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Mobilizing Resources for a More Sustainable World: The Role of Subnational Development Banks

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Abstract

The effective implementation of the 2030 Agenda requires a greater level of capital mobilization and new institutional arrangements that guarantee the better allocation of these funds. Based on concrete results from the experience of the Development Bank of Minas Gerais, in Brazil, this paper argues that Subnational Development Banks (SDBs) can be powerful players within development finance institutions' networks, as their local expertise can bring efficiency and effectiveness to the implementation of development programs. Acting in partnership with larger national and multilateral institutions, SDBs can help better channel available financial and technical resources to promote local impact by adapting sophisticated governance and operational requirements to practical and pragmatic approaches that are suited to their local environments.

Key messages

The new order established by the 2015 global agreements—the Sustainable Development Goals (SDGs), the Addis Ababa Action Agenda (AAAA), and the Paris Agreement—also seems to bring the development finance institutions into the spotlight. One particular type of institution in this group, the Subnational Development Banks (SDBs) could be key actors in bringing efficiency and effectiveness to the implementation of development programs. The local expertise of SDBs directly contributes to less-costly and more-agile credit analysis processes and to better identification and selection of projects, broadening the base of bankable ones.

Although the SDGs mark a strategy of promoting awareness around shared and global problems, they do not make the task any simpler. They hide a certain level of complexity in terms of development finance. It is not only a question of rethinking the volume of financing, but above all, of ensuring that financed projects have the right characteristics to minimize negative impacts and enhance additionalities. Two points are essential: ensure that investments do not contradict social and environmental principles, and improve indicators and tools to assess the alignment of investments with the SDGs.

The Brazilian network of twenty-one SDBs, which has undergone a series of changes over the years, is a viable example of how to connect the SDGs Agenda to local and context-orientated problems in developing countries. The case of the Development Bank of Minas Gerais (BDMG), the largest state development bank in the country, shows how to implement the Agenda at local level. Some examples of this accomplishment appear in the social and environmental objectives of the 2030 Agenda, as SDGs 8 (micro and small companies); 5 (gender inclusion); 9, 10, 11 and 6 (sustainable cities); 3 (health); 7 and 13 (clean energy); and 17 (partnerships).

While multilateral organizations have global reach, access to financial resources, and technical expertise for projects of this nature, subnational banks, such as BDMG, have the capacity to direct resources to the regional or local context, in countries like Brazil, implementing the global agenda on the ground and acting as a gateway to global sustainable investments in developing countries.

Mobilizing Resources for a More Sustainable World: The Role of Subnational Development Banks

1. The Post-2015 Sustainable Finance Paradigm and Subnational Development Banks

In 2015, a set of global agreements initiated the establishment of a new framework for international development cooperation (Orliange, 2020). This set includes, but is not limited to, the adoption of the Sustainable Development Goals (SDGs), the creation of a financing pact for development, the Addis Ababa Action Agenda (AAAA), and the establishment of a collective commitment to combat climate change in the Paris Agreement. The current vision of sustainable development, which unifies previous concepts of economic and social development with a concern for the protection of the environment and governance matters, expands the financing needs to meet the aspirations of future generations, particularly under the unprecedented challenges caused by the combination of a fast-changing climate and the COVID-19 pandemic.

As expressed in the AAAA, multilateral, national, and subnational development banks play active roles in mobilizing resources from the public and private sectors to support high-impact investments in SDG-related projects worldwide. In addition to their traditional roles, such as facilitating the financing of long-term investments (Bruck, 2001), mitigating market failures (Stiglitz, 1994), granting credit to vulnerable sectors and segments with higher risks (La Porta, Lopez-De-Silanes and Shleifer, 2002), and operating counter-cyclically to help economies recover from financial instability (Brei and Schclarek, 2013), development banks also help to create and develop new business models and exploit their potential to contribute to the implementation of the SDGs. Mobilizing resources to finance the Agenda means focusing on channeling investments to meet local needs in a socially acceptable and environmentally friendly manner.

