DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS
Financing for Development Office

Rethinking the Role of National Development Banks

Contents

Executive Summary ... iii
I. Multi-stakeholder Consultations ... 1
A. Introduction ... 1
B. Consultative Process on NDBs ... 2
1. Approach ... 2
2. First Step ... 3
II. Overview of National Development Banking ... 3
A. Historic Overview ... 3
1. Origins and Evolution ... 3
2. Structural Variations ... 5
B. Rationale and missions ... 7
1. General Definition ... 7
2. Actions and Lines of Activity ... 9
3. General Framework of Analysis ... 11
III. The Evolving Role of National Development Banks ... 12
A. Filling Gaps in Financial Sector Development ... 13
1. Providing Long-term Financing ... 13
2. Providing Other Financial Products for Development ... 17
3. Building Inclusive Financial Sectors ... 21
B. Improving the Business Climate ... 25
1. Promoting and Supporting SME development ... 25
2. Reducing Volatility ... 27
3. Acting as a Catalyst ... 28
C. Capacity-Building of NDBs ... 31
1. Improving Prudential Regulation and Supervision ... 31
2. Enhancing Governance and Management ... 32
3. Measuring and Monitoring Results ... 35
Index of Stakeholders ... 37
Bibliography ... 39

TABLES, BOXES AND FIGURES

TABLE 1: THREE OBJECTIVES FOR NDBS ... 8
TABLE 2: THE "FIVE A'S" ... 10

BOX 1: LIQUIDITY MANAGEMENT FOR LONG-TERM LOANS ... 16
BOX 2: BNDA AND VILLAGE BANKS: AN INNOVATIVE APPROACH BY KFW ... 22
BOX 3: THREE SCENARIOS FOR LOCAL FINANCING ... 23
BOX 4: EGYPT'S NATIONAL BANK FOR DEVELOPMENT AND MICROFINANCE ... 24
BOX 5: CATALYTIC ROLE OF NDBS: CASE OF WATER INFRASTRUCTURE ... 29
BOX 6: STANDARD & POOR'S METHODOLOGY FOR RATING GOVERNMENT SUPPORTED ENTITIES ... 32

FIGURE 1: A PYRAMID OF NATIONAL DEVELOPMENT BANKING ACTIVITY ... 9
FIGURE 2: EXAMPLE OF CONSTRAINTS FOR A SPECIFIC PROBLEM ... 11

Executive Summary

I. The Consultation Process

1. How can the role of NDBs in promoting economic and social development be enhanced? This fundamental question will be addressed through a set of multi-stakeholder consultations during 2006-2007. The process will be organized by the Financing for Development Office of UN-DESA, in collaboration with NDBs, International Financial Institutions (IFIs), Regional Development Banks (RDBs), United Nations regional commissions and other interested parties from the official and private sectors, as well as academia and civil society. As a first step, an Ad Hoc Expert Group Meeting was convened on 1-2 December 2005, with a view to identifying and exploring key substantive issues to be addressed during the consultation process.

II. Overview of National Development Banking

2. NDBs evolved over a long period of time in both developed and developing countries, in order to meet important financing needs. Their evolution was influenced by the changing global and national financial architecture. After WW II, the concept of NDBs went through several phases ranging from “Development Finance Companies” to “Development Funds”.

3. A National Development Bank can be defined as a “Financial institution primarily concerned with offering long-term capital finance to projects generating positive externalities and hence underfinanced by private creditors”. This definition is coherent with empirical observations of statutes, history and current activity of such entities. However, focusing on the various organizational set-ups of banks adds complexity to efforts towards finding a more precise definition. Diverse structures (first-tier, second-tier, sectoral, global, export-import banks) and differences in ownership (public and/or private) expand the scope of analysis.

4. NDBs often design and implement their development objectives through rather similar approaches: (i) *Appraising* the economic and social impacts of development projects that seek financing; (ii) *Accompanying* investors over the long run through long-term loans; (iii) *Assisting* sectors that are key to growth through technical assistance; (iv) *Attracting* investors by playing a role of catalyst for large financing operations; and (v) *Alleviating* the negative impact of financial crises through financing that does not follow cycles, by offering loans even during downturns and by pooling efforts with regional financing institutions. Lines of activity evolved significantly since the 1990s, as a result of deeper global integration and a reshuffle of national development banking strategies. The focus on industrialization or import substitution, prevalent in the 1960s, was abandoned or significantly amended, while new objectives of social development, export promotion, support to small and medium size enterprises (SMEs) and innovative credit and loan policies led to the development of new functional activities.

5. A general analytical framework may focus on priority constraints to be addressed by NDBs. It is based on the identification of the causes of a market failure, in particular the main cause

or ‘primary constraint’. Focusing mainly on such constraints will reinforce the efficiency of policies in a context often characterized by scarce political and financial capital.

III. The Evolving Role of National Development Banks

6. The quest for sustainability may well be at the heart of the challenges facing NDBs in the 21st century. The economic sustainability of a project means the provision of essential services on an affordable basis for clients and on a profitable basis for operators. From this perspective, improving the availability of long-term loans and developing financial engineering will not be enough if the economics of the projects are insufficient, i.e. if the loan portfolio does not bring sustainability to the bank. It is thus difficult to approach the challenges of NDBs independently of the issues related to the qualitative and quantitative assessment of development projects and the subsidization of lending or guaranties.

III.A Filling gaps in financial market development

Providing long-term financing

7. NDBs have often been orienting their mission towards long-term projects and providing the corresponding loans. Funding of infrastructure projects indeed is prone to different kinds of failures and requires support from financial institutions. When long-term financing is not offered by domestic or foreign commercial banks, the need for development banks to fill the gap may seem justified. When long-term capital is available to a certain extent for large

instance by avoiding subsidized lending and focusing on market rate loans coupled with grants, to encourage marketable loans for future securitization.

