

The World Bank pushes fragile finance in the name of development

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The World Bank's Maximising Finance for Development agenda is constructing a new financial world order with shadow banking at its core, argues Daniela Gabor, professor of economics and macro-finance at UWE Bristol and one of 120 scholars critical of the approach, in this guest post.

When the global policy elite gathered for the recent IMF and World Bank annual meeting in Bali, their optimism was hard to ignore, along with the new buzzwords of sustainable infrastructure. As Lord Stern, of the influential Eminent Persons Group, put it: "the challenge of achieving the Sustainable Development Goals (SDG) is in large measure that challenge, of fostering the right kind of sustainable infrastructure'

To do do, he said, "you have to have good finance, the right kind of finance, at the right scale, at the right time". The ambition, spelled out in the World Bank's new Maximising Finance for Development agenda, is to create investable opportunities in poor countries that can attract the trillions of global institutional investors.

Yet many observers, including a group of over 120 scholars in the Global North and South, are rather more pessimistic about these efforts to catalyse institutional investment into development interventions.

Our concerns go beyond those of civil society organisations, that the agenda pushes the privatisation of public services in poor countries, in order to generate cash flows for infrastructure-backed securities. The UK is a poster child for the negative outcomes of such privatisation. We view the Maximising Finance agenda as a deliberate political choice, made in global policy communities and in national polities, to policy-engineer a new financial order with shadow banking at its core.

To explain what we mean by that. We follow the Financial Stability Board in understanding shadow banking as market-based finance, connecting banks and shadow banks in the *production* (eg. securitisation of illiquid bank loans) and *funding* (via wholesale markets) of tradable securities. The new financial order, we worry, means a more fragile (global) financial system, one that is cyclically vulnerable to swings in securities prices, and that reduces the space for autonomous developmental strategies in poor countries.

The turn to securitisation

To tap institutional investors, the World Bank and other multilateral development banks (MDBs) plan to rely on securitisation markets, markets systemic to shadow banking. Here's a line from a statement by the G20 Eminent Persons Group:

‘Securitising on a large scale, across the MDB system, will in effect create new asset classes and attract a wider range of investors’.

But will the new push for securitisation learn from the systemic mistakes that transformed the collapse of the Lehman Brothers investment bank in 2008 into a global financial crisis?

Take for instance Room2Run, the African Development Bank’s path-breaking synthetic securitisation deal announced in September 2018. Mizuho International, the structuring bank, noted that "AfDB’s leadership through this transaction has now set the stage for broader adoption of the instrument throughout the MDB community."

The AfDB bought credit protection from a US hedge fund, at around a 10 per cent interest rate, on a \$155m mezzanine tranche of a \$1bn portfolio of private loans. AfDB retained the first loss tranche (\$20m), and obtained capital relief on the A- rated senior tranche.

Notably, the pension fund originally involved dropped out, raising questions about the appetite of patient investors for such complex deals. The AfDB instead deals with the kind of leveraged shadow bank that generates systemic interconnectedness, liquidity risk and pro-cyclical behavior in market-based financial system.

Equally notable, the European Commission provided guarantees for Room2Run’s senior mezzanine tranche, even though it recoiled from this kind of complexity in its own efforts to promote Simple, Transparent and Standardised (STS) securitisation in Europe, where it excluded synthetic securitisation from the STS label. It is also unclear how synthetic securitisation will change the terms of MDBs relationship with the private sector. Will MDBs sacrifice social and environmental covenants used to influence developmental outcomes, instead prioritising the financial performance of the underlying loans?

The incentives are for MDBs to increasingly turn to private sector loans that can be fed into opaque synthetic securitisation deals. MDBs will struggle to create the range of returns institutional investors seek through true-sale securitisation of their public sector loans, given the preferential terms and special nature of MDBs’ relationship with sovereign borrowers. China just announced that it would join the global race to securitise infrastructure loans to solve the Belt and Road financing gap, while the Trump administration approved a new bipartisan push to increase US foreign aid into infrastructure projects. The geopolitical struggle over the Global South will be fought on the terrain of securitisation markets, with little scope for scrutiny and accountability from other developmental actors.

The right kind of finance?

The Maximising Finance for Development agenda goes beyond securitisation of MDB loans. It also introduces the so-called Cascade approach, with the aim to re-engineer financial systems in the Global South around liquid local securities markets that can attract global institutional investors. From the World Bank's 2017 report:

This approach asks the World Bank Group to help countries maximise their development resources by drawing on private financing ... It also means sustained support at the sector and country level to strengthen the enabling environment for private sector solutions—including in developing domestic capital and financial markets to expand the supply of local currency financing available for development.

The Cascade proposes a sequence of steps to remove the structural bottlenecks that prevent institutional investors from channeling portfolio flows into "virtuous" investments in poor countries. Countries should first identify policy and regulatory reforms; if reforms are not sufficient, then identify subsidies and guarantees to de-risk projects - effectively subsidising the alignment of investment returns and "virtuous" principles. If reforms and subsidies are still not enough, then opt for a fully public solution.

The promotion of "domestic capital markets that are deep and liquid" to support the development of infrastructure as an asset class appears to be treated as an unequivocally good idea. It can wean poor countries off the dependency on foreign currency debt. Yet we worry that the World Bank's recipe for engineering liquidity in local securities market, developed together with other international institutions in the Local Currency Bond Market initiative, involves the shadow markets (repo and derivative markets) that turned Lehman into a global systemic event. The Cascade's regulatory reforms and de-risking policies will entrench the kind of financial plumbing that we associate with shadow banking.

Consider India. In a 2016 report, the Financial Stability Board applauded national regulators for easing repo market restrictions in the effort to create "vibrant secondary market liquidity".

If India wanted to develop local securities markets, it had to redesign repo markets according to 'classic' US/European standards (allowing collateral re-use and transfer of legal title) so that foreign investors could easily finance and short securities. The FSB extended the same advice to China. Yet elsewhere, the FSB's Mark Carney warned that:

Securities financing markets fed boom-bust cycles of liquidity and leverage. Ample liquidity and low volatility drove increasing availability of secured borrowing. That created a self-reinforcing dynamic of more leverage, even greater liquidity, lower volatility and even greater access to secured borrowing.

In remodeling their repo plumbing according to the WB/FSB blueprint, countries render their securities markets more sensitive to global liquidity conditions. They are creating fragile financial structures where fire sales of collateral, haircuts and liquidity spirals are typical occurrences. The FSB's repo rules and Basel III do not go far enough to contain such dynamics.

The IMF recognises that encouraging countries to join the global supply of securities exposes them to the rhythms of the global financial cycle over which they have little control. However, we do not have in place the global safety net that would protect emerging and poor countries.

In Bali, Christine Lagarde, the IMF's Managing Director, called on emerging countries to respond with the entire set of tools – including capital controls – to on-going global liquidity pressures. When pushed by the FT's Martin Wolf that the IMF should be a much stronger advocate of capital controls, she recognised that the IMF's institutional view of capital controls as last resort measure is becoming increasingly flexible (albeit not for Argentina).

Her mood, she concluded, was of 'desperate optimism'. Given the global push for re-engineering financial systems around securities markets and portfolio flows, we would ask for more pessimism of the intellect.