Study on Scan of SADC Development Finance Institutions' Environment

CEOs' Forum

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Back Ground

- SADC Development Finance Resource Centre and SADC DFI-work with the financial assistance from German Development Agency (GIZ), have agreed to undertake a study on a Scan of SADC Development Finance Institutions and Environment.
- The purpose of this study is to assess the current status of the development finance institutions (DFIs), in particular:
  a) the policy issues,
  b) institutional and operational environment issues; and
  c) to propose reforms that would enhance the contribution of DFIs both to the national and regional development agendas

Terms of Reference

- This study builds on earlier studies such as the one on the "Need for a Sub-Regional Development Financing Institution in SADC", (Mistry et al., 1998).
- It is intended to respond to regional challenges as articulated in annex 9 of the FIP.
- The terms of reference of this study have three inter-related objectives and these include:
  1. Establishing the current status of the SADC Development Finance Institutions at national, regional and indeed global level;
  2. Identifying and analysing of the impediments faced by SADC DFIs to their effective contribution to the national and regional development process; and
  3. Propose policies which will feed into the SADC DFRC strategy

Interpretation of Objectives

- The ToRs provided by SADC DRFC, have been re-interpreted as follows:

  1) Document the current state of development finance in the SADC region and in particular those relating to policy, regulatory and legal environments of national DFIs;

  2) Identify and analyse the impediments and opportunities relating to cross-border activities by DFIs and recommending measures at national and regional level to address them;

  3) Assess the DFI Network mandate under FIP taking into account other structures such as SADC RDF, PPDF and PPPs.

  4) Propose policy options, framework and action plan to enhance the development of DFIs and their creditworthiness.

Approach.

	Desk study	Data Collection	Country Visits	Analysis of Data
Establish current status of DFIs in SADC region	X		X	
Identify and analyse: a) impediments b) opportunities	X X	X X	X X	X X
Policy options and a possible framework	X	X		

Progress so far

- Due to some foreseen circumstances, the projects was slightly delayed.
- However, we are now back on course and so far three Member Countries have been visited namely: Zimbabwe, Swaziland and Lesotho and the rest will follow soon together with interviews.
- Literature Review of the history of DFIs finalised.
- During the visit to member countries the target institutions are: DFI-Network members, Non-DFI-Network members as long as they are DFIs, MoF, Central Banks and Non-Bank Regulatory Authorities.

Development Banking
Overview

- Back ground.
- What is the concept and purpose of development banking?
  - ✓ Development banking means different thing to different people, in different places, and at different times.
  - ✓ In its original form and in its broadest definition, a Development Bank is a financial intermediary which helps a country reach a higher and sustainable level of development.
  - ✓ Both definitions imply that the purpose of development banking is to bring the country to a higher level of development.

What is Development Banking?

- A development bank is a ‘bank’ or DFI established for the purpose of ‘financing development’.

- The DFIs are designed to provide medium to long-term capital for productive investment, often accompanied by technical assistance, in less-developed areas.

- The DFIs thus fill a gap left by undeveloped capital markets and the reluctance of commercial banks to offer long-term financing

Is there a difference in the terms, ‘development bank’ and DFI?

- The terms ‘development bank’ and ‘development finance institution’ are synonymous with each other although the term ‘development bank’ represents a simpler language.
- In some context, the term ‘DFIs’ is appropriate to use because the term ‘bank’ connotes, among others, a deposit-taking activity, which in some countries DFIs are not allowed to undertake.
- But in the context of ‘financing development’, both terms, however, are used interchangeably.

Ownership of DFIs

- Development banks may be publicly or privately-owned and operated.
- In Asia, Pacific and indeed SSA, about 9 out of 10 development banks are owned by governments.
- The DFIs are often funded by governments through share equity or loans.
- In addition, the cost of financing offered by these DFIs depend on their cost of obtaining capital and their need to show a profit and pay dividends.

Major Roles of DFIs

- A DFI has at least five major roles to play in the economic development of a country:

  1) As an initiator, i.e., with a 'supply-leading' role (in anticipation of future demand) such as in technology transfer, strategic industries, environment issues, etc.

  2) As an institution-builder, i.e., developing new methodologies and systems of raising capital and increasing investments through non-traditional areas such as financing large projects via PPPs, bonds, microfinance, etc.