10. Concomitant to offering long-term resources is the need for adequate guarantees to foreign investors. Added to foreign exchange guarantee mechanisms, some NDBs also aim at attracting foreign investors by extending maturities and reducing

15. Guarantees are also crucial to facilitate the financing of SMEs. For that reason, many NDBs spare no effort to develop specific tools with the country's financial authorities or multilaterals. Loan guarantee schemes for SMEs can contribute significantly to securing loans by participating institutions, in order for SMEs to develop their activity or increase their cash flow.

16. Another line of support is through technical assistance, for both technological and managerial needs. In this field, the expertise of NDBs can be enhanced. Technical assistance can also be provided through partnerships between national development financing institutions, business associations and networks of entrepreneurs.

17. NDBs should also be part of the increasing efforts to promote regional cooperation on innovation. There is a wide variety of regional research organizations and networks throughout the world that link together researchers and policy-makers. NDBs could join efforts to foster research, capacity-building, networking, education and training and would thus participate in increasing the gains from knowledge, through national, regional and interregional networks.

Reducing volatility

18. Private bank lending tends to

policy adjustments, budgetary issues, cooperation and coordination among institutions, human resource requirements, and technology innovation needs.

Measuring and monitoring results

28. A lot of efforts and initiatives are underway in a number of agencies to address the issue of development results. In that regard, it is important that NDBs work in the context of their

"*establish national development banks in order to provide affordable long-term financing, as well as technical assistance, to areas and sectors not adequately serviced by the private sector*."

The present background document provides a broad

economies in transition and developed countries. The World Bank, the International Monetary Fund, United Nations Development Programme and United Nations Regional Commissions are also invited to provide their inputs. Experts from the private sector, academia and civil society, as well as bilateral development agencies and interested governments are also engaged.

2. First Step

An Ad Hoc Expert Group Meeting on the theme: "*Rethinking the Role of National Development Banks*

Likewise, the United States had a distinctive approach to industry financing. Privately-owned "*Merchant Banks*" or "*Industrial Banks*" were performing some of the functions of modern-day NDBs. They provided long-term investment financing of projects that had exceptional risks through venturing into new fields of production promising to yield a high profit, such as the construction of the railroads. The sale of stocks and bonds at the stock markets was the primary source of finance for these banks, which often benefited from bond guarantees offered by the States. Often these States chartered banks that then issued bonds sold primarily in Europe, in the United Kingdom in particular. The proceeds were then used to finance development projects in the issuing State. In this context, Medici Bank, Rothschild and the House of Morgan –originally merchant bankers - and several other private banks thrived after the 1890s: by the early 1910s, they had gained control of a significant number of railroads and industrial firms (Cantillo Simon, 1998). Interestingly enough, at the heart of the late nineteenth century debate on financing infrastructure development in the United States, lay concepts that are still on the agenda today, including: the opportunity of relying on private finance, encouraging the growth of domestic financial markets, and choosing financial instruments that minimize the risk of dependence on foreign funds (Eichengreen, 1995).

At the same period, development banks were also created in certain developing countries. For example, Mexico already had its own development bank early in the nineteenth century, el Banco de Avio. Created in 1821, this bank contributed both to the construction of a North-South railway system and to smaller-scale financing: loans to cotton, iron, silk, wool, and paper manufactures, or lending for machinery purchased in Europe.

In this varying environment for development financing, there were little resemblance in the evolution of NDBs, at least until they faced similar crises in the international financial architecture. The collapse of the stock markets in 1929 indeed had led to a shortage in funds to finance development projects and to a rethinking of the institutional needs for development financing. But while this had led some countries to close these institutions that had often gone bankrupt, still other countries opted for an opposite strategy and built new NDBs to foster the development of capital market. For example, Nafin in Mexico was created in 1934 to promote the capital markets development and to channel funds to productive sectors of the economy.

After World War II, the lack of long-term funding for investment projects encouraged many countries to establish Development Finance Institutions by using public funds. Specific stages in this evolution included "*development finance companies*" (public entities with non-banking activities), "*development funds*" (usually based on special accounts from the Central Bank), ending with what is today known as "*national development banks*". In the past, the literature often used the term development finance institution (DFI) that is still used today to include a greater number of entities than only NDBs, including sub-national and regional development banks and funds. Developing countries that accessed to independence often created their bank, public or private, such as Banque gabonaise de développement in 1960 or the Botswana Development Corporation Limited established in 1970 to be the country's main agency for commercial and industrial development. Of course, the significant expansion of intergovernmental institutions also influenced development financing at that time. NDBs linked up with bilateral donors, Regional Development Banks (RDBs) and global finance institutions such as the World Bank.

Later, the focus on industrialization or import substitution policies, prevalent in the 1960s, was abandoned or significantly amended, while new objectives of social development, export promotion, support to SMEs or innovative credit and loan policies led to the development of new functional activities. Since the 1980's indeed, changes have been provoked by financial crises, governance and management problems. For instance a 1974 World Bank study of delinquency rates in agricultural banks reported that the average arrears rate was 41 per cent, while another 1983 World Bank report had indicated that 39 percent of the development finance intermediaries were experiencing serious portfolio problems (Caprio, 1997). In consequence, international financial institutions dramatically reduced their lending to development finance intermediaries in the early 1990s. But change was also due sometimes by the successful outcomes of NDBs in their core activity that called for their branching out in other sectors in need.

