Multilateral Development Banks

and Their Relations to Hungary

Summary of Doctoral Theses

by

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Short summary of the aims of the research

The aim of the research was to provide a universal definition, to present their operation and activities, and after the presentation of the individual banks, the establishment of classification criterions, that influence the operation and activities of such banks. The doctoral thesis has been carried out under the auspices of the School of Doctors of the Pázmány Péter Catholic University (Faculty of Law), and summarises the knowledge gathered by the author during the past 7 years. Although Multilateral Development Banks feature in a considerable amount of papers, there are hardly any researches that aim to give a complete picture on these institutions. Most of these analysis's focus on a particular bank or a group of banks, and often involve stakeholders (e.g. the bank itself) having particular interests (such as the reform of the particular institution concerned), rendering their research somewhat biased. Studies published by NGOs may often lack objectivity. The aim of this paper is to give a far reaching presentation, that allow an objectivity necessary for independent analysis.

Particular actuality to the research has been given by the consecutive enlargements of the EU, leading at the same time to the accession of the new EU members to the EIB, and also in 2004, by the accession of the Baltic States to the Nordic Investment Bank.

The paper consists of 8 parts, each divided into chapters. The approach of the paper changes with the part concerned, starting with a rather general approach, the definition of Multilateral Development Banks. Each part focuses on a more specific element, while the final chapter concentrates on an individual institution, the EIB. The paper therefore applies a rather deductive approach in its entirety.

Executive summary of the Thesis

This paper intends to give a more complete picture of the numerous Multilateral Development Banks active all around the world, having different ownership structures, activities and geographic distribution. When describing Multilateral Development Banks, most analysis focuses on banks that follow the model established by the World Bank. However, the model included in those definitions may not apply to many Multilateral Development Banks. This Paper uses therefore a wider definition, according to which Multilateral Development Banks are banks possessing international legal personality, and their owners are international legal persons as well

(i.e. states and international organisations). The Multilateral Development Banks mobilise their assets acquired in the private capital markets and from other sources to finance the realization of public needs, which would not (or not at the same level) have been otherwise satisfied. The paper highlights 4 main elements of a Multilateral Development Bank: bank attributes, international legal status, involvement of private capital, and public needs. The banking attributes represent an elementary aspect of their operation, as each Multilateral Development Bank will have to pay back its loans acquired under market condition. The banking activity is an element that distincts Multilateral Development Banks from other international financial institutions. Their international status allows them to operate in regions where lack of political stability prevents foreign investors to enter. As international organisations, they are created by international treaties, their owners are international entities, and they possess international legal personality. The third element of a Multilateral Development Bank is private capital, which is a consequence of banking attributes. The involvement of private capital may occur on two different levels. The more indirect involvement of private capital in financing an MDB project is the financing of the Multilateral Development Bank itself (i.e. buying bonds issued by the institution). A second, more direct financing method by private capital occurs when a project financed by a Multilateral Development Bank is cofinanced by other private investors. The aspects of private sources are often neglected by critics that aimed to reform these institutions. Any such reform may bear consequences to such an institution, as the financing capital markets may not tolerate irregularities in the repayment of the banks resources. The fourth element is public need. Beyond its general non profit purpose, each Multilateral Development Bank is created to fulfil a particular purpose. Such purpose may be the assistance to a particular region, or a particular category of countries or assisting specific sectors. The European Bank for Reconstruction and Development is for example dedicated to provide financial and technical assistance to the transition economies of Central and Eastern Europe, and there are several regional development banks that limit their activities to a particular region. Therefore, a relatively high number of Multilateral Development Banks can peacefully coexist, dividing their "market" geographically or by their particular purpose.