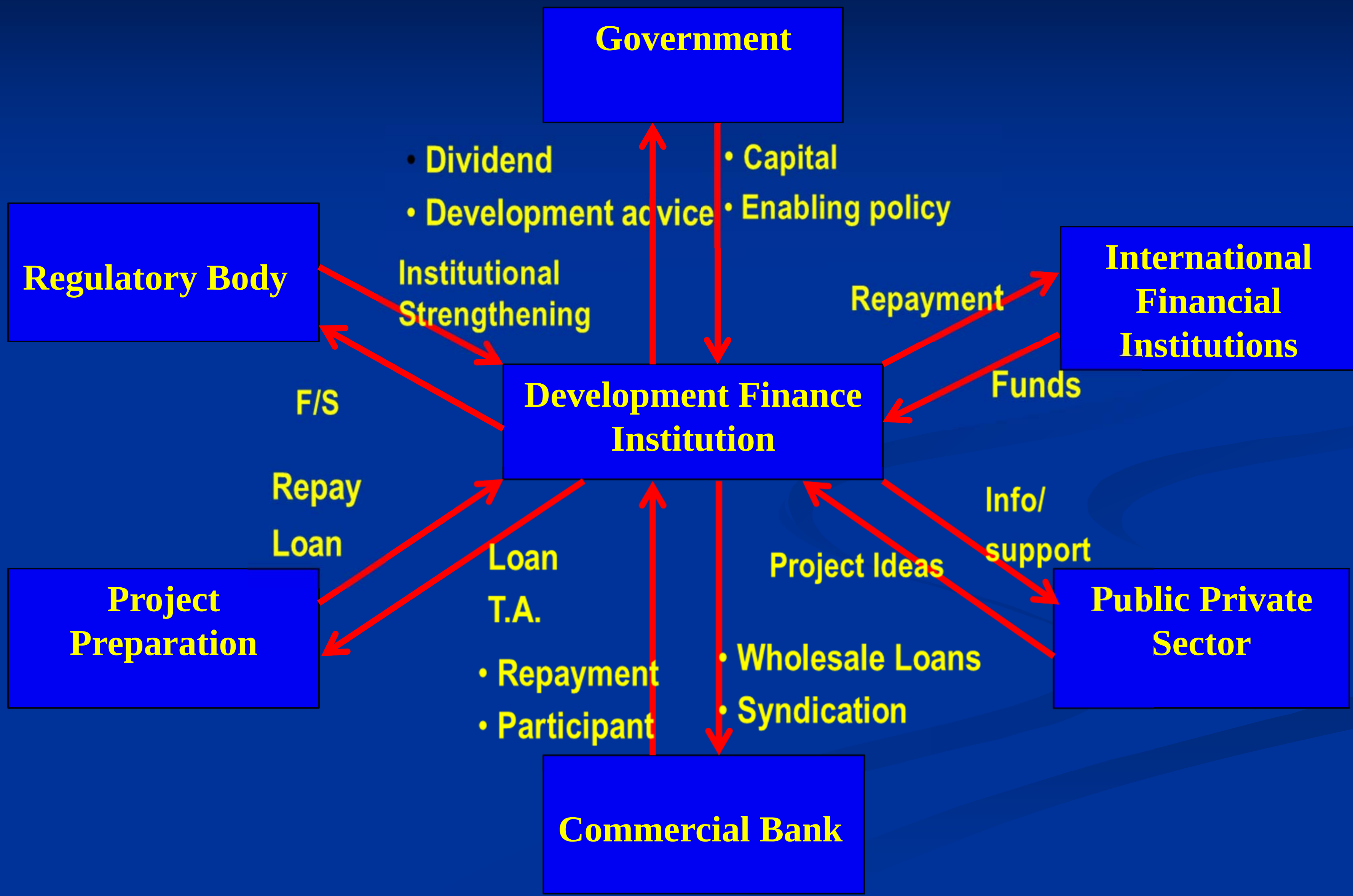
Major Roles of DFIs

3) As a catalyst, i.e., plays a "supply-leading" role (in anticipation of future demand) e.g., technology transfer, strategic industries, environmental projects etc.

4) As development advocate, i.e., promoting the 'business of development' such as job generation, domestic resource mobilization, countryside development, urban renewal, etc. and

5) As a bank of last resort, i.e., providing finance to projects which no other financial institution will fund, thus promoting new and innovative economic activities, e.g., funding for inventors, cooperatives and high-risk investments

Institution Linkage of DFIs



General Types of 'Models' of DFIs Today

a) The policy banking model which provides directed finance through government-supported development banks whose capital are sourced from government, quasi-government and government-guaranteed funds;

b) The universal banking model which provides long-term finance plus advisory services through investment and commercial banks whose capital is sourced from the international financial markets and from their own financial instrument; and

c) The 'standard' banking model which provides development finance through independent development banks whose capital are sourced 'on their own' with little or no support from government

Background to Evolution of DFIs

- DFIs have played a significant role in facilitating the industrialisation in the world.
- For instance, in the post-war reconstruction, of Europe DFIs provided long-term finance.
- Among the most important early DFIs was the privately owned Crèdit Mobilier, established in 1848, which played significant role in Europe & is credited with:
  - ✓ increasing per capital income;
  - ✓ disseminating skills in long-term finance; and
  - ✓ fostering competition.

Background to Evolution of DFIs. *Cont.*

- Despite the success of Crèdit Mobilier, the bank faced the problem of conflict between its developmental objectives and the need for short-term profit (Cameron, 1953; De Aghion, 1999).