We argue that Subnational Development Banks (SDBs), a group of development institutions owned by subnational public entities, including states, groups of states, and municipalities, could play a significant role in SDG financing, regardless of the fact that SDBs have been systematically taken for granted in the recent literature on Development Finance Institutions. As we show with concrete examples in the Brazilian context, SDBs operate at a closer level to public and private beneficiaries, connecting the challenges and opportunities of the local reality with global resources and agendas, and being able to expand the reach and effectiveness of development networks. This capacity has been increasingly boosted as SDBs move towards the incorporation of ESG principles (environmental, social and governance) in their planning and operational activities.

The question that remains is: could SDBs be the gateway to global sustainable investments in line with the 2030 agenda?

2. The hidden complexity in SDG financing

The method of grouping priorities into a set of objectives, with measurable goals and defined deadlines, marks a strategy of promoting awareness around shared and global problems. Common global goals can serve as a powerful management tool to accelerate the achievement of results, while providing for political responsibility, improved metrics, and public pressure around an agenda. The idea of packaging SDGs into clear priorities and goals, translated into different languages and understood by all countries, enables the multiple challenges of sustainable development to be pursued more assertively.

However, it does not make the challenge any easier. The 2030 Agenda includes a broad set of social and environmental objectives, providing guidance and setting concrete goals in areas ranging from poverty reduction to food security, health, education, employment, equality, climate change, ecosystems and biodiversity, among other themes. Through the 17 objectives, translated into 169 goals, it is understood that ending poverty and achieving sustainable development is not possible without also building measures to stabilize the climate. As the MDGs (Millennium Development Goals) were focused on a more restricted set of goals, the evolution to the SDGs has created a new dynamic investment process in sustainable and resilient development, reorienting finance to address the drivers of climate change, resource degradation, unsustainable consumption, and institutional and political conflicts (Shine and Campillo, 2016).

The SDGs also bring substantial changes to sustainable financing, including a much wider range of public and multilateral actors than in the 2000s, with the presence of local institutions, such as SDBs, and a greater volume of private financing (Schmidt-Traub, 2015). At the global level, the financing gap to achieve the SDGs was estimated to be $5 trillion to $7 trillion per year, with roughly $2.5 trillion to $3 trillion per year corresponding to the developing countries' gap (UNCTAD, 2014).

In addition to the volume and multiplicity of actors, there are also changes in the structure of investments. Because of a more complex pattern of long-term SDG investment, changes in financing strategies are needed to develop international and national funds for areas including agriculture and land use (SDG2), gender equality (SDG 5), renewable energy (SDG 7), infrastructure (SDG 9), and peace and security (SDG 16). It is not only a question of rethinking the volume of financing destined for the Agenda 2030, but above all, ensuring that the financed projects have the right characteristics to minimize negative impacts and enhance additionalities. Ensuring that investments do not contradict social and environmental principles is essential, as is building frameworks for sustainable financing, which detail how the finance strategy will be implemented around the SDGs while avoiding the risk of SDG-washing (Riaño and Barchiche, 2020).

3. Subnational Development Banks at the heart of AAAA

The outcome of the third 2015 International Conference on Financing for Development, the Addis Ababa Action Agenda (AAAA), provides the blueprint for financing the SDG goals and considerably expanding the diversity of actors involved in the mobilization of domestic and external financial resources, emphasizing the need for greater coordination between them. Among the list of actors, two groups have gained greater visibility in the AAAA: development banks and subnational and local governments (Orliange, 2020).

The AAAA expresses strong support for development banks: “National development banks, credit unions, and other domestic financial institutions can play a vital role in providing access to financial services” (UN, 2015a, p. 21), “particularly in credit market segments in which commercial banks are not fully engaged and where large financing gaps exist” (UN, 2015a, p. 15). Indeed, development institutions do not grant credit based on the exclusive analysis of financial strength, but also incorporate the nature and magnitude of the project to be financed.

