDB's operational strategy, and strong PFM and ESF processes indirectly underpin the credit rating received. The NDB should be mindful of this fact as it seeks to expand its membership.

The NDB has already displayed an interest in employing FIs to increase the uptake of UCS while mitigating risks. While FIs have been used successfully to this end, this approach has met some criticism. Some FIs have failed to ensure adequate oversight over the implementation of subprojects, giving rise to controversial project impacts.[16] Where the NDB does rely on FIs, adequate monitoring of the institution itself and of subprojects by the NDB would do much to prevent this.

In addition to using FIs to mitigate risk, some of the successful instruments applied by other MDBs that the NDB can draw on include the World Bank's 'Program for Results' (PfR) approach, which links financial disbursements to positive development impacts (rather than the completion of processes). A World Bank review of its PfR approach noted how more than 74% of interviewees agreed that the PfR approach helped to increase UCS, while noting that a key risk mitigation component – anti-corruption guidelines – remained an issue that needed to be addressed.[17] The NDB can also look to introduce technology, such as e-procurement systems that can promote transparency and accountability, into its capacity building or technical assistance approaches.

**Strengthened country systems**. The application of UCS has achieved mixed results in strengthening domestic systems, one of the key rationales for its use. Both the Organisation for Economic Co-operation and Development[18] (OECD) and World Bank[19] indices measuring PFM systems in developing countries have indicated signs of improvement, but have also noted signs of regression.

This is less of an issue for the NDB's current member countries with their well-developed domestic management systems (although there are still capacity and technical gaps). Nevertheless, as the NDB looks to expand its membership, it should ensure that adequate tools are in place to measure the strength of borrowers' country systems. Traditional MDBs' equivalence and acceptability tests (measuring equivalence to their own standards and adequacy of implementation, respectively) have proved cumbersome and expensive.[20] Instead, the NDB could rely on in-country experts in addition to bank staff to assist with assessing PFM and ESF shortfalls. This should be more feasible for the NDB given its limited membership.

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**Commitment to UCS**. In addition to the more technical challenges facing UCS, as highlighted above, the political commitment of both MDBs and countries to the UCS agenda is vital if uptake is to be increased. The five founding members' commitment to UCS is signified by the manner in which it has been adopted by the institution in its initial policy documents. However, this ambition is not necessarily shared by potential new members. Lack of commitment from new members might result in implementation difficulties.

Discerning the intent and commitment of potential new members to the UCS agenda is vital. Three different attitudes towards UCS have been identified: countries that view UCS as non-negotiable; countries that take a more pragmatic view of UCS by identifying weaknesses in their own systems and showing a willingness to compromise on these shortcomings by using MDB systems for select functions; and countries that recognise that their domestic processes often fall short of international best practices and are happy to work with a 'hybrid' country–MDB system.[21]

Once more countries have joined the NDB, commitment to the UCS agenda can be strengthened through the bank's in-country presence. Having a physical presence in a country, with offices staffed by locals who intimately understand the business culture and operating environment and where close networks with key stakeholders can be built, is vital for greater UCS and commitment to this agenda. Not only do local staff assist in mitigating risks for MDBs but their familiarity with domestic systems have also often made them key proponents of greater UCS. Country offices' attitudes towards UCS are often in contrast to those of the headquarters, which are further removed from the environment.

This latter point highlights the importance of adequately capacitating country offices in terms of decision-making power to play an enabling role in operationalising projects. Traditional MDBs have recognised the need for the greater decentralisation of decision-making powers within their organisations. The NDB can do this, for example, by increasing the value thresholds under which country offices have decision-making powers. Such an arrangement should ensure that adequate accountability mechanisms are in place to manage the relationship between headquarters and country offices.

While having a number of country offices might not be immediately feasible (or desirable) for the NDB, considering the cost and capacity considerations, it could certainly be a long-term consideration. The planned African Regional Centre could provide useful lessons for other countries. In the meantime, the NDB should draw extensively on the expertise of local partners, such as local development finance institutions or private FIs, to facilitate loans (noting the caveat around FIs mentioned above). The NDB can also explore, as an interim measure and where necessary, housing a dedicated team in a relevant ministry or institution that remains the key liaison between the bank and its member countries. The NDB already has a Memorandum of Understanding with members of the BRICS Interbank Cooperation Mechanism,[22] which can be employed in this regard.