- To date this conflict issue still remains at the heart of the problems facing development banks.

- Two events are said to have led to the demand for development finance in the early 20th century:

  1) World War I, which led to the need for reconstruction; and

  2) Great Depression of 1929, which led to a shortage of long-term funds in the US and Europe.

Successes of DFIs.

- According to Diamond (1996), the success of the early DFIs can be attributed to factors such as:

  - ✓ private (co)ownership, co-financing of projects with the private sector;
  - ✓ commitment to skills dissemination;
  - ✓ Autonomy;
  - ✓ hard budget constraints;
  - ✓ highly professional staff and managers; and
  - ✓ they also benefited from the post-war economic stability in developed countries.

Failure of these DFIs.

- This success of early DFIs encouraged poorer countries to establish their own DFIs. But many of these banks failed, leading to huge fiscal deficit and poor development outcomes (Micco et al., 2005).
- According to World Bank Report (1989), a range of financial, political and management problems contributed to their failure. For instance, it is said that:
  - ✓ The institutional environment in developing countries was weak and critical skills in management, finance and operations were limited;
  - ✓ Governments or corrupt officials often interfered in DFI activities;

Failure of these DFIs. *Cont.*

- ✓ DFIs were poorly managed and regulated, and did not operate on commercial principles;
- ✓ DFI mandates were rigid and often inappropriate, and they were stand-alone banks instead of being integrated into the whole financial system; and
- ✓ DFIs struggled to reconcile their conflicting objectives of maintaining financial sustainability while pursuing socially desirable outcomes.
- ✓ The World Bank Report (1989:106) sums it up by stating that DFIs 'found it difficult to finance projects with high economic but low financial rates of return and remain financially viable at the same time'.

Restructuring &Adjustment Programme.

- As a result of these problems the period between1980s and 1990s saw the widespread restructuring, closure or privatisation of these DFIs.

- Also despite efforts to strengthen capital markets, many countries still faced challenges of mobilising long-term capital and providing of services such as technical assistance and research to DFIs (IMF & WB 2006).

- Based on this background, history shows that DFIs though faced with these challenges are still critical to our economy – they operate within the constraints imposed by the implementation of (largely “unprofitable”) government policy.

Successful Development Banks: Dimensions & Principles

- However, despite DFIs facing these challenges, Thorne et al., (2009) have developed a Macro-Framework Model for a successful DFI.
- The framework consists of six dimensions namely: “Enabling Environment, Mandate, Regulation and Supervision, Governance and Management, Financial Sustainability, and Performance Assessment”.
- For each dimension certain principles are set out and summarized as follows:

Successful Development Banks: Dimensions & Principles. *Cont.*

1) The Environment:

- Diamond (1996), states that, no factor is more important in influencing a DFI's "success" than stable economy;
- The role of DFIs is determined primarily by the country's socio-economic & political environment and its particular priorities;
- Although by definition the role of DFIs is to address weaknesses in the economic environment, they cannot succeed in a largely dysfunctional system e.g., 16 Francophone DFIs failed in 1980s due to macroeconomic instability in their respective countries.

Successful Development Banks: Dimensions & Principles. *Cont.*

2) The Mandate:

- ✓ A DFI needs an appropriate mandate to ensure that it is correctly positioned within the environment.
- ✓ The first principle is mandate clarity: the mandate of the DFI must be clearly articulated, as a vaguely defined mandate creates uncertainty for the bank, its stakeholders and the private sector.
- ✓ Unclear mandate will allow the DFI to pursue activities not intended by the government ('mission drift').
- ✓ Unclear mandate will gives the DFI more scope to avoid difficult or costly activities ('mission shrink').
- ✓ It also reduces accountability, and increases the opportunities for political interference

Mandate. Cont.

- Local relevance of the mandate - since the DFI aims to fill the gap between the public and the private provision of finance, its role is influenced by the reach of local finance and government's fiscal policies.

- Mandate fit – this means that the DFI must fit into the local economic, political and institutional environment, and complement other financial institutions.

- Complementarity of funding – this means that DFIs should only fund those activities in which it has a comparative advantage (and that are not funded by commercial banks) in order to avoid crowding out the private sector.

- DFIs should aim to mobilise private co-funding of its projects, whether by demonstration or more concretely through risk mitigation measures.

Mandate. Cont.

- Exit strategy - DFIs should always be looking for an exit strategy and a shifting of obligations to the commercial credit markets. Second, the DFI should assist borrowers only until they are financially strong enough to obtain private funding.

- Flexibility - the mandate should be reviewed regularly to take account of changing circumstances. Such changes could stem from a general deepening of the financial system, exogenous influences such as new policy directions, or the success of the DFI's efforts to strengthen the private financial sector.

- Scope of the DFI – i.e., whether a bank should be narrowly focused (and therefore small) or multi-sectoral. No easy answer to this one as each one of them has both pros and cons.