In addition to the important role in financing micro and small businesses, women entrepreneurs, and sustainable infrastructure, the Agenda also recognizes the countercyclical role played by development banks: “especially during financial crises when private sector entities become highly risk-averse” (UN, 2015a, p. 15). In the context of the global pandemic caused by COVID-19, public development banks have also become important mechanisms for providing specific lines of credit during the crisis and adding efforts to the economic recovery.

Alongside the development institutions, another central actor emphasized in the AAAA is subnational governments and local entities, mainly from middle-income countries. The AAAA recognizes that, since investments in sustainable development must be made at the subnational level, it will be necessary to support “cities and local authorities in developing countries [...] in the implementation of resilient and environmentally sound infrastructure, including energy, transport, water and sanitation and sustainable and resilient buildings” (UN, 2015a, p.16).

The reason for going subnational in the establishment of public financial institutions is related to the belief that the combination of national and subnational development policies would lead to improved results, compared to those achievable only with national policies (Ferroni, 2004). In other words, by better knowing and monitoring the needs and peculiarities of their regions, SDBs would tend to act with greater selectivity and effectiveness, favoring local financing and, therefore, acting as drivers of development in their territories. Another argument in favor of SDBs is that provincial or local public banks may increase regional welfare as they prevent capital drain from poorer to richer regions by funding local projects and creditors in a more financially integrated economy (Hakenes and Schnabel, 2010).

Combining the call made to development banks with the emphasis on local governments, SDBs are positioned at the heart of the AAAA. These entities may bring efficiency and effectiveness to the implementation of development programs as their local expertise directly contribute to less-costly and more-agile credit analysis processes, and to a better identification and selection of projects, broadening the base of bankable ones. In partnership with larger national and multilateral institutions, SDBs help to better channel available financial and technical resources to promote local impact, by adapting sophisticated governance and operational requirements to practical and pragmatic approaches that are suited to their local environments (Suchodolski and Modesto Junior, 2020). That combination of strong partnerships, availability of resources, and local expertise can create a much more prosperous space for closing the financial gap in terms of SDG implementation.

Another crucial aspect of the role of SDBs in the process of closing the sustainable financing gap is their capacity to build and run monitoring and evaluation units that provide key information about projects' impacts and degrees of additionally. The improvement of indicators and tools to assess the volume of financial flows and their alignment with the SDGs remains a challenge. It is necessary to develop a culture of evaluation and impact to understand the real use of resources, as well as returns on investment and synergies. This is very important for the assessment of the effectiveness of development programs and funds, since the widespread take-up of ESG practices and requirements tends to increase the likelihood of SDG-washing and other negative practices, which should be prevented by good public governance and information reports.

The next two sections present some concrete examples, based on the Brazilian experience, of how SDBs can work in practice.

4. A Snapshot of the Brazilian Development System and its Network of SDBs

The foundation of the Brazilian National Development Bank (BNDES) in 1952 was the main milestone for the creation a network of regional or state financial development institutions (Horn and Feil, 2019) in Brazil. These SDBs were created to act in a complementary way to the BNDES, establishing themselves as important sources of credit for the regional economy and financial inclusion of sectors that lacked access to credit via the traditional banking system (Ferraz and Ramos, 2018). Created mostly in the 1960s, the Brazilians SDBs make up, together with the BNDES, the so-called National Development System (SNF) and are associated with the Brazilian Development Association (ABDE).

Along with the creation of the BNDES, the bank of the northeast region of Brazil (Banco do Nordeste – BNB) was created in 1952, and later in 1966, the Bank of the Amazon region (Banco da Amazônia – BASA) was funded. In the 1960s, four states already had their development banks: Minas Gerais (1962), Bahia (1966), Paraná (1968) and Espírito Santo (1969), in addition to another regional bank combining three states of the southern region (Rio Grande do Sul, Santa Catarina and Paraná) – the Regional Bank of the Extreme South (BRDE), also founded in 1962. In the 1970s, eight other states would also follow the same trend. The growth of the state financial system would reach its peak in 1988, when state banks, development banks, and state savings banks accounted for 10% of banking system assets and deposits, 17% of operations, and 6% of the banks equity (Salviano Junior, 2004).