Beside the four elements described above, there are 3 elements that some analysis contains, but according to the author, they are not fundamental to their existence and do not apply to all Multilateral Development Banks. The distinction between developed and developing countries is a fundamental element of a number of studies

(e.g. studies focusing mainly on the World Bank), although this distinction is usually significant where these banks operate partly or mainly in developing countries. Consulting activities may form an integral part of the operation of a multilateral development bank (also as a measure to safeguard their investments), however, such activities by banks mainly active in the most advanced and developed countries may be rather pointless, as their borrowers are up to the highest prudential and financial standards. Some Multilateral Development Banks may prescribe particular conditions for their lending, such as obligations to perform certain economic reforms or to maintain sound budgetary conditions. However, many banks (e.g. the Council of Europe Development Bank) do not need such safeguards. Multilateral Development Banks may differ from other institutional models only by one or two attributes. Some of these institutions may not have an international status, or they do not gather sources from the financial markets. Some of these institutions (e.g. other international financial institutions granting non refundable aid, such as development funds) may be complimentary to the activities of the Multilateral Development Banks. The Multilateral Development Banks constitute a particular group of the international financial institutions, as they may contain elements of international organisations and banks. Therefore they can be characterised by a hybrid nature. As international organisations, they are created by international treaties, and both these banks and their owners are international legal persons. As a consequence, these banks and their staff enjoy a wide range of (personal and/or financial) diplomatic immunities, providing an additional guarantee to their operations. The Multilateral Development Banks also dispose over most attributes of a bank as well, however, some basic elements are missing. Multilateral Development Banks bank may not afford to maintain a retail branch as cheap operational cost is a basic element of this model. In exchange, they rely on intermediaries, such as commercial banks or the state administration already created for the spending of funds dedicated to similar aims. Both elements of this hybrid nature are of crucial importance to the operation of a Multilateral Development Bank. The lack of any of these attributes may jeopardize its operation. Without the banking operations, the financing would be much more expensive, and without the international status, its lending activities and with it, the bank's portfolio would be far more hazardous.

Part II. on the structure of Multilateral Development Banks consist of a chapter on external organisational connections, and a second chapter about the internal structure of such banks. The Multilateral Development Banks presented in this paper usually form part of a larger institutional structure with wide range of interconnections.

Two dimensions of the institutional integration are presented in this paper. In one hand, most Multilateral Development Banks are part of an international organisation, having similar members and pursuing similar objectives (vertical integration). On the other hand, it might be necessary to create a number of separate international financial institutions to distinct the banking operations from the non refundable assistance or other activities. In that case the Multilateral Development Bank will be horizontally integrated into a wider range of international financial institutions.

The vertical integration refers to the external relations of a Multilateral Development Bank with other institutions. Multilateral Development Banks are created to foster particular objectives and aims, but in order to gather the impetus necessary for its creation, it is often useful to have an institutional framework, that provides basis for further cooperation. Most Multilateral Development Banks are born embedded into an international organisation or framework already existing or created at the same time as the bank. The Council of Europe Development Bank was created in 1956 by the member states of the Council of Europe. As a partial agreement, some of the Council of Europe members did not joint the bank for various reasons. The bank has no formal operational relations with the organs of the Council of Europe. However strategical decisions, such as decisions on the capital, or institutional reforms are carried out by the framework institution (the Council of Ministers). The main task of the European Investment Bank group is to promote the interests of the European Union (in all its necessary aspects). Although the European Investment Bank has an international legal personality distinct from that of the European Union, it is closely embedded into the institutional framework created by the Treaties. The widest institutional framework that the World Bank can rely on is provided by the United Nation. This framework includes the Secretariat, the programs, funds, and specialised agencies, which are established by partial agreements of the member states. The World Bank being one of the specialised agencies of the United Nation, has wide range of autonomy, that includes a distinct budget and governing organs, but they report to the Economic and Social Council and/or the Assembly. Although the European Bank for Reconstruction and Development is not part of such an institutional framework, it is far from being separated from the development community. The European Bank for Reconstruction and Development has inherited several elements of the World Bank's International Bank for Reconstruction and Development, although some of the contradictory elements have been modified, as sign of the evolution of the Multilateral Development Bank model. As owner of the European Bank for Reconstruction and Developments, the European Investment Bank proves to be one of the closest institutional partner of the European Bank for Reconstruction and Development. The Nordic Investment Bank is embedded into the co-operational structures of the Scandinavian countries. The objectives of the Nordic Investment Bank are consistent with the specific needs of the Scandinavian countries, in particular with regard to the environment.