Successful Development Banks: Dimensions & Principles. *Cont.*

3) Regulation and supervision:

- ✓ Poor regulation and supervision by State (i.e., MS), of DFIs have contributed to the downfall of many DFIs, such as Development Bank of Zambia in the 1990s;
- ✓ A primary concern here is that the ownership role of the State creates a potential conflict of interest in the regulation and supervision of DFIs.

State as the Owner. *Cont.*

- Thus, corporate governance guidelines calls for government to act as an 'informed, accountable and active owner and that government should:

  1. ensure that its ownership role does not distort its policy decisions;
  2. create a clear and simple set of legal rules governing state-owned enterprises;
  3. make the developmental roles of these institutions and any funding for such roles clear and transparent; and
  4. ensure that state-owned institutions do not enjoy special privileges.

State as supervisor

- The counterpart of the ownership entity is the supervisory entity, which should be separate and independent of the ownership function.
- To this end, it has been suggested before that Basel Core Principles should be applied to DFIs.
- Also suggested is the establishment of an independent supervisory capacity to protect the State against both credit and reputational risk, while also protecting the private sector from unfair competition from DFIs.
- The question of whether DFIs should be subject to the same rules as the private sector however still remains unresolved to this day

State as supervisor. *Cont.*

- The reason for this problem is clear. For instance, on the one hand, DFIs pose more regulatory challenges than do private firms:
  - ✓ for the state, the conflict of interest noted above; and
  - ✓ for the DFIs, the problems of political interference and the state's poor regulatory capacity.
- Also the fact that DFIs operate in under-served markets and under difficult conditions, over-regulation may be counterproductive as it could inhibit innovation and risk-taking.
- Thus IMF and WB have called for DFIs regulation with a light touch so as not to destroy them.

State as supervisor. *Cont.*

- Argument for this proposal is that: DFIs should be regulated and supervised along the same lines as the private sector, possibly with a caveat regarding capital adequacy.
- What would happen if Basel Capital Accord, which aligns capital requirements with risk was applied to DFIs?
- Note that during an economic downturns, the overall risk of default is higher and Basel triggers higher capital adequacy requirements and reduces the supply of credit.
- Thus if Basel was applied to DFIs during the bad times of the economy, it would significantly undermine the ability of DFIs to provide counter-cyclical funding

Market supervision of DFIs . *Cont.*

- Market supervision of DFI could be supplemented by market-based measures such as credit ratings.
- Although credit ratings are not a formal element of external governance, they help both the government and DFIs to gauge the quality of the DFI's financial management.
- Thus growing consensus among development economist is that DFIs should submit themselves to the discipline of credit ratings to help them access private capital markets.
- In summary, the primary principles for the regulation and supervision are a combination of market oversight and a clear separation of the ownership and supervisory roles of the government.

Successful Development Banks: Dimensions & Principles. *Cont..*

4) Governance and management:

- The quality of governance and management has often meant the difference between the success and failure of the DFI in the same environment.

- Role of the board: A properly functioning board is a critical success factor for a DFI as it prevents undue political interference in the DFI's day-to-day management.

- The board annually contracts with the government on the objectives of the DFI and has a fiduciary duty to oversee performance against those objectives.

Successful Development Banks: Dimensions & Principles. *Cont.*

- The Board also oversees the management of the institution and is accountable to both the government and the stakeholders for ensuring high standards of corporate governance.
- It must ensure that the DFI has a clear performance contract, a strategic plan for achieving the objectives of this contract, proper financial controls and auditing, and a high level of disclosure.
- It must also ensure the ethical functioning of the organisation through a written code of ethics and adequate measures to prevent corruption (Scott, 2007).

Successful Development Banks: Dimensions & Principles. *Cont.*

- Internal management
  - ✓ The management of the DFI, overseen by the board, must set up appropriate internal governance systems;
  - ✓ And ensure that the institution achieves its financial and developmental objectives while meeting regulatory requirements.
  - ✓ From a financial management perspective, DFIs should adhere to the general principles of sound financial management.
  - ✓ Also uphold professionalism in all aspects of operations, as well as fairness.

Successful Development Banks: Dimensions & Principles. *Cont.*

5) Financial sustainability:

- According to Diamond (1996) financial sustainability is the capacity of the DFI to attract, on the basis of its own performance, the capital required to pay its creditors, sustain its shareholders' interest, and support its own growth.
- There is a fine line between financial sustainability and profitability, which may imply that developmental objectives are not being met.

Successful Development Banks: Dimensions & Principles. *Cont.*

6) Performance assessment

- It must be noted that performance assessment contributes to clear policy decisions in the DFIs.
- When the public and the government are well informed about the costs and benefits of the activities of DFIs, these institutions have a powerful incentive to become more efficient.
- On the sustainability side, DFIs are assessed in terms of standard financial ratios of efficiency (i.e., ROE & ROA) and on the basis of their subsidies.

