The Potential and Significance of BRICS Bank

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The idea of creating a separate bank or financial institution with focus on financing of infrastructure projects in developing countries and controlled by developing countries themselves has been in the air for quite some time. It is widely felt that developing countries are unlikely to get major help from the existing multilateral institutions such as the World Bank and the International Monetary Fund which are seen as being run primarily to protect the interests of developed western countries. There was a talk of setting up an Asian IMF during the East Asian financial crisis, as help from IMF was seen to be too little besides being packaged with controversial conditionality clauses. Though the plan to set up a new organization remained on paper, several Asian countries have seemingly adopted a strategy to build foreign currency reserves to get independence from the undependable western 'duo'. In this background a recent agreement reached by BRICS countries to set up a New Development Bank (NDB), popularly termed as BRICS Bank, is seen as a significant development that would lift BRICS from just being a talking forum. It is also seen as a positive development as the organization, operated and controlled by the

developing countries themselves, could be more successful in pushing development among developing countries through, inter alia, meeting high infrastructure requirements in developing countries, fulfillment of which is now considered synonymous with economic development.

This paper attempts an assessment of potential significance of the proposed new bank from three distinct but related perspectives. Firstly it would enquire potential role for a specialized development Bank (DB) vis-a-vis much wider and deeper international financial markets in providing funding solutions. Secondly, it would examine the sources of synergy among BRICS members to operate and run a new Multilateral Development Bank (MDB) that caters to the funding needs of large, capital intensive infrastructure projects either from all developed or from BRICS member countries alone. Lastly, it would assess the important, rather the crucial, role of political cooperation among the sponsor nations in realizing full potential of the proposed bank.

Potential Role for a BRICS Bank

The idea of a DB has had a long and checkered history. NDBs have existed since the nineteenth century in Belgium and France. The essential idea was that the state would adopt a lead role in providing long term funds and take lead to coordinate to bring technology and real resources together. In the aftermath of the devastation of the Second World War, the International Bank for Reconstruction and Development (IBRD) was established as a multilateral organization to facilitate reconstruction in Europe and economic development in developing countries that were getting political freedom. Simultaneously, the International Monetary Fund (IMF) was also set up on multilateral basis for maintaining stability in exchange rates and payments mechanism. While reconstruction in Europe was over without any controversy, the role of IMF and the World Bank, also known as Bretton Wood twins, in providing finance to developing countries has been quite controversial. Particularly, conditionality clauses stipulated by IMF that were perceived to be promoting free market ideology remained a bone of contention. That explains periodic calls to set up a new organization controlled by and of developing countries.

Together with the establishment of the Bretton Wood twins, several governments have promoted specialized DBs that are operating nationally. Notable among these are KfW in Germany, Korea Development Bank, Japan Development Bank, and IFCI, ICICI, and IDBI in India.

In India the central government initially promoted DBs for industrial development by providing initial promoter equity and facilitating raising of long term debts through domestic and at times overseas markets/multilateral organizations. Such measures provided wherewithal in their formative years. Later, sector-specific banks were established which focused on development of sectors such as agriculture, small industries, or exports.

New MDBs have also been set up regularly in the past. These include the African Development Bank (AfDB) (1964), Asian Development Bank (ADB) (1966), and the European Bank for Reconstruction and Development (EBRD) (1990), all of which had regional lending focus as reflected in their nomenclature. ADB and AfDB have also developed countries outside their area of operation as non-regional members who have contributed to MDBs' capital but do not borrow from these entities.

However, operations of MDBs have not kept pace with tremendous increase in cross-border investment flows. Over the years, cross-national flows have grown significantly and include activities of long term foreign direct investors (as also short term portfolio investors which are ignored here) vis-à-vis annual lending by international DFIs (Table 1). It is observed that flow of disbursements from select major MDBs are quite low in relation to annual inflows of FDI whether on global level or flows to developing countries alone. The same conclusion emerges even if the comparison is done in terms of *outstanding* portfolios of DBs and *stock* of FDI in developing countries. The above comparison may be appearing unfavourable to DBs which finance projects which are not necessarily commercially lucrative and hence may not be attractive for commercial financers. Without doubt, DBs were set up to bridge the gaps in the financial system. In that sense, investment facilitated by DBs, however small, would be a positive contribution to incremental investment and resultant income growth and employment.