However, state banks have undergone several transformations. Changes caused by financial crises, problems of governance and internal management reduced their size, especially in the state financial institutions affected by the 1980 crisis. From the 1990s onwards, influenced by liberal reforms, the Brazilian Program for the Reduction of the Public Sector's Presence in Banking Activity (PROES) was launched in 1996, with the objective of cleaning up state and development banks for privatization purposes. The states that controlled the banks could opt for their privatization, extinction, or transformation into development agencies.

Notwithstanding the dramatic changes to the structure of the system, nowadays the Brazilian SNF still has 21 subnational development institutions divided into: 16 development agencies, three development banks – at regional and state levels – and two regional multiple banks. This extensive network of development institutions thus represents a strong basis for exploring the capacity of SBDs to deploy global resources for sustainable development at the local level.

One state institution in particular, the Development Bank of Minas Gerais (BDMG), stands out from the list of Brazilian SDBs. Its lending model incorporates 2030 Agenda premises into financial products, processes, and funding.

5. SDG Lending Model: The Development Bank of Minas Gerais (BDMG) in Brazil

BDMG stands out as the largest state development bank in Brazil and first subnational institution in the country to raise funds on international markets for sustainable operations. Founded in 1962, BDMG operates in the second-largest Brazilian state in population and the country's third largest economy. The Bank has established itself as a financial service and knowledge platform that provides not only credit lines but is also engaged in project preparation and technical assistance. It is also the main credit supplier to Minas Gerais' pool of 853 municipalities.

The encouragement of sustainable development and concern for future generations have increasingly been incorporated into BDMG's way of acting and internal policies over the years (BDMG, 2020a). The ESG principles are an essential part of the investment analysis and decision process, incorporating not only financial issues, but environmental, social, and governance aspects. The integration of environmental risks into its policies, the importance of social performance (referring to the way the organization treats its employees, the community and the customer, through social responsibility and in its products and services), and the constant improvement in management and transparency systems, represented in corporate governance practices, are an increasing part in BDMG's strategy.

The SDGs are considered as vital to the performance of the BDMG. As stated in its annual sustainability report, the Bank recognizes and reinforces its commitment to the SDGs by overcoming the barriers that restrict financing for sustainable development and taking advantage of opportunities to increase investments in Minas Gerais state. BDMG is also part of the Climate Action in Financial Institutions Initiative and, recognizing its commitment to the SDGs, is also a signatory to the United Nations Global Compact.

To link its portfolio to the objectives and goals of Agenda 2030, a framework was developed by BDMG with the objective of financing or refinancing investments that have clear and significant socio-environmental impacts and that contribute to the SDGs. The Sustainability Bonds Framework (BDMG, 2020b), also called SDG Framework, certifies that part of the BDMG portfolio is in accordance with the Sustainability Bond Guidelines of 2018, which combine principles for green and social financing. In addition to allowing international bond issuance for this purpose, the framework provides clear guidelines on eligibility criteria for sustainable and social projects, exclusion of sectors with negative impacts and indicators for impact reports.

In order to ensure independence from the project eligibility process and ensure that the labeling process has positive additionalities, BDMG's SDG Framework was also subject to an external evaluation carried out by a specialized international company with a set of independent auditors. Such a process is known as Second Party Opinion (SPO).

With the publication of its own SDG Framework, BDMG took another step towards investment efforts with clarity on where it is possible to provide effective results. In the post-COVID-19 period, the SDG Framework should also be useful for generating new fronts and actions for economic relief and recovery, with a focus on the goals of Agenda 2030.

Analyzing the connection between the SDGs with BDMG financed portfolio, in a systematic way, from a Framework with clear and measurable criteria, it is possible to verify the relationship with 13 SDGs, and 28 of 169 targets, both in social and green categories. By going deeper into the SDG Framework and BDMG portfolio, it is possible to identify some concrete finance experiences related to the SDGs, as described below.