Most of these institutions have thus profoundly evolved in the last two decades. Some were privatized or even closed, as detailed in the next sections of this document. Others, in particular in Latin America and Asia, managed to diversify and to adapt to a changed financial environment. By adding the provision of other financial services including working capital, advisory services, leasing, insurance, entrepre([(ainsu0 of ne)8 en1, suppor3ii the deve0.0e,)6.1(e)-0.1(ta)4

growth of capital markets and of availability of long-term lending from the private sector. Another key factor is related to the performance of State-owned banks and parastatals that triggered a strong rebuttal from IFIs that pushed for their restructuring or closing. Those elements are studied in more details in the last part of the document. Therefore there are now various kinds of ownership models and it is getting difficult to distinguish between public, private and public-private structures that often evolved significantly through time:

- A majority of NDBs are State-owned, but within public ownership models the structure varies. Some have their resources drawn from a special account from the country's Central Bank, Treasury or Ministry of Finance, and in such cases tend to be only development funds rather than banks;
- Some banks have mixed federal and state ownerships, such as the German Bank of Development Kreditanstalt für Wiederaufbau (KfW), which became a major development agency;
- Some have mixed national, foreign and multilateral ownership. In such cases the development banks act as vehicles for international cooperation, in particular regarding private sector development, and official development assistance. For example the Development Bank of Kenya (DBK) is owned by the Government of Kenya, Netherlands' Fin.-Maatschappij voor Ontwikkelingslanden N.V. (FMO), the Commonwealth Development Corporation (CDC), Development Bank of Germany (DEG), and the International Finance Corporation (IFC);
- Some are private entities, often a result of privatization since the 1980s encouraged by national and international decision-makers in view of poor economic, social and financial results. The belief that there is a negative relationship between economic growth and state ownership (La Porta, Lopez-de-Silanes, Shleifer, 2000) may continue to play a role in this evolution;
- In developed countries, there are also a wide variety of ownerships: the Dutch government for example owns 51% of FMO while the government of Norway owns only 15% of Eksportfinans ASA. In Austria, Oesterreichische Kontrollbank AG is owned entirely by leading Austrian banks and in the United States, Private Export Funding Corp. is owned by American banks and companies, while Eximbank of the United States is wholly owned by the government;

Second, NDBs are further split between models of first-tier or second-tier banks. Second-tier banks are prohibited to use public deposits for lending to the private sector. Banco de Comercio Exterior de Colombia S.A. for instance is a semipublic corporation, a rediscount bank that provides financial services to foreign trade companies and micro enterprises, to SMEs and large companies targeting the domestic market. It is also a second-tier bank, the second largest in Colombia in terms of assets and the largest in terms of loan portfolio (Source: Inter-American Investment Corporation). Some institutions evolved from one stage to another, such as for instance COFIDE in Peru (Corporación Financiera para el Desarrollo), a state-owned financial institution acting as a second-tier bank, which used to be a first-tier bank until 1992. COFIDE thus only uses resources from multilateral development banks, foreign commercial banks and the capital market, and uses a national coverage of more than 40 first-tier financial institutions for its operations.

Recent NDBs tend to be second-tier banks, in particular due to the fact that, often, first-tier banks performed poorly and appeared politicized in their decision-making. However there are cases of countries considering the creation of first-tier banks – such as Nicaragua, about which certain development agencies expressed concern, especially regarding the consequences on the microfinance sector (CGAP, 2005).

Third, a last organizational difference deals with the mandates of the banks, between 'sectoral', 'universal' and ExIm banks. Details regarding the specific lines of activity associated to these types of banks are given in Section II.B and Part III of this document. Generally speaking, 'sectoral' banks focus on specific sectors. The two main focuses of activity of sectoral banks are usually agriculture - such as BNDA in Mali - or SME ch as

Therefore, although the definition given by Panizza is by no mean contradictory with those considerations, it may be refined: national development banks can be defined as "*financial institutions set up to foster economic development, often taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities*".

2. *Actions and Lines of Activity*

Despite these variations, the activity and success of national development banks rests on several requirements that do not significantly differ from one bank to another. They include (Figure 1) good governance and good management, adequate financing products, sustainable policies and regulation and supervision. NDBs also design and implement their development objectives through rather similar *actions*, as illustrated below:

(i) *Appraising* the economic and social development impacts of projects looking for financing;

(ii) *Accompanying* investors over the long run through long-term loans;

(iii) *Assisting* sectors that are essential to growth through technical assistance;

(iv) *Attracting* investors by playing a role of catalyst for financing operations;

(v) *Alleviating* the negative impact of financial crises through a financing that does not follow the economic cycles, by offering loans even during downturns and by pooling efforts with regional financing institutions.

Figure 1: A Pyramid of National Development Banking Activity

Table 2: The "Five A's"

Action	Target	Mechanism	Challenge

3. *General Framework of Analysis*

NDBs can contribute to solving a number of market failures. In particular they can promote financial sector development (III.A) by offering long-term loans and other financial products and by helping to create inclusive financial sectors. They can also enhance the climate for business and attract private sources of capital in the domestic economy (III.B), including by reducing economic volatility in the country, acting as a catalyst and promoting and supporting SMEs.

Nevertheless NDBs need to act on the right constraints, in order to avert renewing past mistakes. Many of them used to intervene either in sectors that (i) were not crucial for economic take-off or for the development of the country, or (ii) in sectors where these institutions did not have satisfactory competencies and capabilities, and (iii) in an unsustainable, politicized or poorly managed fashion. It might thus be necessary to carry an in depth micro, macroeconomic and strategic analysis before advocating for a specific intervention by NDBs. Due to the relative inertia inherent to any development project, from the preparatory phase to the disbursement, it is all the more important not to make any strategic mistake.

A general analytical framework may focus on priority constraints, as illustrated by the following decision tree (Figure 2). This figure shows the variety of causal explanations to any given ed for a country in which private investment and entrepreneurship are low: what should be done to remedy to this problem? It might be that while an NDB in country A may have no role to play, contrary to the bank in country B. It would be the case for instance if the problem is due to poor geography or low human capital in country A, and to high cost of finance or coordination externalities in country B.

Figure 2: Example of constraints for a specific problem

This approach can be used for analysis of NDBs rationale and missions and builds upon two types of information:

- The various causes to an identified constraint: market failures ought to be identified so that tailored solutions may be applied that might require public intervention;

- The primary cause or "main constraint": knowing a whole set of causes is not enough indeed – except for attempts to conduct 'wholesale' reforms', which are difficult to implement and had limited results in experiences conducted in Latin America in the 1990s. The goal is to remove the barriers that hamper growth the most in a country, by focusing on the economic constraints with the highest "shadow prices" in the economy, whether it be for health, education, basic infrastructure, SME support or financial sector development. Focusing mainly on such constraints will also reinforce the efficiency of policies in a context often characterized by scarce political and financial capital of reformers (Hausmann, Rodrik & Velasco, 2005).

