Banco de Inversión y Comercio Exterior

Development Banks:
Some Questions and Answers

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Development Banks:

What are they, and what are they for?

Development Banks vs. Commercial Banks

- ***Commercial Banks:***
  - ✓ Are typically privately-owned, but some are state-owned
  - ✓ Take deposits from the public
  - ✓ Do only first tier (directly to borrowers)
  - ✓ Lend to both firms and households
  - ✓ Lend both short (mostly) and long term, and for both consumption and investment

- ***Development Banks:***
  - ✓ Are state-owned *(all DB are state-owned, but not all state-owned banks are DB)*
  - ✓ Do not take deposits from the public
  - ✓ Do both first and second tier (through private commercial banks)
  - ✓ Lend only to firms
  - ✓ Lend mostly for investment uses (not working capital) and long term
  - ✓ Focus on clients underserved by commercial banks

How many DB worldwide? Broad definition: some 400; Narrow definition: some 100.

The Rosy View: Market Failures as DB Rationale

- **Asymmetric information and intermediation costs**

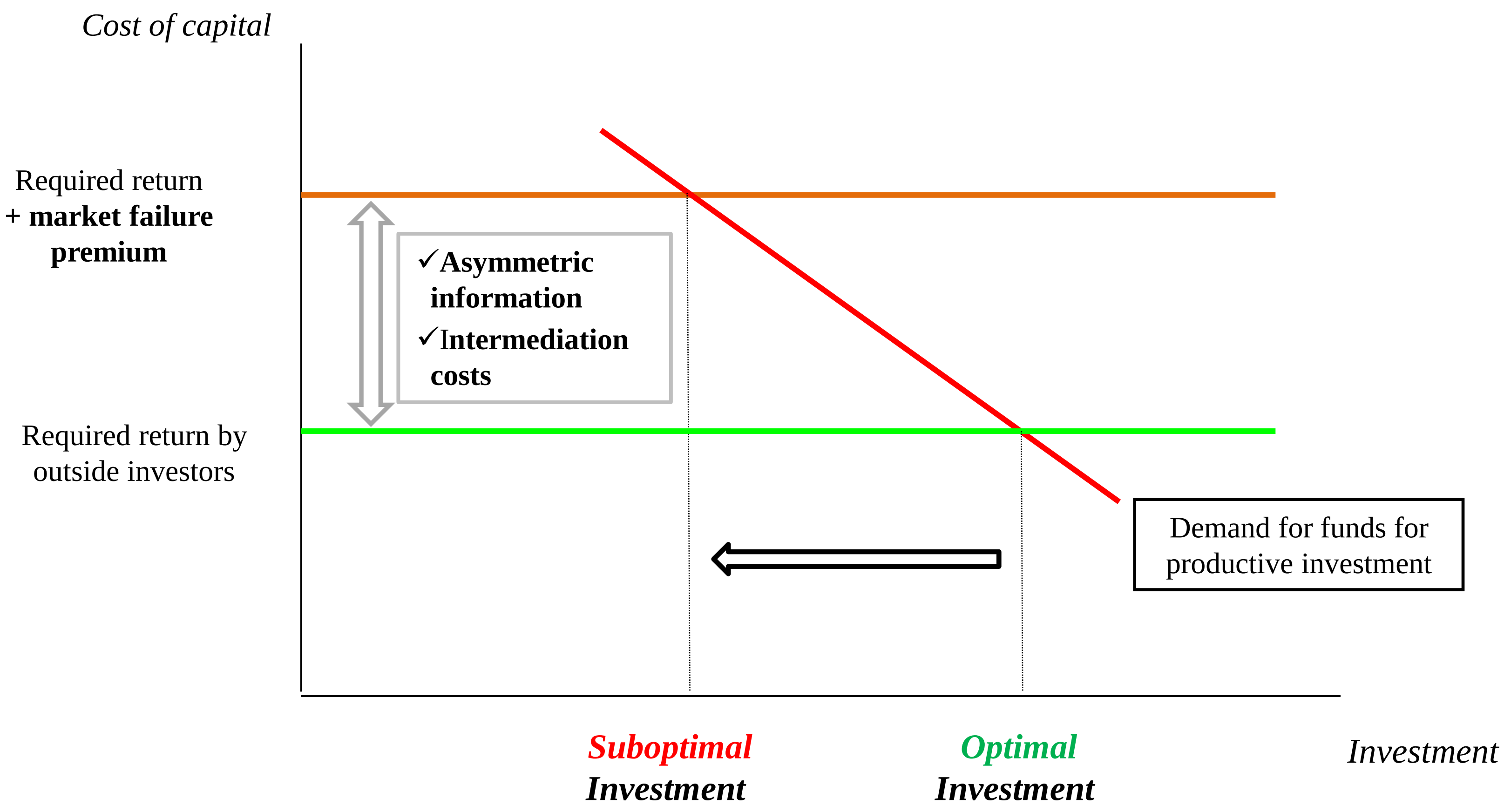
- *Adverse selection*
- *Moral hazard*
- *Financial intermediation costs in connecting savers and borrowers*