Table 1: Cross Border Flows: Multilateral agencies vis-à-vis Capital Markets

(US $ billion)

	Disbursements during		Outstanding at end	
	FY 2009	**FY 2013**	**FY 2009**	**FY 2013**
IBRD	18.56	15.83	105.7	143.8
IDA	9.22	11.23	112.9	125.1
ADB	10.58	8.54	59.4	79.8
EBRD*	8.20	8.14	43.8	62.7
Af DB**	2.90	4.80	24.3	29.4
Total	49.46	48.54	346.1	440.8
FDI Inflows (World)	1221.8	1451.9	18427	25464
FDI Inflows (Developing Countries)	532.6	778.4	5364	8483

*Converted from Euro ** Converted from UA

Source: World Investment Report 2014 for data on FDI inflows/ stocks. Data on operations of DBs for their annual reports sourced from respective websites.

However, the gap in selection criterion adopted by MDBs and private financers may not be very large because MDBs also fund non-sovereign projects and that too in consortium with other (private) financers. If the numbers of projects that are viable over medium term are limited, it may partly explain the reason for relatively modest scale of operations of MDBs vis-à-vis FDI flows. Moreover, it would also limit their ability to mobilize to provide finance on the scale required to meet infrastructure funding needs of developing countries unless the projects are commercially sound even over a long time frame.

It is noteworthy that all MDBs meet their financing needs to a large extent by borrowing through international financial markets. Thus organizations that were initially set up as a better alternative to financial markets have now developed a complementary relationship with them (Table 2).

Table 2: Funding Pattern of Multilateral Agencies (end FY 2013)

	Paid in Capital	Capital & Reserves	Borrowings	Total Liabilities (including Others)
World Bank	13.43	39.52	142.4	325.6
ADB	5.97	17.14	61.63	115.8
EBRD	2.05	8.55	43.03	67.5
AfDB	4.8	9.26	19.98	32.66
Total	26.25	74.47	267.04	541.56

Source: Data on operations of DBs for their annual reports sourced from respective websites.

Data in Table 2 indicate that nearly 50 per cent of their balance sheets are funded by borrowings from international financial markets. MDBs also undertake derivative transactions to manage currency, interest rate, and liquidity risks confronted by them. These operations add to both assets and liabilities of these organizations which lead to an understatement of the contribution to the funding pattern of real "assets". Nevertheless, as MDBs need to convince international investors about the safety of instruments on offer, the project selection criterion cannot really be *very* different from what confront private financers.

Competition and deregulation have impacted operations of various DBs. With large scale deregulation, globalization, and market integration measures, several industry segments, including the financial services sector, have became competitive particularly since the 1990s. In such a situation, both finance and non-finance business companies often try to diversify their operations by increasing their presence in several markets and products. DBs too have diversified moving away from their protected narrow turfs in their attempts to become "universal". In the United States, repeal of the Glass-Stiegel Act removed the regulatory barriers between investment banks and commercial banks. The Development Bank of Singapore (DBS), a model DB for several years, took path to universal banking as it entered retail banking. A recent World Bank survey of DBs also reflects the diversified nature of DBs.

Government ownership, preferred access to funds, and a focus on providing long term funds (by way of loans, equity or guarantees) to target sectors are the major characteristics of DBs. The World Bank survey has defined DB to have at least 30 per cent state owned equity with an explicit legal mandate to reach socio-economic goals in a region or sector of a particular

market segment (Luna-Martinez and Vicente, 2012). This arguably is quite liberal definition and may qualify all commercial banks in India as DBs!

The survey found that DBs have moderate shares of domestic banking assets though the predominant government ownership still holds good. In only 5 per cent institutions state owned equity was below 50 per cent while in 75 per cent institutions it was still 100 per cent. It was found that their funding sources were quite diversified; 41 per cent of DBs were able to access deposits from general public and 89 per cent of them had access to loans from other financial institutions or debt issuance in the local market. As regards lending, 52 per cent DBs were in both retail and wholesale lending while 36 per cent were only in retail lending. While 90 per cent of them offered long-term loans, their portfolio seems to be diversified as 85 per cent were also offering working capital loans and 74 per cent bridge or short-term loans.

In India, two large DBs entered commercial banking space by entering the retail market to mobilize cheap deposits and extend relatively safe retail loans. Many state level DBs have become moribund though these are not formally closed. As domestic capital markets became deeper, large and established companies have multiple options to raise financial resources from international and domestic capital markets and would use bank loans only when these are comparatively advantageous.