Financial Inclusion of Micro and Small Enterprises (MSE): SDG 8

One of the themes covered in SDG 8 deals with expanding access to banking services to encourage financial inclusion. According to Organization for Economic Co-operation and Development, micro and small enterprises (MSEs) accounted for 86% of the total number of companies in Brazil, generating 40% of formal jobs in 2015 (OECD, 2018). However, even though the contribution of MSEs to the economy is clear, the segment still faces financing obstacles when compared to larger companies (Beck, 2013). Access to adequate and timely credit at a reasonable cost is a critical problem faced by MSEs, who typically deal with higher transaction costs and stricter collateral requirements. The theme is also mentioned in the AAAA, highlighting both the importance of financing for small businesses, and the need to use new technologies to grant credit.

In this sense, the performance of BDMG with MSEs is unique. Considering the classification in the General Law of Micro and Small Enterprises in Brazil[1], which defines MSEs as companies with gross annual income up to BRL 4.8 million (about $850,000), BDMG's disbursement for MSEs between 2019 and the 2020 first semester was BRL 226 million (about $40 million), covering 4,359 MSEs. Of the amount disbursed, 86% was granted through the BDMG Digital platform[2], an online credit system launched in 2012, based on integration of databases, information provided by customers, and credit scoring risk analysis model. And 27% of disbursements to MSEs were directed to cities with below average HDI (Human Development Index).

In the context of countercyclical policy, typical of a development bank in times of crisis, and also encouraged in the AAAA, BDMG launched in April 2020 the BDMG Solidario Coronavirus (Solidarity Coronavirus) with reduced rates and extended grace periods in response to the health emergencies brought about by COVID-19. Since its start, 843 companies have been served in 196 municipalities by the program, with BRL 31 million ($5.5 million) disbursed. BDMG also joined the National Support Program for Micro and Small Enterprises (Pronampe), being the second financial institution in the country prepared to transfer funds from the Federal Government program. In the first wave of operations of the program, more than BRL 215 million ($38 million) was made available in just over

1. Brazil Federal Complementary Law No. 123 of 2006, available at: http://www.planalto.gov.br/ccivil_03/leis/lcp/lcp123.htm.
2. BDMG Digital plataform is avaliable at: https://wwws.bdmg.mg.gov.br/bdmg-digital/home

a month of operation, covering more than 2000 companies and 9000 jobs, using the entire budget provided by the Economy Ministry.

Gender inclusion: SDG 5

When it comes to gender inclusion, expressed in the goals of ensuring full and effective participation of women and equal opportunities for leadership in economic life (SDG 5), also recognized in the AAAA, BDMG has a specific credit line for entrepreneurial women of MSEs in Minas Gerais. To be able to access the 'Empreendedoras de Minas' line, the women must have business capital stock equal to, or higher than 50% for at least six months. In 2019 and the half of 2020, BRL 58 million ($10.3 million) was disbursed to 1,595 companies, with 16% of all that delivered via the BDMG Digital platform.

Sustainable cities: SDGs 9, 10, 11, and 6

BDMG financing for municipal infrastructure aims to improve the quality of life for Minas Gerais's inhabitants, in line with SDG 11 (Sustainable Cities and Communities), reinforces planned urbanization, in an inclusive and sustainable manner, strengthening regional development (SDG 10), and also infrastructure projects (SDG 9). BDMG has a current active portfolio of BRL 600 million ($106 million) destined for the public sector, with 421 Minas Gerais municipalities with active contracts (data from first half of 2020).

BDMG finances, with its own resources, and/or using money from multilateral institutions, projects from Minas Gerais municipalities such as renovation and expansion of public buildings, sanitation (also complying with SDG 6), and mobility and urban drainage. It also provides resources for the acquisition of machinery and equipment. In 2019 and the first half of 2020, BRL 183 million ($32.4 million) was disbursed to 224 municipalities (26% of the municipalities in Minas Gerais). For SDG 6 alone (Clean water and sanitation), BRL 16.4 million ($2.9 million) was allocated to different projects on sewage, water, and solid waste treatment, 99% of which was disbursed to the public sector at the municipal level.