The second aspect of the institutional framework of Multilateral Development Banks, the horizontal integration concentrates on the relations with other international financial institutions. This second aspect covers other international financial institutions that pursue their objectives in cooperation with the Multilateral Development Bank concerned. In some cases these international financial institutions are embedded into the same institutional framework on an equal level, in some cases they are in the ownership structure of the Multilateral Development Bank, either as shareholder or as part of their portfolio. The Council of Europe Development Bank is one of the few Multilateral Development Banks that do not have such specialised financial co-institution. Any activity, which is not compatible with the banking attributes shall be carried out on separate trust accounts. Within the European Investment Bank group, the European Investment Bank provides long term investments, while the European Investment Fund contributes to the economic development of the European Union by providing risk capital investment mainly to SMEs. Beside the European Investment Fund, the

European Investment Bank is also shareholder of the European Bank for Reconstruction and Development. Established in 1944, the World Bank is not just the largest source of development aid, but also the first and most influential Multilateral Development Bank in the world. The World Bank group itself has a wide range of tasks, which are carried out by a series of international financial institutions, that include the International Bank for Reconstruction and Development, as the prototype of all Multilateral Development Banks. The European Bank for Reconstruction and Development has no such coinstitution. Unlike other Multilateral Development Banks, it may carry out capital investments, e.g. in order to facilitate privatisations. Similarly to the World Bank, the Nordic Investment Bank group consist of a wider range of institutions.

The internal structure of a Multilateral Development Bank shows elements of both international organisations and banks. The organisational aspects are however dominated by the attributes of an international organisation, with some particularities, such as structures with two plenary organs. The primary plenary organ provides representation on the highest level with a more general mandate. However, a more general mandate implies also that the plenary organ usually does not intervene in the approval of individual projects, nor will it act in individual cases. It only defines the general guidelines according to which the secondary plenary organ establishes the actual portfolio. This secondary organ usually consists of experts either delegated by the member states, or directly employed by the Multilateral Development Bank itself, while the primary organ consist of representatives on the highest (usually ministerial) level. These two organs can rely on an independent administration structure, which is somewhat similar to a structure of a commercial bank, apart from the retail branch. As the traditional banking supervision may usually not supervise Multilateral Development Banks, the internal and external auditing body is the only possibility for banking supervision. An independent dispute settlement forum is particularly important, as these institutions are not subject to national law or any to the jurisdiction of any national court.

The fundamental operational principle of a Multilateral Development Bank is based on its banking activity. The private financing provides the most important value added in comparison to other sources of funding (e.g. to development funds). Bonds issued by Multilateral Development Bank are one of the most prestigious forms of investment and provide diversification possibilities for private investors. The rise of major globalised investors, such as pension funds, opened new perspectives for Multilateral Development Banks in the past 20 years to expand their funding. As their main source of funding comes from private investors, Multilateral Development Banks have to pay particular attention to ensure their sound and prudent operation, in particular that the member states banking supervision authorities usually may not supervise their activities. On the other hand, the member states guarantee that all due borrowings of the bank will be paid back. The ownership structure provides a twofold guarantee to investors: prudent member states, such as Germany, or the US, not just guarantee, that all debt will be paid back properly, even in case of a default of the bank, but they also reduce the chance of an eventual default by ensuring that the banks follow similarly high prudential standards. The fact that among others, some of the most prudent states provide guarantee, may not explain the fact, that these banks may obtain loans on better condition than their most prudent member states on their own. This can be explained partly by multiple guarantees provided by several sovereign owners, and partly by the loan scheme provided by these banks. Multilateral Development Banks usually provide funding for states or financial institutions unlikely to default allowing a very sound portfolio.