Such analysis should be carried with a long-term view. Even though evidence may be found to identify constraints in the current environment, knowing what the next constraints will be is more difficult. In that regard, the process of adapting policies to changing circumstances was successful in Korea for instance over the past three decades, where bottlenecks to growth were identified early. The Korea Development Bank and the Industrial Bank of Korea were key to this forward-looking approach. The rationale of NDBs may thus include a necessary set of capacities (financial, technical), to react quickly and contribute to an efficient identification of the main constraints in the economy, actual and future.

Finally, once this analysis is over, a final step before deciding of an intervention may be to assess if an NDB would be the relevant institution indeed to respond to the identified problem. It is well-known, in particular, that some NDBs used to overlap with a number of private financing tools or actors when offering loans, financing to SMEs or equity.

III. The Evolving Role of National Development Banks

Transverse to all the considerations that follow is the quest for sustainability of national development banks. It is indeed the belief that some of these institutions carried unsustainable lending practices under heavily subsidized conditions that led to criticisms and, sometimes, dismantling. The World Economic and Social Survey (WESS) 2005 lists a few of the non-

infrastructure investment and maintenance expenditures are about 7% of GDP for all developing countries and up to 9% of GDP for low-income countries.

Yet long-term funding for infrastructure goods is affected by different kinds of difficulties. First, especially in Latin America, despite financial reforms to enhance intermediation and increase saving rates, the problem of insufficient saving persists. This means that the engagement of development banks continues to be necessary to strengthen the market (ECLAC, 2003). Second, long-term lending faces a number of well-known market failures (lack of information, excessive collateral requests, lack of credit guarantees, mismatch between assets and liabilities maturities in firms, legal inefficiencies or cost of contracting). This requires from governments a holistic approach to create the adequate environment for long-term projects, including sectoral reforms to reinforce competition and facilitate entry by new producers. Entry barriers are often an important obstacle to growth (Tybout, 2000), in particular regarding regulatory constraints. Market failures also require: better regulatory arrangements and supervision; efficient tariff regimes based on cost recovery; predictable policies for key sectors of water and sanitation, or energy; and effective mechanisms to allow for the resolution of disputes which arise in sectors such as infrastructure, where contracts are often valid for a 15 or 20-year time period. All these elements depend on national policy-making that goes much further than what NDBs can accomplish, but that are nevertheless crucial to their success.

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As a result, some NDBs tend focus heavily their long-term loans on infrastructure. Some have geared almost all their resources to this purpose. For instance, from the time when the China Development bank was established in 1994 to the end of 2005, nearly 90% of its lending was directed towards infrastructure in eight key industries - power, road construction, railway, petro-chemical, coal mining, telecommunications, public facilities, and agriculture.

Certain developed countries' banks also use long-term infrastructure loans as a form of official developmiective -asrriers-Fnrry oi thanle004il258(i).0002 Tc0.0movech as

Lending over the long term for infrastructure projects is obviously a complex challenge that requires proper project finance assessment. This is true in particular for energy projects, for which typical public-private partnerships, or more sensitive independent power purchase projects, have sometime been disappointing in terms of revenues (user tariff setting difficulties) and consumer satisfaction. Thus, it might be advisable for an NDB willing to take part in such projects to wait, for instance until the construction phase is over in order to partially reduce their exposure. This is what BNDES did in the case of the Norte Fluminense Light Project in Brazil, a 780MW electricity deal (distribution and generation) where most private sponsors had left by the end of the construction phase: BNDES offered project finance (70% of the financing through loans, the rest being equity provided by the sponsors) only when commercial operations started.

Private vs. official resources for infrastructure financing

The financing of infrastructure is very much linked to opportunities of private sector resour5 0(sab5n(vks1saz

- Offer long-term loans to domestic investors or also to foreigners. This has significant impact on the bank's activities and ownership. For instance, the National Development Bank of Botswana decided that both foreign and domestic investors would be eligible for long-term loans and equity capital. Nearly a third of the bank's loan value is owned by foreign sources (Source: NDB of Botswana);
- Pool resources: this is true not only at the regional level but also at the local level. The so-called "Bond banks" pool underlying loans to municipalities by consolidating them into a size that is marketable. Bond banks offer two important advantages: the reduction of risks and the economies of scale. Although they differ from the traditional nature of NDBs – they are intermediaries that can finance themselves on the market- they provide an interesting case for analysis. Developed countries offer interesting bases for discussion, such as KommuneKredit in Denmark, Crédit Municipal in France, or the Finance Corporation for Municipal Enterprises in Japan.
- Develop far-fetched instruments: co-financing, credit lines, equity, mezzanine finance (subordinate loans or participation certificates) or syndications, possibly with regional financial institutions;
- Go as far as acting as a market-maker -admittedly in a smaller extent than their regional and multilateral counterparts. As stated in the WESS 2005, *"it may be desirable to design institutional arrangements in which development banks play an essential role in the creation of new markets, including different mechanisms for long-term lending";*

A number of additional innovative instruments could also be developed by building fully or partially on the private sector. In particular long-term, fixed-rate loans for infrastructure projects could be bought by national development institutions from private lenders, thus creating a new secondary market for long-term financing (Dodd, 2005).