Due to opacity and small scale, these barriers are more intense in the case of young firms or first time borrowers

- **Externalities**

- *Underfunding of socially valuable projects with low value to commercial banks*

Productive investment and financial market failures



The Gloomy View:
How much is said, can be, and done to fix market failures?

- *Rhetoric abuse about the scope and results of DBs:*
  - ✓ Politicians and policymakers alike tend to praise the role of DBs in leveling the financial playing field for all firms
  - ✓ DBs look great on paper, but in practice they face colossal challenges to live up to their promise
- **Why so difficult to overcome market failures?**
  - ✓ Hard to pinpoint firms worth serving *(more on this next)*
  - ✓ Empire-building and other portfolio-expansion incentives in state-run firms
  - ✓ Distortive political interference
  - ✓ Fiscal costs

What does the hard evidence say?

- Not much, mainly due to data constraints

Luna-Martínez and Vicente (2012): World Bank Survey on 90 DBs in 61 countries

Business Development Bank of Canada (2009): Survey of areas of DB activity, not actual data, on 373 DBs in 92 countries

Inter-American Development Bank (2013): Some aggregate data (not by bank) for 56 DBs in 22 LAC countries.

What does the hard evidence say?

⇨ DB impact evaluation: A tricky business

Suppose our performance measure is job creation

More jobs? Not enough

More jobs than in similar firms without DB support? Not enough

Last one + additional payroll > fiscal cost? Enough

Handful of microdata-based papers for LA:

IDB (2011, 2012): Positive effects on employment, exports and investment in Brazil and Colombia

But too few studies to pass judgment

⇨ ***Badly needed transparency and data disclosure to improve accountability and impact evaluation.***

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Complementarity or competition with comercial banks?