The model of a Multilateral Development Bank can be summarised as the following: such an institution is usually established by a set of member states (or other international entities) that subscribe a certain amount of capital to the bank. It will be vested with an international legal personality with all due powers and immunities. However, member states are in fact not required to pay in the total subscribed capital. Above the subscribed capital actually paid in, the callable capital remains at the member states disposal, but will be due to be paid when needed (however, it is unlikely, that callable capital would ever be needed with sound financial management, as the actual sources are provided by private investors who will buy the securities provided by the Multilateral Development Bank. The bank forwards the funds acquired at most favoured conditions directly to its beneficiaries on a non profit basis, allowing conditions unavailable even for sovereign securities of its members states with the highest credit rating.

One of the most successful example of the Multilateral Development Bank model is the European Investment Bank, which being established among the first such institutions, is currently one of the most important European lender. From the borrower states point of view, a Multilateral Development Bank is competing with the traditional forms of state financing (such as state bonds). A government may opt for borrowing loans (usually bound to a particular purpose) from a Multilateral Development Bank or issuing their own bonds with probably worse conditions. The Multilateral Development Bank sources may be even more attractive, when the Multilateral Development Bank obtained them on better conditions. On the other hand a Multilateral Development Bank may acquire own sources other than the traditional, refundable ones, such as non-refundable contributions of member states, or funds that are not own sources, but entrusted as co-financing to benefit from the banks institutional prestige, experience and established procedures.

The banks funds are allocated according to the operating principles enshrined in the long term operational plan. The individual priorities of the Multilateral Development Banks differ substantionally, therefore several Multilateral Development Banks may coexist peacefully in the same geographical area. In case of common priorities there are also possibilities to provide co-financing for each other. Multilateral Development Banks primarily active in developing countries focus on poverty reduction or basic infrastructure, while the ones active mainly in developed countries concentrate on improving competitiveness. The example of Hungary underlines the wide range of diversity of the services of Multilateral Development Banks. Initially Hungary was dependent on the World Bank's International Bank for Reconstruction and Development. After an economic and social reform, Hungary began its integration into the new international economic order. The conversion of its planning based economy into a market based economy had been aided by a specialized institution, the European Bank for Reconstruction and Development. This bank was specifically created to ensure a sound conversion of the Central and Eastern European countries (such as to provide infrastructure investments, or participate in bank privatisations), but several other institutions provided additional funds, in accordance with their lending principles and priorities. The wake of its newly created market economy and the gradual integration into the European institutional framework allowed Hungary to move towards Multilateral Development Banks that provide loans on better conditions. As the economic conversion in many countries had been successfully concluded, and the Council of Europe Development Bank and the European Investment Bank intensifies its activities in the European Union accession (and since 2004, member) countries, the World Bank and the European Bank for Reconstruction and Development are forced to shift their focal points toward the countries to the former Soviet Union. At the same time, as a member state of the European Union, Hungary had assumed new responsibilies in the international institutional order. As owner of the European Investment Bank, Hungary is a donor of loans and aids to developing countries. This process applies to most central and eastern European countries, that joined the European Union in 2004, although their economic rhythms differed substantially in the past 20 years. But the market (if we may say so) they offered for Multilateral Development Banks followed a similar pattern. After decades of World Bank dominance, in 1990 the European Bank for Reconstruction and Development offered an alternative (or co-financing opportunity) to these countries. The accession to the Council of Europe allowed some of these countries to join the Council of Europe Development Bank, which provides loans on much better conditions, than the previous institutions. Although its loans are bound by the rather narrow range of priorities (and therefore its lending is limited), the Council of Europe Development Bank was the first unipolar bank, that most central and eastern countries could join. With the European Union enlargement, in 2004 the new member states also joined the European Investment Bank, allowing a substantial rise in the Multilateral Development Bank loans. At the same time, the Baltic countries joined the Nordic Investment Bank, a Multilateral Development Bank established by Scandinavian countries. The latter two institutions are purely unipolar institutions, where the difference between poor developing borrower countries and developed donor countries completely missing.

