

**Towards financing  
development:  
an economic framework for  
development banking**

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# Scope

- National DFIs
  - Ownership: significant or full state ownership
  - Sources of funds: fiscal, concessionary and/or market funding
  - Application of funds: primarily wholesale
- Some principles apply more generally

# Financing role

- Funding mobilisation for underserved segments, e.g. long-term lending, SMEs, microfinance lenders, sub-national government
- Financial market and private sector development
- Countercyclical lending
- Special initiatives: regional integration, new technology, special funds, post-disaster reconstruction

# Developmental role

- Project identification and preparation
- Capacity building and training
- Monitoring and evaluation
- Research and advice to clients and government
- Coordination of funding

# Principles for DFIs

- Government
  - Risk of fiscal liabilities
  - Risk of non-delivery of development
  - How to ensure DFI efficient and effective?
- DFI
  - Risk of (unprofitable) government directives
  - Risk of political interference
  - How best to manage conflicting objectives?
- Balance accountability and autonomy

# 1. Environment

- Macroeconomic stability
- Structural and microeconomic efficiency
- Political stability
- Supporting institutions

# Macro-economy

- Sound fiscal discipline
- Balanced economic growth
- Balance of payments stability
- Price stability
- Absence of financial repression

# Microeconomic conditions

- Reasonably efficient resource allocation
- Adequate infrastructure and capacity
- Developing private sector
- Reasonable competition and market discipline
- Sufficient skills and technological development

# Political environment

- Political stability
- Political support for DFI
- De-politicisation of role of DFI
- Absence of strong interest group activity
- Absence of corruption
- Reasonable level of government capacity

# Institutional environment

- Legal system
  - Independent legal and justice system
  - Protection of property and creditor rights
- Accounting and auditing
  - Internationally accepted accounting principles
  - Proper regulation of accounting professions
- Financial infrastructure
  - Efficient settlement system
  - Adequate information flows
- Regulation and supervision
  - Market-based framework
  - Good corporate governance

# 2. Mandate and role

- Mandate clarity
- Local relevance
- Institutional fit
- Complementarity
- Flexibility
- Scope

# Mandate clarity

- Prevent mission drift (undesirable expansion of activities)
- Prevent mission shrink (avoiding difficult or costly activities)
- Provide certainty to private sector
- Increase transparency and accountability
- Reduce potential for political interference

# Local relevance and institutional fit

- Address local needs and priorities
- Supplement existing fiscal capacity and foreign/donor finance
- Integrate with rest of financial system
- Complement other local institutions

# Complementary finance

- Mobilise private funding by mitigating risk
- Borrowers graduate to private funding (exit strategy)
- But:
  - Assumption of effective and efficient private sector
  - Moral hazard for both bank and clients
- Hence:
  - Define DFI role in line with private sector weaknesses
  - Set criteria/targets for co-funding with private sector
  - Or formal mechanism for discussion

# Flexibility

- Regularly review mandate
  - Changes in policy
  - Changes in external environment
  - Growing private sector capacity
- Refocus operations
  - Lifecycle
  - Institutional capacity

# Scope

- Specialised DFIs: covariant risk, limited skills, coordination, narrow financial base
- Multi-sectoral DFIs: mission creep, mission shrink, governance, systemic risk, spread too thin?
- Thus:
  - Ensure appropriate market (portfolio diversification)
  - Consider governance, coordination and regulatory capacity
  - Complement macroeconomic, financial and institutional capacity

# 3. Governance

- Ownership
- Supervision
- Corporate governance
- Financial sustainability
- Evaluation

# Ownership

- Mainly government owned
- Rationale: developmental services underprovided by private DFIs and banks
- Provision of developmental services
  - Fully funded – costly and risky
  - Unfunded – underprovided
  - Separated – independence, effectiveness?
  - Ring-fenced and reimbursed

# Supervision

- Balance operational autonomy with oversight
- Same supervisory principles as commercial banks
- Lighter touch: innovation and risk taking
- Supplement with market supervision: credit ratings
- Government conflict of interest: owner and regulator
  - Separate ownership, policy making and funding
  - Ownership policy
  - Single ownership entity?

# Corporate governance

- Similar corporate governance principles as private sector
  - Transparency
  - Accountability
  - Fairness
  - Responsibility
- Role and independence of board
- Accountability and capacity of management
- Availability and retention of professional staff
- Sound operational and risk management
- Appropriate financial management

# 4. Funding

- De la Torre's Sisyphus syndrome
- Adequate capitalisation by government
- Encourage approach to donors and capital markets (credit rating)
- Fiscal support only to reimburse non-commercial activities done for state

# Fiscal support: examples

- Agency activities
  - Unprofitable agency activities undertaken on behalf of government
  - Research, evaluation and advisory services for government
- Once-off costs
  - Start-up or rehabilitation costs (of clients)
  - Development costs of significant or high-risk products
  - Disaster management
- (Financial) development
  - Capital market development
  - Pilot projects, new technology or R&D
- Capacity building
  - Institutional development, e.g. MIS
  - Capacity building, training and mentoring

# Fiscal support: criteria

- Overcoming market failure or strengthening the market
- Measurable benefits that exceed costs
- No interest rate subsidies
- No overt market distortion
- Design:
  - Clear objectives
  - Thorough needs assessment
  - Targeted, specific and capped fiscal support
  - Transparent budgeting and targeting
  - Fair and equitable allocation
  - Regular monitoring and review
  - Short time period or sunset clause

# 5. Evaluation

- Clear performance contract
  - Agency problem – information asymmetry
  - Multidimensional outputs – some “invisible” but crucial
  - Incentivisation and target setting – yardstick competition?
- Regular evaluation against agreed objectives
- Assess financial and developmental objectives
  - Measures of outreach: worth, cost, depth, breadth, length, scope; social audit (likelihood of future impact)
  - Financial measures: standard financial ratios, subsidy dependence
- Could this be achieved in other ways?

# Summary

- What environment do they need?
- What is their role in it?
- How are they controlled?
- How are they run?
- How are they funded?
- Do they make a difference?

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