Risks

Long-term loans increase liquidity risk, and therefore require lenders to maintain sufficient long-term liabilities, equity, or other sources of funding. This might call for increasing the amount of equity and donor grants. Also, for banks using various funding sources such as savings, domestic bond issues or bank loans, sophisticated asset-liability management is necessary to manage interest rate, liquidity, and foreign exchange risks, as described in the next part (A.2);

Box 1: Liquidity Management for Long-term Loans

Long-term loans account for more than half of outstanding loans of the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, which uses long-term deposits and government-negotiated loans from the World Bank or ADB to ma

2. *Providing Other Financial Products for Development*

<u>*Short-term financing*</u>
Many NDBs used to provide significant amounts of short-term loans and less for long-term projects. Admittedly this was not systematically the case – BNDES for instance was specifically created in the 1950s in Brazil to offer long-term loans that were insufficiently provided in the economy. Yet this was a frequently used mechanism, in particular by agricultural development banks in the past. Unfortunately, these short-term loans used to perform poorly and contributed to the poor financial health of a number of development financing institutions starting in the 1970s: repayment rates were too low, lenders were insufficiently screened and loans were rolled over too easily. The development impact was low.

Therefore short-term loans seem not to have the favor of policy-makers, all the more as this kind of lending is more readily available from private commercial banks. Moreover, in a context of increasing interest for infrastructure development, there is today less focus on short term financing. This evolution is visible in particular by the fact that second tier banks are used to increase the maturity of loans to businesses, by providing funds to first tier development banks for longer periods of time.

Yet, simply put, short-term markets remain a priority for financial sector development. If there are no short-term markets, there cannot be long-term markets – just as there ought to be a secondary market. There is thus still ground for NDBs to provide this type of products and most of them do offer short-term loans, for several reasons including:

- Because even for infrastructure development there are several much-needed short-term products not readily available from the banking sector in certain developing countries. This includes trade finance, working capital, personal loans and treasury services;
- Because interest rates by private commercial banks are often high for SMEs;
- Considering the growing link between certain NDBs and existing microcredit institutions, the short-term loans that characterize microcredit are being added to the portfolios of these NDBs;
- And because exporting firms face particular e cannot beg:

Multilateral and regional development banks are currently promoting projects that can foster securitization and structured finance. IFC for instance works in emerging markets to establish specialized institutions and provide advisory services to clients in structuring securitization transactions. The IADB's approach is to avoid subsidized lending and focus on market rate loans coupled with grants, to encourage a competitive environment for private sector bank lending and marketable loans for future securitization.

Syndication

Syndication is underdeveloped in many developing countries and needed in a number of emerging markets. Syndicated loans are credits granted by a group of banks to a borrower. They are "*hybrid instruments combining features of relationship lending and publicly traded debt*" (source: BIS). They enable the distribution among institutions of bank loans and securities, in order to share risk and future returns. Credit syndication appeared in the mid 1970s, and at the time of Mexico's sovereign default in 1982, syndicated loans amounted to most of developing countries' debt. After the restructuring of the Mexican debt in 1989 (Brady bonds), emerging market borrowers shifted their preference toward bond financing. Only since the last decade has the market for syndicated credits thrived again.

In certain international and regional development institutions, syndication now accounts for significant amounts of financial commitments: for instance, loan syndications at the IFC account for nearly 13% of its commitments, accounting for more than a billion dollars a year. Several development banks have set up project pipelines for syndication, which are constituted of development projects receiving MDB or RDB loans, not only A-loan type but also B-loans, with long tenor. NDBs can co-finance such projects. For example, the IADB co-financed the energy project "ATE II Transmission Line" in 2005 with BNDES: IADB brought $60 million in A-loan and $10 million in B-loan with a 13 year tenor. Such co-financing, opening the door to large syndication deals, should be promoted for infrastructure projects.

Syndication also accounts for a growing share of the activity of NDBs, which, with the support of private commercial banks, leverage important resources for domestic projects. There are complex examples – like the above-mentioned case of ATE II - and simpler ones: syndication can use only one NDB and one main bank – such as Banque de Développment du Mali and Société générale for instance who had syndicated a total amount of $288 million in 2003 for the Compagnie Malienne pour le-20.785 -1.150.064syndicataion

Syndicated loans have thus become a significant source of financing for emerging economies. The international market (i.e. for deals with one foreign lender) accounts for a third of all international financing, including bond, commercial paper and equity issues (Ganadecz, 2004). Following the wave of privatizations in emerging markets, banks, utilities, and transportation and mining companies (where syndication is widely used to reduce credit risks) have started to displace sovereigns as the major borrowers from these regions (Robinson, 1996). In this new environment, NDBs will need to assess and grow their capabilities to increasingly build upon such syndicated loans to finance infrastructure projects.

Equity and quasi-equity financing

Equity financing includes long-term subordinated securities with stock options and/or warrants. Once profits have paid back the return on investment, the financial institution can sell its share of the business. Quasi-equity includes convertible debt and subordinated loan investments, with a fixed repayment schedule, and preferred stock requiring less

is the case for instance of the Overseas Private Investment Corporation (OPIC), established in 1971 as a self-sustaining United States government development agency, whose direct equity investments through its supported funds complement its insurance and project finance activities.

markets guarantees. Similarly, the IFC offers sophisticated products of risk management, including hedging of currency, interest rates, and commodities.

The capacity to offer similar ways to support complex or unusual deal structures could only be developed by certain large NDBs, with sufficient available expertise on derivatives, a capacity to take risks over the long run, an excellent rating and good relationships with financial markets. Overall, NDBs should work with partners to advance further on technical risk mitigation projects. This can entail:

- Sharing project risks with private sector actors, multilaterals and agencies of donor countries: for instance the Rio Polimeros integrated ethylene and polyethylene project, in 2000 in Brazil, saw the three main lenders to the project, BNDES, Ex-Im Bank of the United States and SACE (Società italiana di Assicurazione dei Crediti all'Esportazione) group together to offer a combination of construction and commercial operating period comprehensive commercial risk and political risk guarantees.
- Working with multilaterals: in particular, the IFC and MIGA can be relevant partners for NDBs with strong assets. For instance in 2003, the president of BNDES announced the Brazilian government's intention to create an infrastructure investment fund, backed by the assets and shares of public sector companies and enjoying a multilateral guarantee by MIGA: the fund may be used to guarantee long-term public sector obligations and to issue debentures. The framework which Minas Gerais in Brazil has put in place also includes a fund based on the idea of using state-owned assets and shares as collateral for public sector obligations (source: PWC, 2003);
- Working with regional institutions: mechanisms implemented recently with success, for
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especially in Latin America (World Business Survey 2002). That is why some NDBs provide support to SMEs in gaining access to both domestic credit and financial markets. In particular this means supporting microfinance institutions and fostering local financing and promoting entrepreneurial talent for industrial development. It is the prime objective of certain development banks, such as the Andhra Pradesh Industrial Development Corporation in India. These elements are further described in Section B.1.