Successful Development Banks: Dimensions & Principles. *Cont.*

- According to Yaron's (2005), Subsidy Dependence Index (SDI) takes account of all sources of funding.

- The SDI is calculated by dividing the annual net subsidies received by the average annual yield on the loan portfolio.

  - ✓ A Negative SDI shows that the DFI is generating sufficient profit to cover all subsidies at market interest rates;

  - ✓ A Zero SDI value shows that the DFI is financially self-sustainable; and

  - ✓ A Positive SDI value shows that the DFI needs subsidies to survive.

Trends in SADC DFIs

Legal Persona	**All the DFIs visited were established under the Act of Parliament**
Mandate	All DFIs have mandates which are mostly broad
Sectors of specialisation	All MS visited had at least the DFIs for the Industrial development, SMEs and Agriculture
Industry oriented DFIs	All industrial development DFIs are acting as holding institutions (no exit strategy so far)
Boards	All DFIs have boards but with varying degree of composition: some boards with few government officials, others full of government officials and others even being chaired by Permanent Secretaries
Regulatory and supervisory issues	Little regard to the role of the regulation and supervisory matters for most of the DFIs visited
Legal Regulatory policy	By extension, this mean absence of the legal regulatory framework governing DFIs
Assessment	Very little evidence of the assessment criteria for policy mandate of DFIs are in place.
DFIs turning into Commercial Banks	Some of the DFIs into commercial banking and some have gone into consumer lending
DFIs Collecting Deposits	Central Banks not even concerned (Monetary stability)

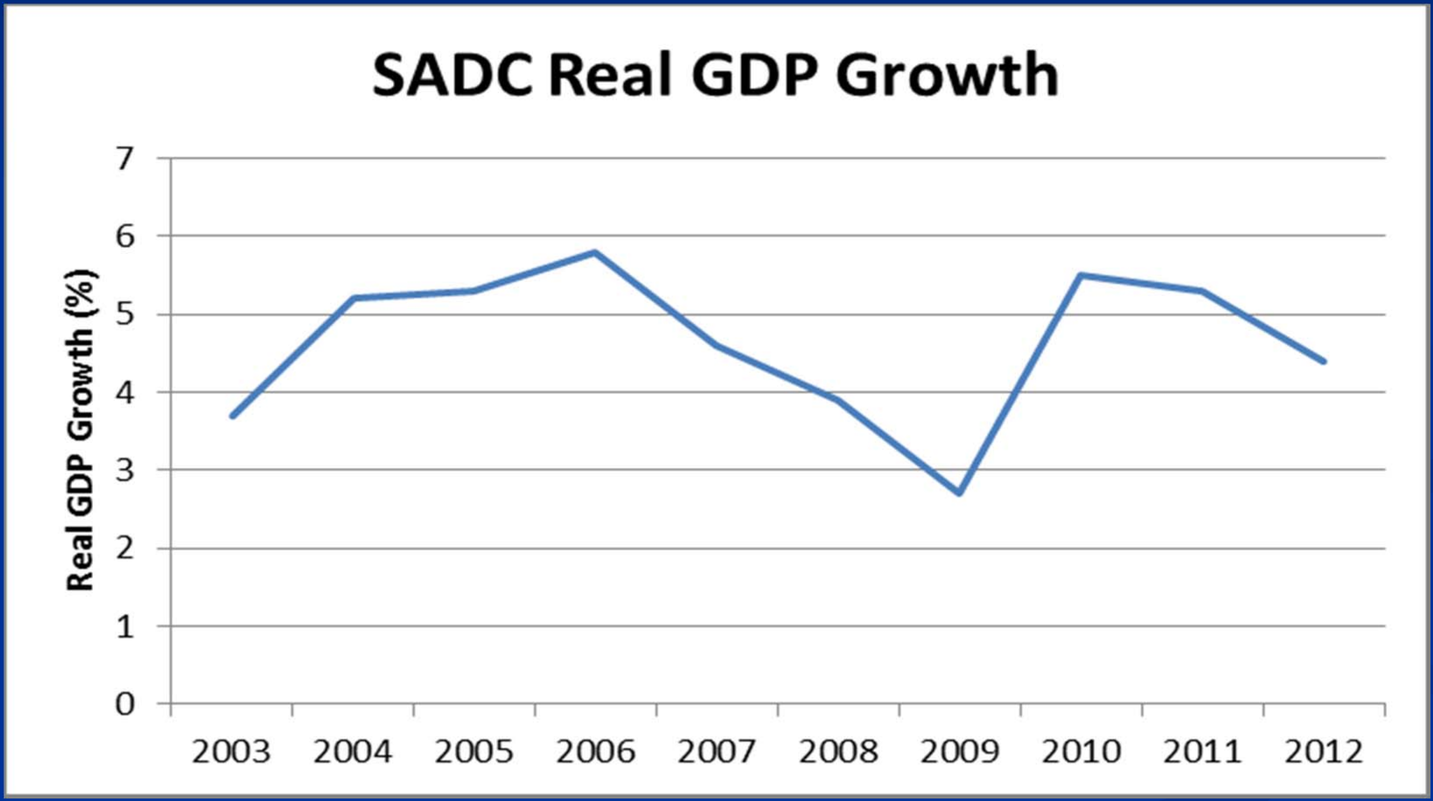
Findings of the Study so Far Include.