Health: SDG 3

For basic essential services, such as health infrastructure (SDG 3), BRL 130 million ($23 million) was allocated during 2019 and the first half of 2020. More than half—55%—was disbursed during the first half of 2020, when three new lines of working capital and investment for the health sector were made available to companies of all sizes, from pharmacies, distributors, and manufacturers of hygiene materials, to laboratories, industry, and hospitals. The lines have contributed to strengthen the state's health care system capacity to respond to the COVID-19 pandemic effects.

Renewable energies: SDGs 7 and 13

To substantially increase the share of renewable energies in the global energy matrix, financing projects in this field is crucial. Linked to SDG 7 (Clean and affordable energy) and SDG 13 (Action against global climate change), the volume disbursed in 2019 and the first half of 2020 exceeded BRL 113 million ($20 million), mainly with resources from BNDES and multilateral institutions, such as the European Investment Bank (EIB). In 2019, in order to obtain resources to finance clean energy generation and energy efficiency projects, BDMG signed a unique contract with the EIB that resulted in the raising of €100 million. The credit line was intended to finance renewable energy generation projects—solar photovoltaic energy, small-scale hydroelectric energy, and bioenergy plants—and energy efficiency, including public lighting, and efficiency in buildings and industries.

The partnership between multilateral banks and subnational institutions to create resource lines for sustainable purposes, such as the example mentioned above, is an example of the possibilities for new international cooperation agreements cited in the AAAA. While multilateral organizations have global reach, access to financial resources, and technical expertise for projects of this nature, subnational banks such as BDMG have the capacity to direct resources to the regional or local context in countries like Brazil, implementing the global agenda on the ground.

Partnerships and knowledge platform: SDG 17

One particular SDG not related to credit itself, but adhering to the strategy outlined by BDMG, is SDG 17: partnerships for the goals. Partnerships are understood as means for the implementation of the global agenda, connecting the resources available internationally with the implementation of the agenda at local level.

In relation to partnerships, BDMG stablished several technical cooperation links with multilateral organizations throughout 2019, and also organized events in order to discuss how development institutions can rethink their business models and institutional roles in the face of new global frontier thinking. In the first group, technical cooperation allows new learning for the BDMG internal team. The construction of the SDG Framework itself was a result of technical cooperation with the Inter-American Development Bank. In terms of events, the first Meeting of Chief Economists of Development Banks in Latin America was held in Minas Gerais by BDMG, together with the Latin American Association of Financial Institutions for Development (ALIDE), bringing together 30 institutions from 11 countries in September 2019. Also in 2019, the Bank has also hosted a Pre-BRICS Summit event in November 2019, and took part in a panel regarding the role of Development Banks in climate-related programs at the United Nations Conference on Climate Change – COP 25.

Final Considerations

Practical examples from Brazil show that SDBs can be a powerful ally in the international effort to mobilize financial resources to more effectively implement the SDGs.

The BDMG case shows that once there is a better alignment of global development agendas with local expertise and operational capacity, projects are actually implemented and produce meaningful impacts. This alignment has at its core a few fundaments: I) adequate funding, which may come both from strong partnerships between local actors and international institutions, and from functional green financial markets (green bonds); II) The incorporation of ESG principles into the core of the organization's strategy, including clear frameworks and decision-making incentives that drive the organization along a solid sustainability path; III) the development of monitoring and evaluation capacity and systematic reporting, providing transparency on the institution's operations, and improving its accountability to other stakeholders.

Further efforts are needed to support SDBs around the world to better explore their potential as development platforms. More specifically, initiatives are welcome that promote technical cooperation, digital transformation (including better access to innovation and technologies that are changing the financial sector), and risk mitigation.