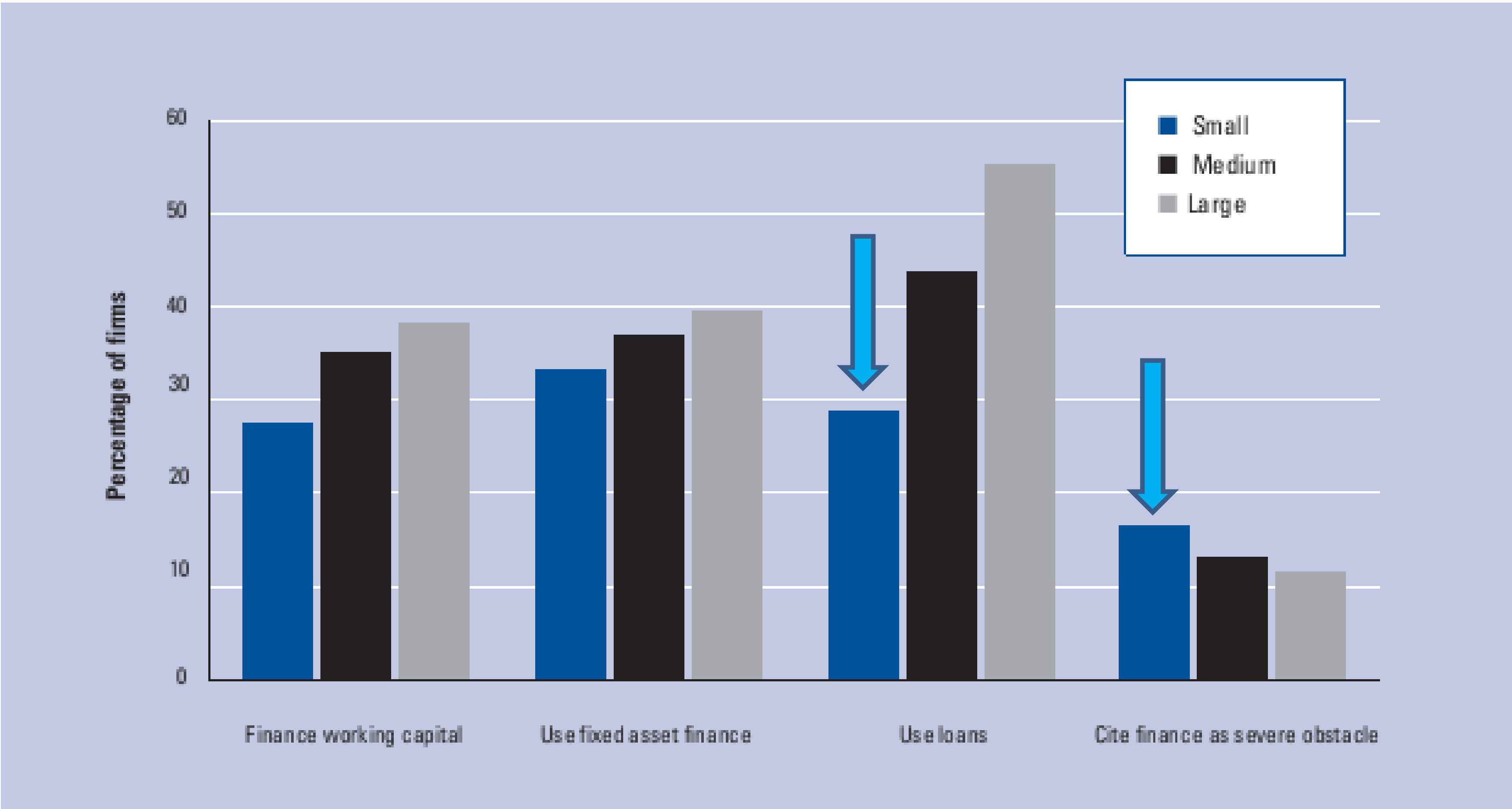
⇨ DBs should do what others banks cannot or do not want to do

❖ Why? Avoid mere **crowding-out**, with zero or negative social value added

❖ How? **Financial inclusion** (small firms) and **longer maturities** (all firms)

Credit supply or credit demand constraints?