**Procurement**. Procurement continues to be contentious in the relationship between MDBs and borrowers. Considering that it holds significant process risks for development projects, MDBs typically prescribe procurement guidelines. However, procurement rules dictated by MDBs have tended to conflict with the development policies of borrowing governments (eg, using procurement as a developmental instrument to promote the participation of small and medium enterprises or marginalised groups) or have resulted in domestic companies being excluded from MDB-financed projects.

**Procurement rules dictated by MDBs have tended to conflict with the development policies of borrowing governments**

The NDB's procurement guidelines recognise these shortcomings of past approaches by dictating UCS in the case of public sector operations or client systems for private sector operations. Similarly, the World Bank and the AfDB's new procurement policies have highlighted UCS as their core approach. The World Bank and the AFDB also, however, stress the need for significant post-award contract management, an area that was neglected in the past but that can contribute significantly to reducing the mismanagement of funds and ensuring positive development outcomes. The NDB places responsibility for this primarily on the borrower, but should look to support this process by adequate monitoring, and offering capacity building and technical support where required.

**Capacity building**. Capacity and capacity building have significant implications for facilitating greater UCS. One needs to consider the capacity of both MDBs (number of staff and required technical expertise) and borrowers to employ UCS. Capacity building should also be holistic, focussing on strengthening country systems rather than individual projects. It should also focus on both strengthening institutions and capacitating individuals. While capacitating individuals contributes to better functioning of systems, they are often tempted to leave the public sector for higher salaries in other sectors. It is therefore important to also strengthen governance processes and operations.

At the same time, the capacity of civil society should not be neglected. Civil society plays an important role in keeping government accountable to domestic PFM and ESF processes, often on behalf of marginalised or disempowered individuals. This is important where MDBs relinquish more control to governments through UCS. The encompassing nature of capacity and capacity-building requirements poses significant challenges for the NDB, notably in relation to its intention to keep a small staff complement.

The NDB would do well to support country-specific capacity-building strategies, developed by countries themselves (to enhance buy-in and appreciating local context), that strengthen country systems as a whole, rather than just individuals. It should further take into account in-country ability to provide that capacity (eg, university courses), and civil society. It should be noted that enhancing country capacity will benefit all development partners (through better management of loans or grants) in addition to ensuring that countries are better equipped to manage their public finances. Other MDBs and development partners have displayed a keen interest in enhancing social infrastructure and services (OECD bi-lateral donor spend on 'government and civil society' programmes under this broader category comprised more than 5% of total global overseas development aid spend in 2015).[23] The NDB should thus look to engage and cooperate with countries and development partners to ensure coordinated support in this regard.

The NDB also needs to consider financing capacity-building efforts. One option is to leverage a marginal levy on loans to raise additional funds for this activity. While making loans more expensive (and hence less attractive to borrowers) may be discouraging, the vital role of capacity building should justify this marginal cost. Another option would be to employ 'profits' from NDB loans towards capacity building. Unlike many other MDBs, the NDB does not have a concessional window that requires replenishment every other year. While other MDBs contribute proceeds made from loans above and beyond what covers their operational costs to finance their concessional windows, the NDB can gear these proceeds towards capacity building. Again, the appetite of shareholders – both founding and potential new – to such an approach would have to be tested. Lastly, the NDB could also consider creating a dedicated capacity-building fund. The bank's Articles of Agreement provides for special funds to be set up, such as the mooted project preparation facility. A similar fund could be created to support capacity building.

## CONCLUSION

The NDB's nascent approach to UCS is encouraging. However, there is a wealth of experience and lessons that can be learned from other MDBs. This will become more important as the NDB expands its membership and the relatively lean organisation has to support implementation in countries at different stages of development. By participating in global dialogues on UCS, the NDB can draw on the experiences and thinking of traditional MDBs. At the same time, it can help shape and reform this dialogue by sharing its experiences to date. In doing so, the NDB and its members will contribute to its stated desire to 'contribute to an international financial system conducive to economic and social development [that is] respectful of the global environment'.[24]

## ENDNOTES

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2 Development partners (including multilateral development banks [MDBs]) as well as aid-giving and -receiving countries committed to a greater use of country systems (UCS) in the Paris Declaration on Aid Effectiveness in 2005.

3 Forthcoming.

4 MDBs such as the World Bank and the African Development Bank have signalled their commitment to greater UCS by implementing pilot programmes to test their UCS approaches and developing key policies that place UCS at their core. See Prinsloo C *et al.*, 'Informing Multilateral Development Banks' Approach to Use of Country Systems', GEG Africa (Global Economic Governance Africa) Discussion Paper, forthcoming.

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