Moreover, with preferred access to long term funds provided to DBs curtailed, if not stopped altogether, they had to diversify their funding. They could not carry on with providing long-term sources to targeted sectors on an *exclusive* basis. Moreover, it may perhaps be argued that with the development and matured financial system the need for development banking is reduced if not over.[1]

Is the decline, if not fall, of DBs relevant in deciding whether a new MDB would be successful? While it may be difficult to generalize from specific experiences of DBs, the declining trend cannot be altogether ignored. Both national and multilateral DBs are expected to meet shortfalls in the financial system's ability to deal with certain risky (but preferred from long-term societal benefits perspective) projects/sectors / clients. In addition, DBs were to synchronize / coordinate among different operators and government agencies to facilitate development of such preferred segments and to provide with necessary policy support.

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[1] This is however contested and continued need for national DBs is argued. Aldo and Lazzarini (2014) present a case for active state intervention based on success of such policies in Brazil which includes experience of BNDES as state directed lender. Roy (2014) seeks a distinct role for DBs in India in the light of success of BNDES.

What MDBs aspire to do instead is to manage risks associated with cross-country investments, improve information flows across investors located in different countries, bring about policy coordination among different countries, and facilitate implementation of cross-country projects: cross-country road or rail lines, irrigation, flood control projects that involves river flowing across two or more countries. This would depend mainly on mutual trust and willingness to cooperate and collaborate among sponsor members of MDBs.

Besides facilitating investment across different countries, multilateral DBs were set up to facilitate mobilization and channelization of funds for development projects considered risky but important in the post-war environment wherein international financial markets were not functioning and hence multilateral approach was adopted. However, over the years, with the development of international financial markets, MDBs could also supplement their resources through borrowing in international markets. Data in Table 2 also indicate that MDBs are operating at low debt equity ratios. This perhaps is part of their strategy to keep risk at lower levels which facilitate ensuring 'good' credit rating and access to the capital market on favourable terms. If MDBs have to maintain current debt equity ratio, their ability to expand operations gets linked to additional equity either by way of ploughback of profits or fresh capital contributions from members. Process of capital enhancement is time consuming as the experience of the Bretton Wood twins indicates.[2]

DBs are most effective when they are able to mobilize, in addition to finance, real resources that would facilitate conception, design, and successful implementation of large, capital intensive projects where established financiers are unwilling or unable to tread. While improved availability of long-term finance certainly provides more leeway in establishment of long gestation projects, DBs would be most effective when they are successful in choice of entrepreneur-promoter, technology, and market.

Infrastructure projects certainly need long term funds and the requirement of developing countries is quite large. But non-finance factors too are equally, if not more, complex and important as these involve several aspects such as pricing, entry of new players which are related to national policies, land acquisition (quite substantial in the case of road and solar energy projects), and rehabilitation of project-affected activities/persons. Projects spread over two or more adjoining countries heighten the operational risks as projects need to deal with regulations of several governments and inter-government agreements. MDBs may be

[2] The developed country governments are unable to agree to contribute to additional capital required for their respective enhanced quota with their domestic fiscal problems and need to control expenditure to achieve deficit reduction. Many national DBs have faced similar situations which have largely eclipsed their role.

well suited to deal with cross-national projects as DBs managed by multilateral forum may be well equipped to hammer inter-governmental agreements so very essential for implementation of such projects.

The promoters of MDBs supposedly would have a common urge to facilitate economic development in the target group of countries or region. But as there are already several multilateral development banks which are centered on different regions like Asia (ADB), Africa (AfDB) and Europe (EBRD), besides the World Bank which operates globally, the case for one more such organization is not obvious.

The relatively small size of the portfolio built up by multilateral DBs (Table1) could either be owing to limited financial resources garnered by these institutions or the limited investment/lending avenues that are considered creditworthy by such lenders. If the limited scale of existing MDBs reflects lack of 'acceptable' projects, the success of the proposed bank would depend on generating a large number of acceptable projects. BRICS Bank may be able to augment bankable projects by adopting a different criterion which many more projects would be able to meet. It may also be argued that risk profile of projects can be improved through better cross-country coordination if 'indigenous' promoters are more successful than their developed counterparts. This would naturally depend on mutual trust and willingness to cooperate among sponsors of the proposed BRICS bank.

Another source of comparative advantage of MBDs promoted by developed west is because western or developed country stake may lead to better credit rating. Superior ratings enable MDBs to access international markets on favourable terms. Therefore, intermediation of multilateral banks is likely to enable developing countries to get finance at better terms in relation to the terms their standalone credit rating would imply. The critical issue would thus be whether or not the proposed BRICS Bank would be able to access international markets on similar (or even better) terms vis-à-vis IBRD/ADB or EBRD without the parentage of developed western nations.