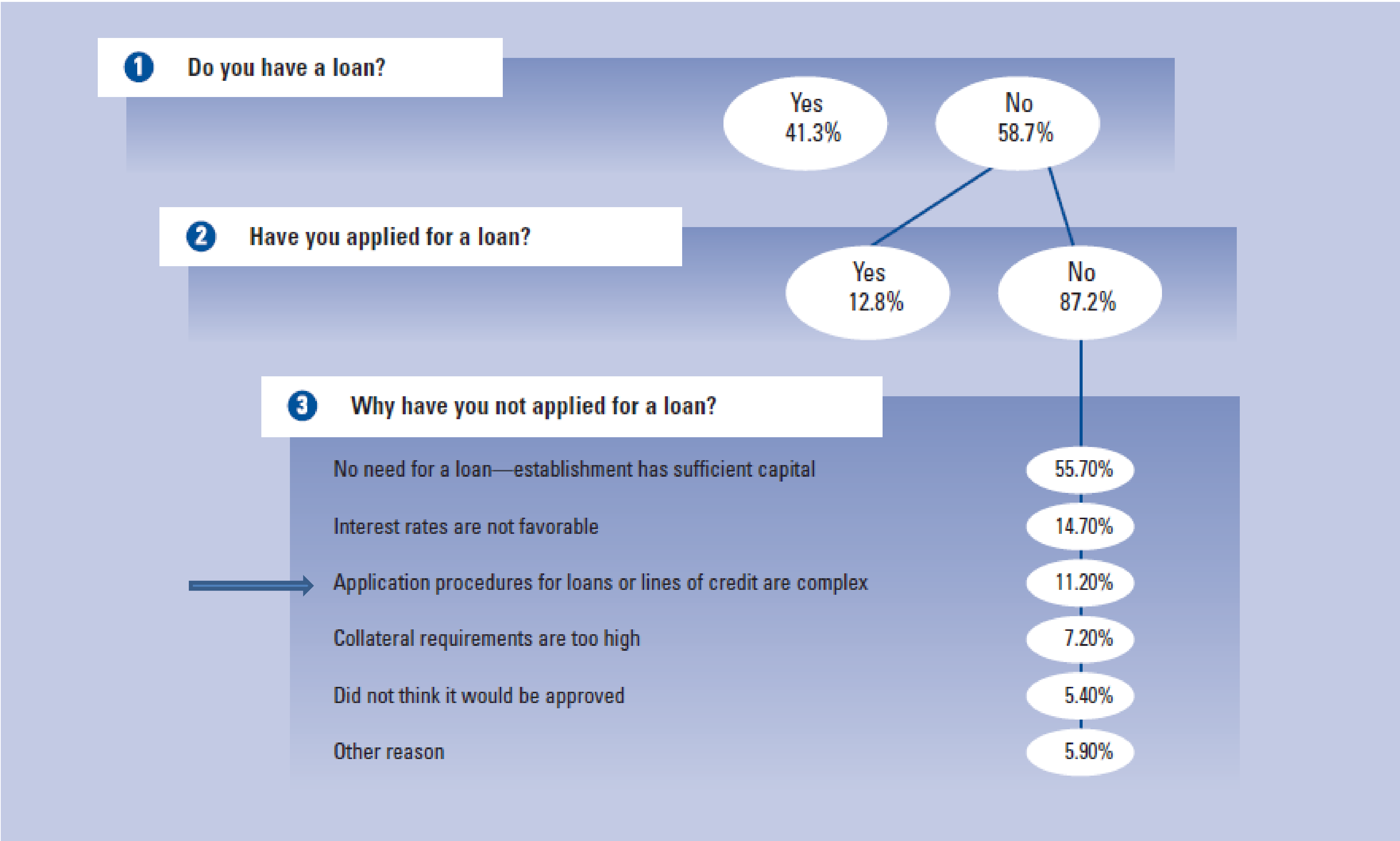
Figure 1: Comparison of financing of small, medium, and large enterprises



Source: The World Bank's Enterprise Surveys and author's calculations. Averages across firms and countries are from Enterprise Surveys undertaken between 2005 and 2009.

Firms of all sizes, and everywhere, prefer self-financing (pecking order)

Credit supply or credit demand constraints?



Source: The World Bank's Enterprise Surveys and author's calculations. Numbers reflect averages across all Enterprise Surveys between 2005 and 2009.

Source: Beck (2011).

About the *"complex application procedures"*...