1) Macro-economic and political environment of the MS.

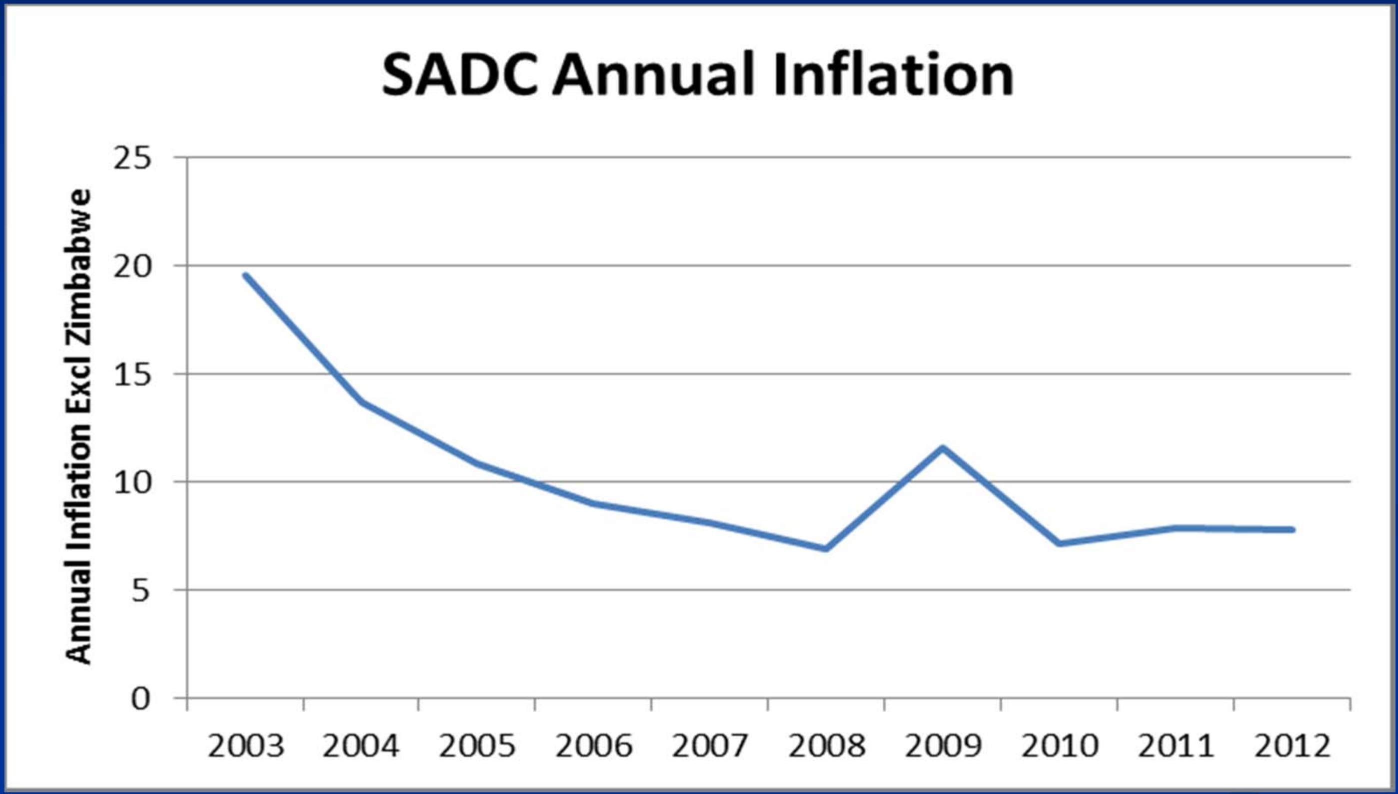
- ✓ Generally there has been a general improvement in this area (e.g., most macro fundamentals have improve – inflation, GDP growth, Debt to GDP ratios, foreign exchange reserve cover and political stability).

- ✓ See Macroeconomic graphs showing trends of data on Real GDP growth, Annual Inflation, Government Deficit (% GDP) and Public Debt (% GDP) on the next few slides.