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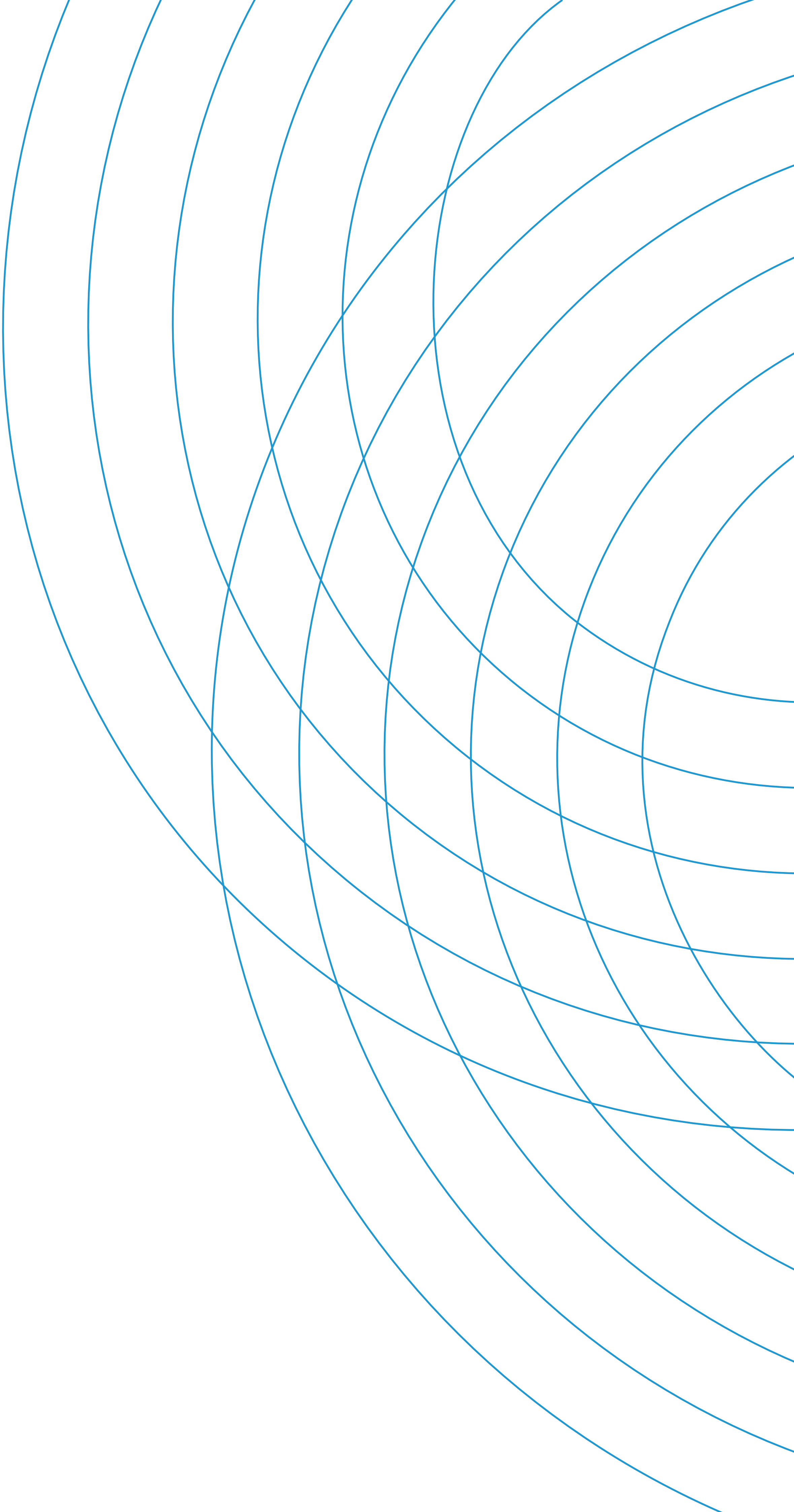

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