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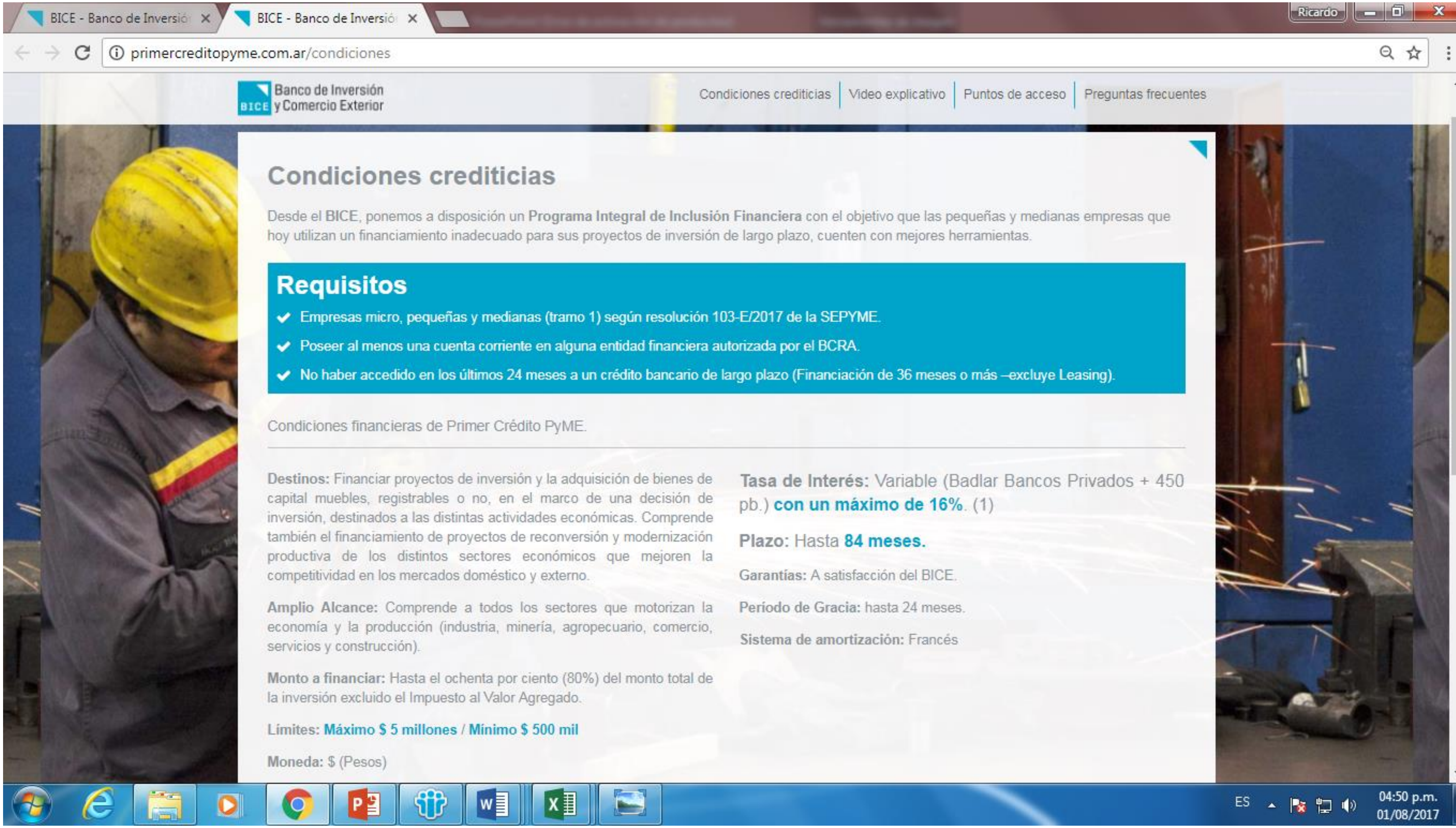
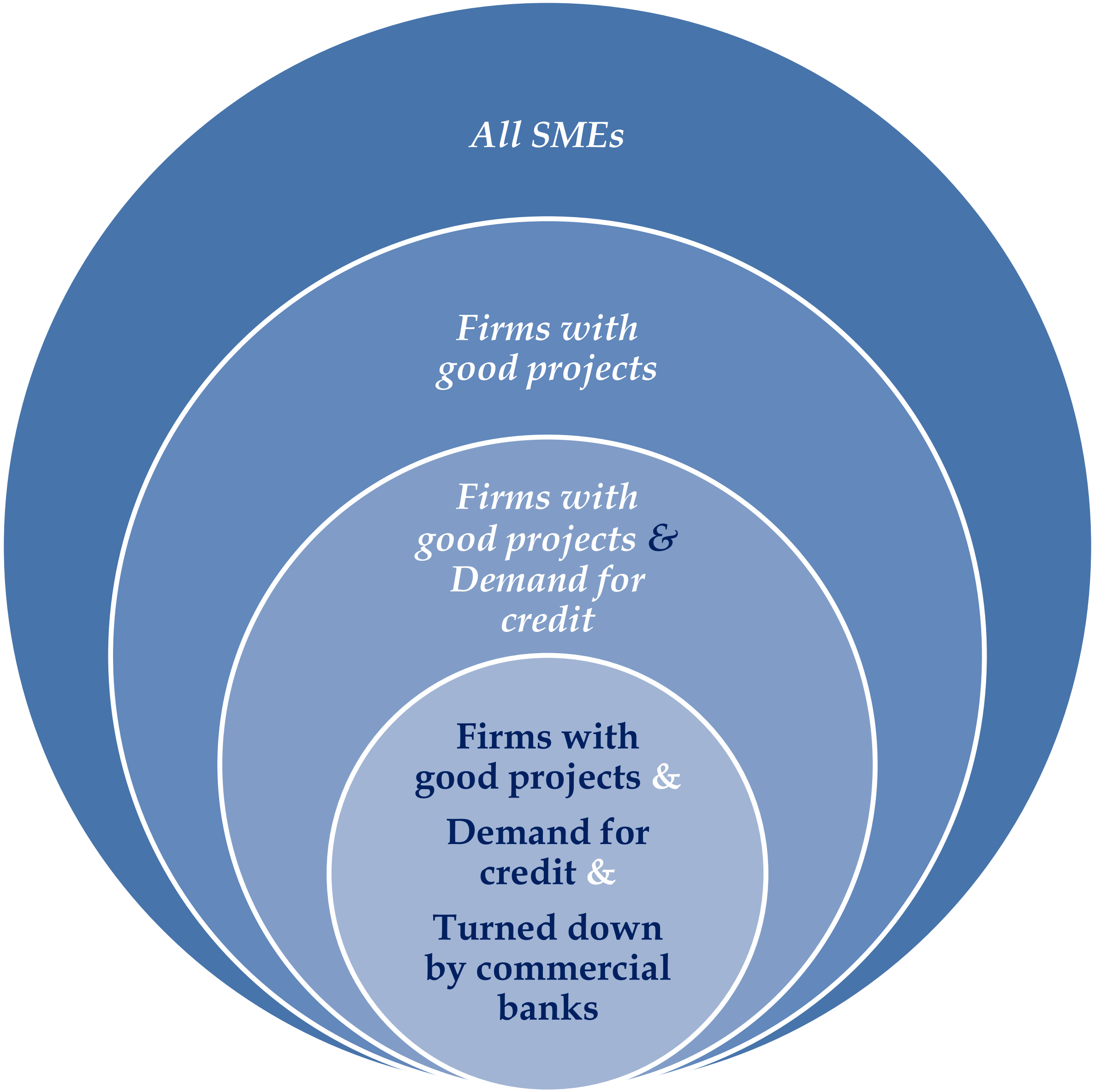