Access to credit for rural development

For rural development, certain NDBs, in low income countries in particular, have a crucial role to play. The goal is to offer an access to financial services to agricultural workers that are often unbanked despite significant financial needs. Thus a number of agriculture development banks often offer a wide array of service to its poor clients, which can include credits, savings accounts, and administration of trust funds – as for inst

were successfully reform like BankRakyat Indonesia (BRI) and the previously mentioned BAAC in Thailand and BNDA in Mali. Further analysis could be pursued on this issue.

Local financing

NDBs considering a shift of resources toward local financing should take into account local markets specificities, the need for advantageous financial products requiring State intervention, and understand the reason behind the disinterest by commercial banks regarding this market.

The last two decades saw a conversion of direct lending operations into "apex" lending mechanisms by IFIs and bilateral aid agencies. The process for apex loans is rather simple: firms looking for financing contact an intermediary bank, which sends the project for approval to an Apex bank. The Apex bank screens the projects, sometimes forward them to the IFIs or bilateral agencies, for approval. Only then does the intermediary institution disburse the loan. This has several benefits often not found under conventional loans, in particular by allowing for long-term loans, for instance by phasing payments of loans in smaller amounts over a long-term. Another significant advantage of such mechanisms for NDBs is that financial institutions that handle the resources also assume the credit risk on the loans they approved.

Apex banks led to an expansion of financing made available on a sub-national basis. Examples abound in that regard, such as NABARD in India, established in 1982 as an apex institution, accredited with all matters concerning credit for agr adffssumsat flture a.5(s)-5.4tact an fD il aidto.4 creolateraic

medium or long-term loans with cities, at market rates and according to prudential rules in conformity with the country's bank laws. Examples: DBSA and INCA (South Africa and SADC).

Source: Agence Française de Développement (AFD)

Microfinance Institutions

Microfinance Institutions (MFIs) may contribute to the reduction in inequality, which is mostly

also help in establishing credit bureaus that are said to be a major drawback to building an inclusive financial sector. However, by so doing commercial banks need to adapt to a singular market. It is successfully managed by microcredit organizations because they resort to informal organizational structures; they know how to adapt to irregular cash-flows, and to sectoral and geographical heterogeneity (Rosengard, 2004). Thus NDBs interacting in the microcredit market will need to be careful in their strategy, as credit services that do not fit with needs will affect the poor clients they are supposed to serve.

B. Improving the Business Climate

1. Promoting and Supporting SME development

There are two institutional ways for domestic institutions to promote and support SMEs. The first is to enhance the capacity of existing NDBs, and the second is to create development banks focusing specifically on SMEs. This is the case for example of India, where the Small Industries Development Bank of India (SIDBI) was created in 1990 as a specialized financial institution of the Central Government. But whatever the institutional choice made by governments, the aim regarding SMEs is similar: the promotion, financing and development of SMEs. This can be conducted through the supply of low-interest funds directly to SMEs or through financial institutions, which in turn finance them under a refinancing system, and through medium and long-term lending as developed earlier in this paper.

In order to reach these objectives, certain development banks considered the reviewing of their strategy a necessity, by adopting a clear client oriented approach with SMEs. The relationship with the client is indeed an important element for NDBs willing to develop or focus on this segment. For instance, NAFIN in Mexico has redefined its strategy in depth in 2002, for operations as much as for management, to foster a client-oriented approach and enhance the quality of service.

Financial mechanisms

There are various financing mechanisms that can help support SME, from working capital loans to leasing or foreign currency loans and equity assistance. It can also include the provision of indirect financing, through refinancing of banks. There are several interesting examples in that regard in Latin America, noticeably in Mexico through NAFIN or Chile, through the second-tier banks Corporación de Fomento de la Producción (CORFO) and its Branch for technical cooperation Servicio de Cooperación Técnica (SERCOTEC). It is also true of Banco del Desarrollo or BancoEstado.

Examples on the financing side of SME support include the creation of equity funds schemes for small projects, of venture capital funds or, as mentioned previously, of guarantee funds for SME loans that often lack the necessary collateral. Under venture capital mechanisms, development banks usually create subsidiaries, partially based on successful cases in donor countries, in Canada (Development Bank of Canada), Japan (JBIC) or France (AFD/Proparco). Under equity arrangements, instead of providing loans to SMEs, NDBs take equity or shares in the enterprise. The share will be held in the name of the bank, which will receive as its remuneration a portion

of annual dividend that relate to the shares it has acquired. Equity participation usually covers up to 50% of project costs, with varying floors and ceilings for investments though. Shares acquired under this process can be held over long periods.

Guarantee mechanisms

There is no consensus on the advantage of mechanisms such as loan guarantee schemes that are accused of encouraging moral hazard and adverse selection, but also of having high administrative costs due to inadequate procedures, of delays in the payment of claims, and limited demand by SME borrowers. In the past many of the loan guarantee schemes failed due to mismanagement of the guarantee funds by executing agencies and banks (UNCTAD, 2001). For instance, the Guarantee Facility for the Financing of Small-Scale Enterprises in Lesotho was funded in 1991 by UNCDF in the form of a deposit to Lesotho Bank. Yet it had a very high loan default rate (58% on average) coupled with insufficient monitoring and lack of response to defaults, as noted in a subsequent evaluation of the project five years later. It might thus be fairly reasonable to think that guarantee schemes would be, whenever possible, better channeled through NDBs known for their good management and relationships with SMEs rather than directly to commercial banks with an unclear record for monitoring small businesses.