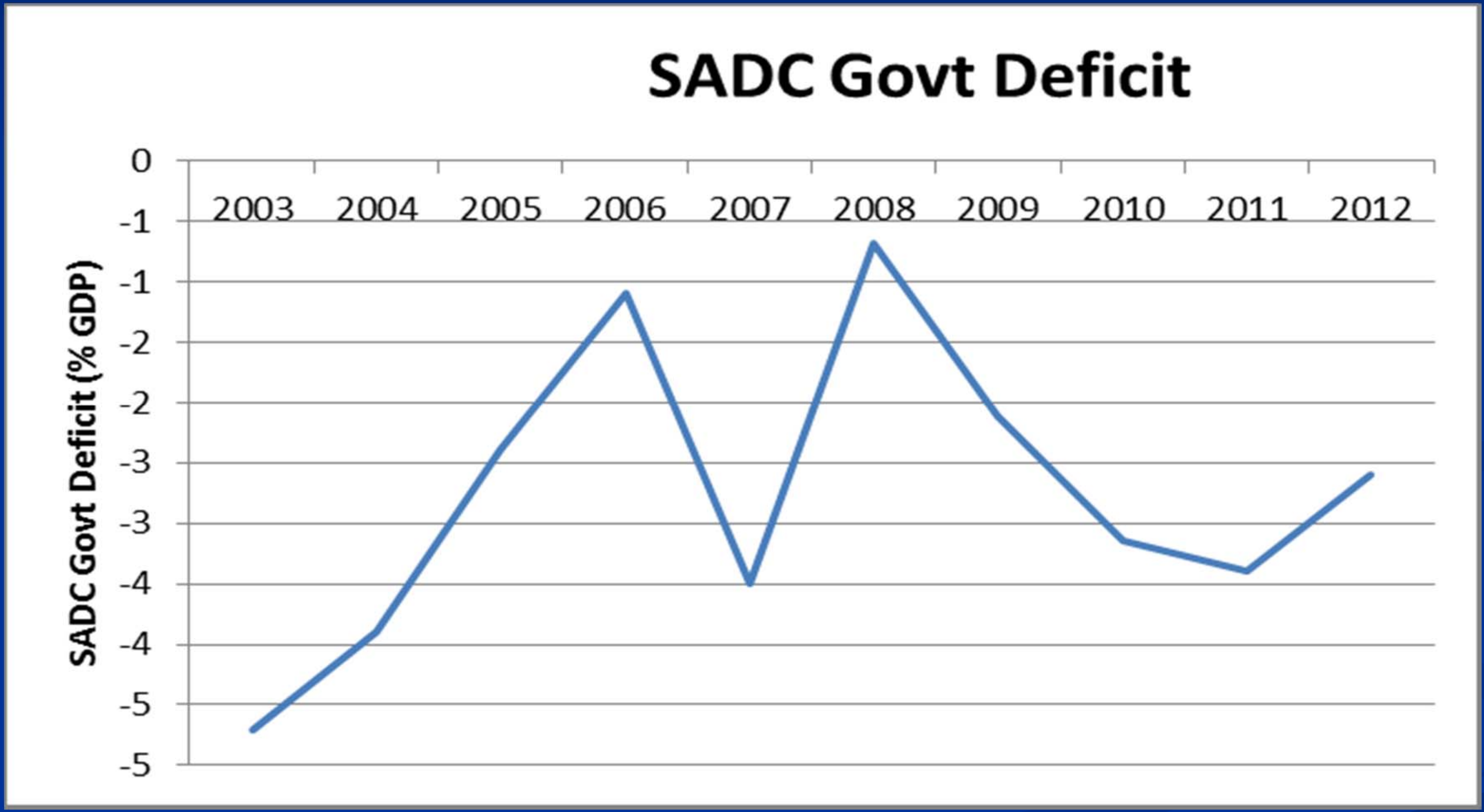
SADC Real GDP Growth



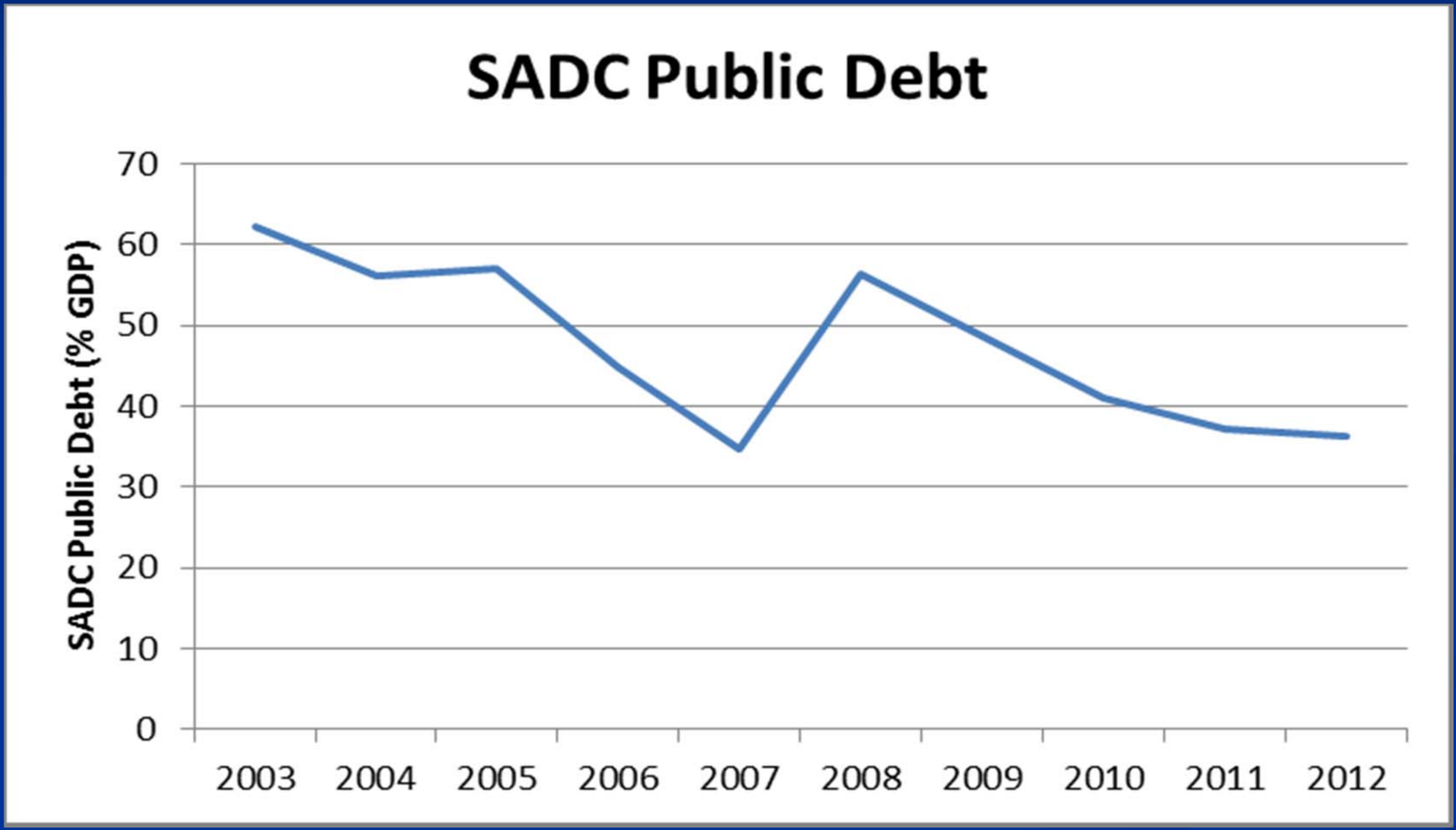
SADC Annual Inflation Rate



SADC Govt. Deficit (% GDP)



SADC Public Debt (% GDP)



Findings of the Study so Far Include.

On Mandates so far we have found that there is:

- ✓ mission drift;
- ✓ mission shrink;
- ✓ Lack of mandate fit into the local economic, political and institutional environment;
- ✓ Lack of complementarity with financial institutions;
- ✓ Lack of initiatives to mobilise private co-funding resources for projects; and
- ✓ No exit strategy or strategy to shift obligation of funding to commercial sector.

Findings of the Study so Far Include. *Cont.*

3) On Regulation

- ✓ To some extent have not seen clear and distinctive line between ownership role of the government and regulation and supervision;
- ✓ In some cases certain institutions are not even regulated at all;
- ✓ For those regulated by Central Banks, not much consideration has been factored on Basel effects on DFIs;
- ✓ DFIs not credit rated thus posing the challenge of rising resources on the capital markets

Findings of the Study so Far Include. *Cont*.

4) On Governance

- ✓ So far not seen annual contracts between governments and the board on the objectives of the DFIs; and
- ✓ Not seen independent board so far.

5) On Financial Sustainability

- ✓ No clear distinction between financial sustainability and profitability has been observed among the DFIs visited so far.
- ✓ Most DFIs visited tend to look at profitability of their institutions as opposed to sustainability.
- ✓ Adequate initial capitalisation?

Findings of the Study so Far Include. *Cont.*

- Performance Assessment
  - ✓ No single DFI visited was assessed on the basis of the Development finance mandate given to it by government;
  - ✓ Not one single DFI visited so far is assessed on the basis of the subsidies received.
- Other findings include lack of:
  - ✓ financial product innovation.

Big Question

- The big question then is: which of our institution today fit into the description or characteristics of a proper DFI?

- It must be emphasised that the gap for which our DFIs were created to fill is still there and has even become pronounced today; and

- DFIs are still relevant today as they were in 1848 or 1980s and 1990s.

- DFIs are still suppose to fill the gap between government fiscal grants and private capital sector.

Way Forward

1) Finalise collection of data from all remaining DFIs and also conduct interviews with all relevant parties.
2) Finalise the Analysis.
3) Finalise the draft country reports and send them to their respective countries for input.
4) Finalise the draft abridged report.
5) Validation meeting.
6) Final Draft.

Thank You

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