About the *"complex application procedures"*...

Massive or selective clientele?



But do DBs have the informational advantage to target these projects?

Hard or soft borrower information?

What tools do intermediaries use when screening loan applicants?

⇨ *Hard information:* Credit history, accounting books, collateral.

⇨ *Soft information:* Personal interaction with borrower and on-site visits to assess character, effort and entrepreneurial skills.

Comparing hard and soft information methods

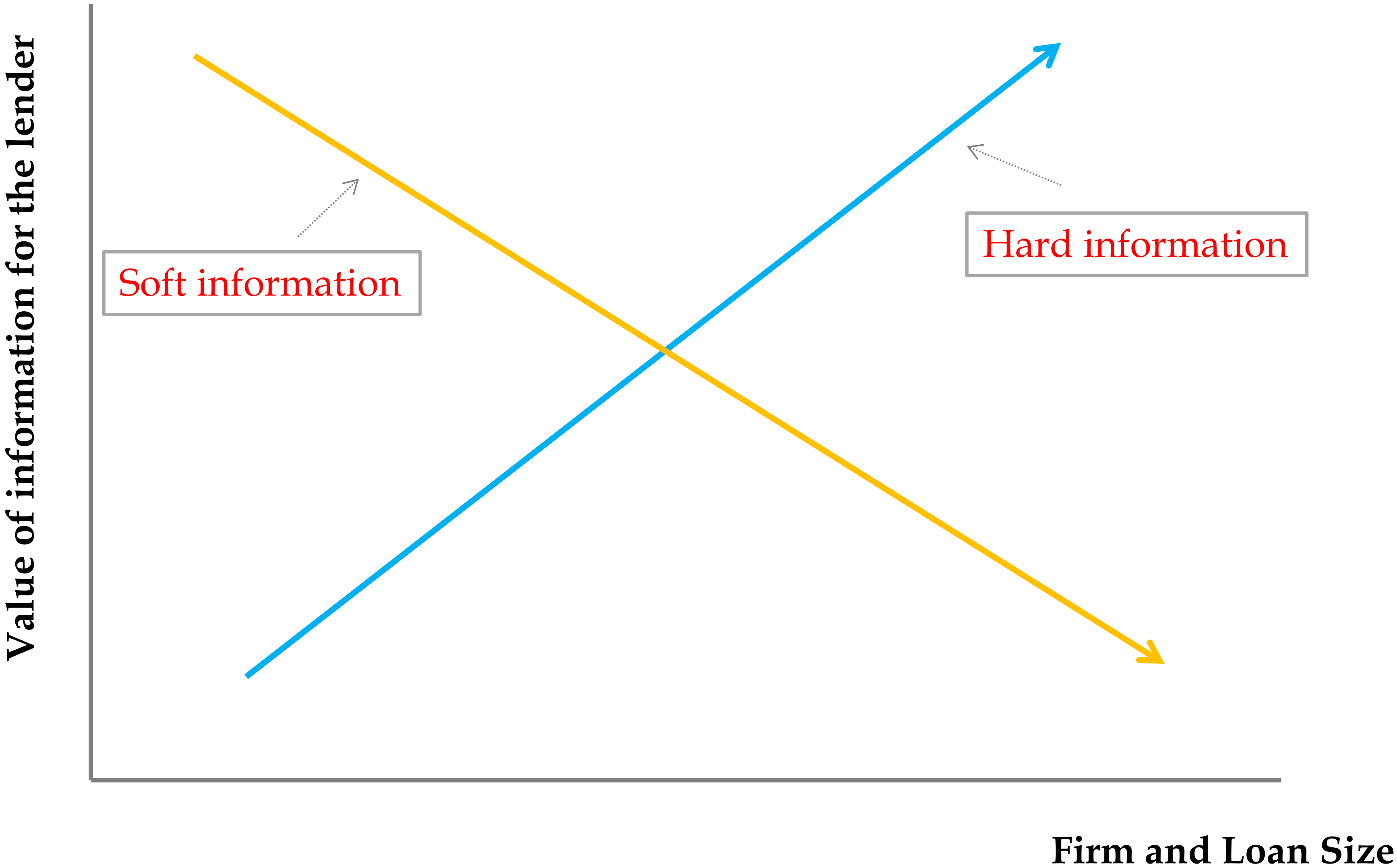
Hard information

- ✓ Quantitative
- ✓ Backward-looking
- ✓ Fact-based
- ✓ More science than art
- ✓ Suitable for older, bigger, collateral-abundant applicants
- ✓ IT-intensive with high fixed costs and strong economies of scale

Soft information

- ✓ Qualitative
- ✓ Forward-looking
- ✓ Perception-based
- ✓ More art than science
- ✓ Suitable for younger, smaller, collateral-scarce applicants
- ✓ Labor-intensive with low fixed costs and weak economies of scale

Firm Size and Information Requirements by the Lender



Hard or soft borrower information?

What do most CBs do?