Whether this would happen on a large scale depends on mainly political factors. Can BRICS nations develop mutual trust and augment a kind of social capital that would enable them to widen the range of acceptable projects?[3] This may happen through lowering of perceived project risk if BRICS ensures better policy coordination and resolution of multi-

[3] Certain hydro-electricity projects in Arunachal Pradesh could not get approval from ADB because of China's objection as it considered the project location being in disputed territories. Unless there is a different view by China, these projects may not get approval from the proposed new bank either.

governmental issues. Alternatively, if the BRICS Bank develops higher risk appetite, it could choose more projects vis-vis other MDBs.

But will the BRICS Bank accept more risk? Chandrasekhar (2014) has argued that the BRICS Bank may mirror the Bretton Woods twins in its lending policy because it is empowered to accept non-borrowing members who may get up to 20 per cent of voting power "which would permit developed countries to enter the decision making process". Moreover, a major portion of borrowing limit is linked to adherence of member countries with IMF conditionality. Apart from strategic geo-political considerations in certain projects, if the acceptability criterion for the new bank remains same as or similar to that prescribed by (say) IBRD or ADB, the new bank too would face similar constraints in its choice of projects.

Will the BRICS Bank augment currently available financial resources? As revealed through Table 2, bulk of the resources raised by MDBs is through short/long-term borrowings from international markets. Also, a significant portion of resources so mobilized is held in the form of safe/ liquid investments to achieve target risk profile (investments in sovereign securities limits credit risk profile, and facilitates managing liquidity risk at portfolio level besides helping in management of interest rate / currency risks). It may be noted that funds brought in by promoting countries are relatively small even in relation to authorized or callable capital. In their initial formative years, funds were contributed by promoter members, but in subsequent years importance of promoter funding dwindled as external funds were raised as debt through international markets. Short or medium term loans and bonds are refinanced to lend for long term.

Cross-National Support for Success

The key issue is: Does the BRICS Bank have any advantage over existing MDBs? What could be the source of such advantage, if any? The operations of the BRICS Bank would be based on cooperation as each member country would have one vote unrelated to its contribution to the Bank's capital. It is also stated that no member would have veto power. The bank would have its headquarter in China and its first president would be from India. While the first chairman of the Board of Directors would be from Brazil, the first chairman of the Board of Governors would be from Russia. The bank would welcome other members but BRICS members would always control minimum 55 per cent of its ownership. The World Bank has estimated infrastructure gap in developing countries at US $ 1 trillion and the BRICS Bank is expected to focus on it. New members may be added in future. The proposed contingency

reserve arrangement will provide liquidity support to members who face balance of payment difficulties. It would thus combine features of WB and IMF under one roof.

The authorized capital of the BRICS Bank would be US $ 100 billion. In addition, it would maintain a currency pool reserve of another US $ 100 billion. Each member would contribute US $ 10 billion; the initial paid up capital would be US $ 50 billion making it a MDB with highest equity. The currency reserve pool would come from unequal contributions; China would contribute 41 per cent, Brazil, Russia, and India would contribute 18 per cent each, South Africa will contribute 5 per cent.

It appears that the BRICS Bank would face stiff competition from another proposed MBD, viz. Asian Infrastructure Investment Bank (AIIB). It is noteworthy that China has been pursuing this proposal to form a new organization with a view to steering development along the ancient Silk Route in a manner free from western backed lenders such as the World Bank and ADB. The AIIB would be set with registered capital of US $ 100 billion. Infrastructure requirement in Asia, estimated at US $ 800 billion per annum till 2020, is quite huge and perhaps enough potential would be there for both the BRIC Bank and AIIB. Recent reports indicate that India has accepted to become a founder of AIIB along with 20 other countries, mostly from Asia. Each member's voting right is expected to be in proportion to its GDP in PPP terms. This would perhaps mean China would have the largest stake, while India's share, though at number two, would be considerably lower. It is possible that even in the BRICS Bank, China may have the largest stake but China may have more dominance and therefore higher maneuverability to control affairs of AIIB vis-a-vis BRICS Bank.

It may be noted that the capital of both MDBs is similar: US $ 100 billion. The currency pool mechanism of the BRICS Bank is a unique feature. Both organizations are likely to focus financing of infrastructure projects. It may therefore be instructive to compare the two proposed organizations in terms of their ability to mobilize debt funds from international investors and their ability to mitigate risks associated with infrastructure projects.