Guarantees are crucial to fa1 -1.s30.00069 T9otho was

focusing on growth of human capital, knowledge and IT. For instance, Malaysia's development banks have put strong focus in the recent years on professional development, IT training and engineering centers, as illustrated in Malaysia by Industrial Development Finance Berhad, Sabah Development Bank Berhad or Bank Pembangunan & Infrastruktur Malaysia Bhd (source: Institute Bank-Bank Malaysia). Through cooperation among their members, associations of development financing institutions (ADFIMI, ADFIAP, etc.) are also providing advisory and consulting services.

Overall, enhancing technical assistance can be conducted through partnerships between national development financing institutions, business associations, and networks of entrepreneurs or business development service providers. It can focus on:

- Project development: to support the planning and design of projects. Grants can be applied towards project development costs, such as needs assessments, feasibility studies, or environmental assessments;
- Training: to offer workshops and seminars aimed at providing practical instruction in the financial administration and planning, as well as other essential management skills.

Looking at sectoral specificities on these issues, there is in particular a strong need for technical assistance in the agricultural sector, as mentioned earlier. Several Sub-Saharan African countries beefed up their focus on this sector, as for instance BNDA, which ceased focusing only on lending – a policy that had failed in the 1980s - and has been increasingly offering technical expertise in a successful commercial fashion. In Asia, the same process has been taking place since the early 1990s, as illustrated by the National Bank of Vietnam which provides support to the agriculture sector in collaboration with donors such as the Canadian International Development Agency.

2. Reducing Volatility

Private bank lending tends to react

the sense that the credit extended by state-owned banks located in developing countries tends to

- Increasing linkages: successful infrastructure projects are made possible when they are not conceived as stand alone projects but are part of development plans. To do that, it is necessary to look at sectoral linkages and to develop the potential for synergies, for optimum economic and social returns;
- Facilitating investment: local investors need to be in relationship with foreign sources of capital and technologies, and foreign private investors require credit, political and foreign exchange risks to be addressed before they join in the projects. Some NDBs have thus put increased emphasis on this role in the recent years through:
    - Enhancing the attractiveness of the country to investors: For instance, the Lesotho National Development Corporation has a specific mandate to promote Lesotho as an attractive investment location for both foreign and indigenous investors;
    - Guarantee mechanisms: to enhance credit by fostering electronic factoring, guarantee funds and venture capital. Gu

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Public-private partnerships (PPPs) have become more common for the financing of infrastructures (WEF, 2005). In developing countries, Mexico and Chile are among the first countries, in the 1980s, that used PPPs to promote private sector participation. PPPs represent a very significant potential for investment in infrastructure as they can contribute to leveraging important amounts of financial resources. In that regard, they account for a growing share in NDBs' strategy for financing infrastructure projects. Through BNDES for instance the Brazilian government, with Corporación Andina de Fomento (CAF), the Inter-American Development Bank and Fonplata, has been implementing recently a number of transport projects aimed at improving regional integration.

National development banks can make good use of PPPs to transfer risks and encourage large-scale financing operations in developing countries. Just as regional or multilateral development banks, some NDBs can act as facilitators, promoters or even investors. New funding packages are put forward to support PPPs, including equity financing, loan assistance, technical assistance and project debt finance, which for instance are all being implemented by South Africa's DBSA. Risk transfer must be clearly understood though, as PPPs admittedly lower the overall level of operational and financial risk, but the viability of PPPs still rests in part on the public sector. Regional integration can also be facilitated through public-private partnerships. For instance, the Rio Group of Latin American countries has envisioned in 2004 a regional approach to infrastructure development that would involve PPPs, based on examples found in the EU.

However, efficient PPPs require a proper legal and regulatory environment. Fiscal responsibility by the government is necessary and should include restrictions in assuming new liabilities without proper funding. This was for instance the purpose of a 2004 reform of PPPs in Brazil that, in particular, limited the exposure of State-owned banks and NDBs to PPPs. These measures "were intended to improve the public sector's payment credibility, which has been compromised by broken contracts in the recent past" (Harvard International Review, Spring 2006). Similar or stronger legislations in other developing countries are needed to extend the time period of payments through bond issuing, with cash flow securitization. It might also be useful to allow the use of market tools such as guarantee funds to facilitate some PPPs.

Regional integration

As illustrated by previous examples, national development financing institutions can also pursue efforts to be part of the partnership with regional and multilateral institutions that play a catalytic role. Such institutions often support State, provincial or local projects. Reading the IADB's Institutional Strategies, for instance, shows how regional entities may be willing to act as catalyst for domestic development projects, in which NDBs can take an active role. The IADB in particular works with borrowing governments to support projects sponsored by the private sector, NGOs and State, provincial and local governments that strongly contribute to the achievement of national development goals and in which IADB may play a catalytic role.

Further integration can be promoted by RDBs together with sub-regional development banks and NDBs. This is being done in many regions and in particular in the Middle-East and North Africa

region, for instance by the Islamic Development Bank. IDB indeed improved its operational relations with NDBs through a greater utilization of its lines of financing. Among these are the provision of 'free limits' in the approval of sub-projects of up to 25 per cent of the overall approved amount of the lines of financing, and the securing for the national development financing institutions of a margin of 3-5 per cent over and above IDB's mark-up.

NDBs can also develop direct linkages with other NDBs to foster the regional impact of their activities and common strategies. For instance the Industrial Development Corporation (IDC) of South Africa and Lesotho National Development Corporation (LNDC) are now cooperating on capacity building, technical assistance, economic research and project financing.

C. Capacity-Building of NDBs

1. Improving Prudential Regulation and Supervision

Challenges of regulation

In the early and mid-1990s there was significant private sector participation in infrastructure projects in developing countries. After the East Asian financial crisis hit in 1997, it became clear that many of the projects carried large hidden public costs. This was partly due to the fact that regulatory issues in infrastructure sectors had not been properly tackled. Costs were not properly disclosed, tendering and procurement policies were inadequate, tariffs were not scrutinized closely, and regulatory bodies were weak and lacked the technical expertise and power to enforce laws and regulations.