As a consequence to their international character, Multilateral Development Banks operate mainly in countries different from their seat. Since the borrower is often the state of operation, there might be a conflict of interest, tempting the borrower to eventually undermine the investment by means of its own legal system. Therefore Multilateral Development Banks usually make legal arrangements to gain independence from that legal system. This allows them to settle legal disputes in a court outside of the jurisdiction of the borrower state, and also to ensure it’s financial and diplomatic immunities. Dispute settlement and immunities are provided for by international agreements, usually in annexes of the same agreements that created the institution. From the legal system of the borrower or member state (and for their natural and legal persons), however, these agreements have to be introduced through internal legal acts. One of the few exceptions is the European Investment Bank, which had been created by the EC treaty, therefore the direct effect and direct applicability of European Union Law bypasses the above mentioned gap between international and internal law. However, where European Union law does not apply, the activities of the European Investment Bank are governed by international law. In the case of Hungary, an international treaty governed the relations between Hungary and the European Investment Bank until the EU enlargement. With the enlargement, the Treaties have introduced the European Investment Bank to the Hungarian legal system.

The international legal personality is a distinct character of Multilateral Development Banks, vesting it with immunities, that provides additional guarantees for their operation. Through their international status, Multilateral Development Banks are above national law in many aspects and are on an equal footing with other states. Multilateral Development Banks are often embedded into larger institutional framework.

There are a number of classification criteria for Multilateral Development Banks. Although their size, priorities, and members differ substantially, there is a main classification criterion, dividing Multilateral Development Banks into two main subcategories: unipolar and bipolar banks. The purest form of unipolar Multilateral Development Bank is represented by the Council of Europe Development Bank, which only lends to its member states, and its lending is proportionate to its ownership. In case if bipolar banks, a number of wealthy developed countries subscribe the majority of the banks capital, without ever borrowing from the bank. The poorer borrowers are also member states and usually have more votes than it would be justified, based merely on their ownership. Therefore the ownership is divided into two interest poles. The pure form of this bipolar model is the World Bank. However some banks share attributes of both models.

While the first criterion was based on operational aspects, based on geographic aspects, the second criterion differentiates between global, regional and sub-regional Multilateral Development Banks. The most important global Multilateral Development Bank is undoubtedly the World Banks

International Bank for Reconstruction and Development, being active in most continents, it has well over 100 members states. Regional development banks focus their activities on a particular region, although their members include countries from other continents as well. The participation of the US or Japan in the European Bank for Reconstruction and Development ownership improves investor confidence and strengthens the bank's legitimacy. Banks belonging to the third group focus on a particular region not just for its activities, but also for its ownership structure. The sub-regional Multilateral Development Banks prefer to keep its membership within the region concerned. The Islamic Development Bank or the Council of Europe Development Bank having different backgrounds, the reasons to limit their ownership vary significantly.

The third criterion for classification is based on structural aspects. Most Multilateral Development Banks operate within a wider institutional framework. The Council of Europe Development Bank is part of an international institutional framework, provided by the Council of Europe, the bank and the institutional framework mutually strengthening each other. In the case of the European Investment Bank, the European Union has provided the initial impetus necessary for its creation, and the European Court of Justice provides a dispute settlement forum. Through its increased vertical integration, the European Investment Bank takes recourse to several institutional elements of the European Union framework. The horizontal integration embeds the Multilateral Development Bank into a framework of other international financial institutions, whose operations complement the financial services of the bank. The World Bank consists of 5 international financial institutions, complementing the refundable loans provided by the International Bank for Reconstruction and Development with non refundable aids, consultancy services or dispute resolution.