Table 3: Stock of FDI, 2013

(US $ billion)

	Inflow	Outflow	Share (%) in Inflow+Outflow
Brazil	724.64	293.28	7.6
Russian Federation	575.66	501.20	8.0
India	226.74	119.84	2.6
China	956.79	613.58	11.6
Hong Kong China	1443.95	1352.35	20.7
South Africa	140.05	95.76	1.7
Total BRICS	4067.84	2976.02	52.3
All Developing Countries	8483.01	4993.34	100.0
World	25464.17	26312.63	

Source: World Investment Report 2014

At this stage it would be difficult to guess the credit ratings assigned to these two proposed MBDs. AIIB would have China and India as founder members together with other members from Asia. The BRICS Bank, on the other hand, would have at present only BRICS nations as members though it too would accept other members in future. If both banks are assigned similar credit ratings, their ability to attract funds from long term investors may not be very different.

It is expected that the BRICS Bank will consider investment proposal from among its member countries. It is difficult to hazard a guess which countries its major projects would come from. Given its recent huge infrastructure expenses, it is likely that many such projects could be from China. Moreover, cross-country projects may involve only China and India among present members of the BRICS Bank. AIIB may have more such projects given its members are from Asia.

In such projects MDBs could intermediate to minimize the risk. But several projects may still be single country. Indian infrastructure segments (electricity, telecom, roads) are plagued by several policy related issues: difficulties in land acquisition, allocation of spectrum, and coal.

It is no wonder fresh investments are stalled. Would MDBs be able to help resolution of such country-specific issues?

As regards mobilization of funds, would these new banks have any advantage in fund mobilization? To the extent MDBs are successful in lowering of project risk profiles, all investors would evince more interest and fund mobilization may, therefore, be easier. Would investors from that region have a positive bias towards "their" projects? All BRICS members have received more inflow of funds vis-à-vis outflow of FDI (Table 3). BRICS countries account for little less than 50 per cent of stock of inward investments to developing countries and their share in stock of outward investment is even higher at 60 per cent. Thus, BRICS members themselves would have considerable investment demand as also surplus investible funds. Whereas the net investment inflow is on account of preferred investment destination, China alone has had positive BOP for several years.

Although, as China reorients its strategy to boost domestic consumption, some analysts expect Chinese surpluses would reduce in future. But other analysts feel that, as Chinese population grays in future, saving bias would increase. At present China accounts for about 26 per cent of world investment which has increased from 4 per cent in 1995.[4] At present, China would have a sizable share of world investible surplus. As the impact of higher consumption would only be felt steadily, Chinese current account surpluses would look for investment avenues globally for quite a few years. Thus China may have significant potential influence on proposed MDBs as an investor with significant and sustained current account surplus. Because state control is most prominent in China, it would be able to leverage efficiently through a homogeneous view which may not be possible in a private enterprise economy where individual views could be more diverse. China perhaps would participate and support each institution (BRICS Bank, AIIB) to the extent it meets its strategic objectives. If it has more effective role in affairs of AIIB, its commitments may be more towards AIIB. It thus appears the BRICS Bank may need to compete with AIIB for projects and perhaps even (Chinese) funds.

In such a scenario, the politico-strategic factors would be most relevant. If WB and IMF were partial to US or western countries, BRICS Bank or AIIB too would not be immune to such considerations. Given the dominating presence of China, such considerations are likely to be China-oriented. If other countries are successful in countering Chinese strategy, Chinese funding support could be less enthusiastic. If China is more successful in implementing its strategy through AIIB, operations of AIIB may be witness quick acceleration.

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[4] "The Age of Cheap Capital," *Business Standard,* November 2, 2014.

Conclusion

Though infrastructure funding gaps are huge in developing countries and in Asia, that alone may not be sufficient for success of the BRICS Bank or AIIB. The business potential for MDBs that are controlled by developing countries themselves is at least theoretically sizable. However, their ability to cooperate without constraints of geo-political objectives is not obvious. Moreover, the new MBDs in all probability would borrow from international capital markets to supplement their investible resources. That would mean the criteria for acceptable support-worthy projects may not be very different from the ones currently accepted by MDBs like IBRD/ADB/AfDB. Therefore the constraints that limit funds availability from existing MDBs would remain operative for both the BRICS Bank and AIIB. Moreover, China being the only country that is able to generate significant investible surplus on a sustained basis, it may be able to exercise decisive influence of pace and direction of investment flows from the new MBDs. Chinese interest and influence may be the decisive factor in determining the pace at which the BRICS Bank and AIIB would operate in years to come.

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