Such issues go beyond this analysis and to address them it might be necessary, in addition to efforts by the banks and governments, to use technical assistance by the multilateral and regional banks as well as bilateral agencies. For instance, the ADB currently assists regulatory authorities' institutional strengthening in Azerbaijan, India, Pakistan and the Philippines. These activities involve the provision of technical advice for tariff setting, regulatory judicial processes and settlement of disputes.

Bank regulation and rating

Building legitimacy of institutions through rating is another important part of a country's progress toward deeper capital and credit markets and requires strong and independent supervision mechanisms. But before analyzing the specific need for rating of NDBs, one should also address country-level needs. By giving an independent assessment of the credit worthiness of a country, rating can indeed help attracting new investors – it is even a requirement for many of them. In that regard, rating is being increasingly used in loan markets, for bank regulation and domestic markets (Kotecha, 2004). Regional Development Banks are aware of this need and for instance the Islamic Development Bank was recently involved in the creation of an International Islamic Rating Agency (IIRA).

The rating of NDBs themselves is an important elem

allocation, and diverts resources away from activities that are vital for poverty eradication and economic and sustainable development" [para.13] and

- The World Summit Outcome document: "*We acknowledge that good governance and the rule of law at the national and international levels are essential for sustained economic growth, sustainable development and the eradication of poverty and hunger*" [para. 11]; "*We resolve (…) to make the fight against corruption a priority at all levels and welcome all actions taken in this regard at the national and international levels, including the adoption of policies that emphasize accountability, transparent public sector management and corporate responsibility and accountability, including efforts to return assets transferred through corruption, consistent with the United Nations Convention against Corruption*" [para. 24.c].

A related matter is the need for expertise in auditing and independent oversight of these institutions. Banks need indeed to have mechanisms in place to ensure sufficient oversight of projects, at the various stages, from approval to implementation phases. This should include financial and administrative, environmental and social impact analysis. It should be ensured that resources have been used appropriately, that the executing organization complied with financial contractual clauses and that internal control procedures are effective. Progress in that regard has been significant in the recent years for some banks. The Banque Gabonaise de Développement for instance launched a review of its supplier and an audit of its branches, and such efforts contributed to attracting new bilateral and multilateral support to the bank. The government of Gabon, which launched an important sector-related forest environment program (PSFE) in 2004, received the backing of the World Bank and a bilateral development agency (Agence Française de Développement), resulting in new credits by these institutions.

Management

Management and organizational efforts include the establishment and adequate composition of a board of directors and a large degree of autonomy in decision-making. The board of development banking institutions, when established, should take the management of operational risks as seriously as the control of financial risks. They should be accountable for their management on a regular basis. Best practices can be fruitfully shared in that regard with existing structures at a regional and multilateral level. Functional committees, comprised of Board members and senior executives, could be established to reinforce the oversight of the NDB's management.

Previous inconsistencies and bureaucratic complexity had led some development banks to manage resources under short-term criteria, and they often demonstrated as a consequence a poor collection record with their borrowers. Especially at times of economic crises, those banks' management was unable to react swiftly enough and tended simply to roll over the loans. Credit allocation in some NDBs often reflected "*poor risk management, which, combined with inadequate collection policies, kept loan recovery rates much lower than those of commercial banks. Financing based on fiscal sources and multilateral institutions, combined with a lack of budget transparency, generated a high opportunity cost for these resources*" (Titelman, 2005).

The planning, implementation, and evaluation stages of project cycles ought to include result-based approaches, with adequate accountability, monitoring and evaluation mechanisms. Part of the monitoring can be done in-house through adequate desk and field monitoring, review of project implementation and review of project completion reports.

Yet while the impact of projects may in theory be measured through a simple cost-benefit

Index of Stakeholders

A

Ad Hoc Expert Group Meeting · 3
ADB · 13, 15, 16, 21, 31, 39
AFD · 15, 20, 24, 25, 34, 39, 40
Afreximbank · 7
Agence Française de Développement · 34
Andhra Pradesh Industrial Development Corporation · 22
Andra Pradesh Development Bank · 8
Austria · 6

B

BAAC · 16, 23
BANADESA · 22
Banco de Avio · 4
Banco de Comercio Exterior de Colombia S.A. · 6
Banco del Desarrollo · 25, 33
BancoEstado · 8, 24, 25
Bancolombia · 24
Bank of Uganda · 23
Banque agricole et commerciale du Burkina · 8
Banque gabonaise de développement · 4, 34
Banque Régionale de Solidarité · 8
Banrural · 22
Blue Book · 21
BNDA · 7, 22, 23, 24, 27
BNDES · 5, 7, 8, 15, 17, 18, 19, 21, 30, 33
Botswana · 4, 16, 19
Botswana Development Corporation · 4, 19
Brazil · 5, 15, 17, 19, 21, 30, 33, 39
Burkina · 8, 23

C

CAF · 8, 30
Canada · 25
Caribbean Development bank · 8
Caricom · 8
Chile · 8, 24, 25, 30, 33, 40, 41
China · 14
China Development bank · 14
COFIDE · 6
Colombia · 6
Commonwealth Development Corporation · 6
Compagnie Malienne pour le Développment · 18
CORFO · 25
Council of Europe Development Bank · 8
Crédit Municipal · 16

D

DBSA · 5, 7, 18, 23, 30
DEG · 6
Denmark · 16
Development Bank of Kenya · 6

E

ECLAC · 14
Egypt · 7, 24, 39
EIB · 23
EKN · 15
Eksportfinans ASA · 6
Eximbank of the United States · 6

F

Finance Corporation for Municipal Enterprises · 16
FINFRA · 14
FMO · 6
Fonplata · 30
France · 3, 15, 16, 18, 25, 33

G

Gabon · 8, 34
Germany · 3, 6, 15, 22, 33
GIEK · 15
Guatemala · 22

H

Honduras · 22

I

IADB · 8, 1, 17

K

Bibliography

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