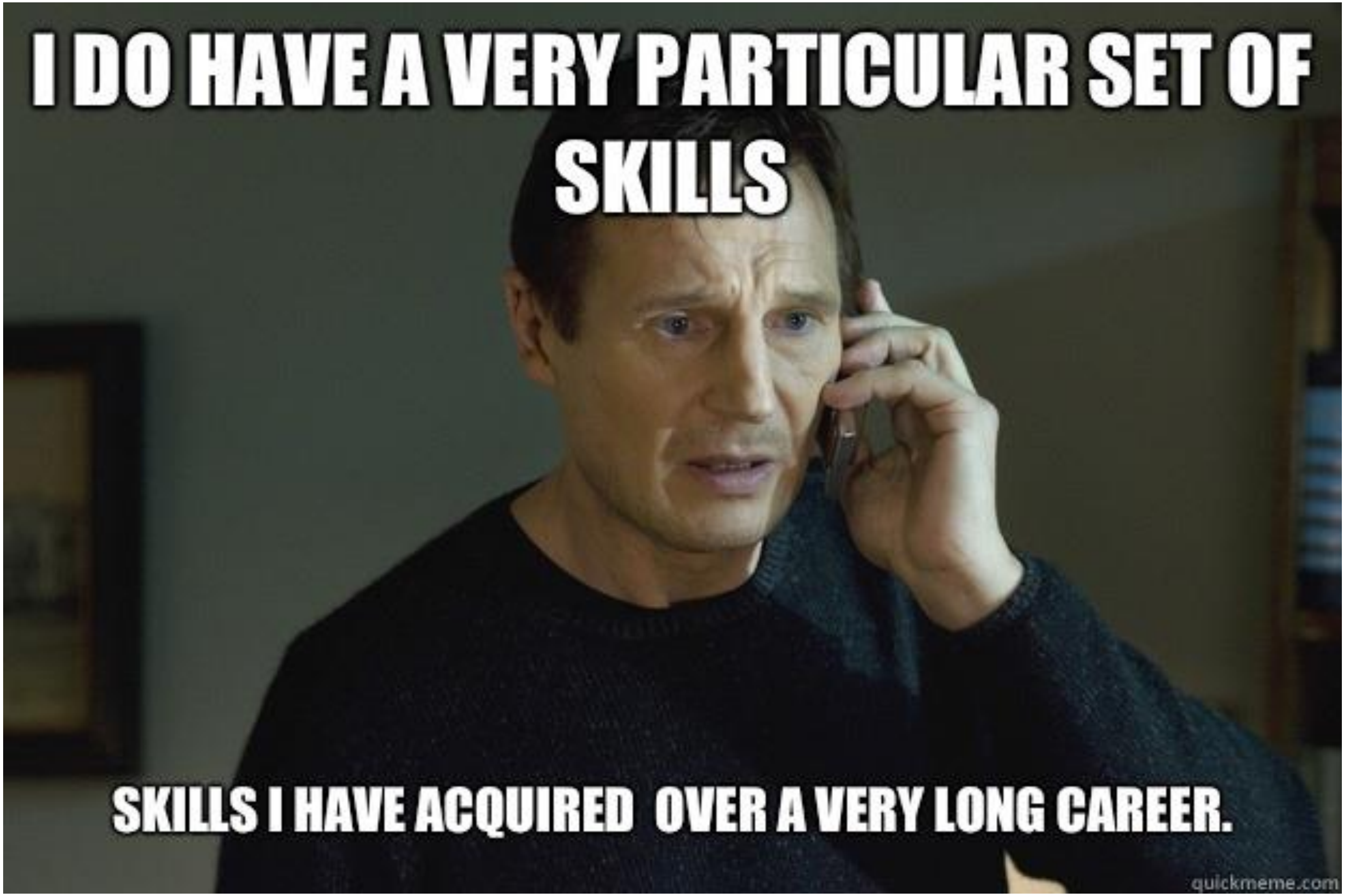
They heavily rely on hard information.

This explains why some valuable small, new or innovative projects are rejected.

What should DBs do?

If DBs apply the same client search techniques as CBs, they are bound to go after the same clients – all fishing in the same pond!

→ If DBs want to target financially excluded SMEs, they need to lean more – yet not totally- towards soft information


I DO HAVE A VERY PARTICULAR SET OF SKILLS
SKILLS I HAVE ACQUIRED OVER A VERY LONG CAREER.
quickmeme.com

Additional DB debates

- ***High or low target profitability?***
  - ✓ Positive but below market for financial sustainability. Too high returns should be channeled toward more bening loan conditions.
- ***High or low target NPL ratio?***
  - ✓ Reasonably low, but higher than peers (in light of its mandate, DB must tolerate more risk).
- ***First or second tier?***
  - ✓ Both. In first tier, better control over credit allocation. In second tier, broader clientele base and scalable operation.
- ***Small or big firms?***
  - ✓ Mostly small, but big firms provides economies of scale and may need maturity stretching

Additional DB debates

- ***Startups and microcredits?***

  - ✓ Not directly. They require screening and monitoring technologies unfamiliar to most banks. But feasible via second tier to specialized intermediaries.

- ***Target firms or sectors?***

  - ✓ Firms, as long as they meet the basic conditions (i.e., genuine financial constraint). Picking winning sectors has typically proved to be an elusive task.

- ***Permanent or temporary DB assistance?***

  - ✓ Temporary, only until building good credit history and hence CBs become willing to take on the client.

Additional DB debates

- ***Standard or lax regulation?***

✓ Lax, but still under proper control. Most DBs do not take short-term deposits from the public, but they must remain accountable to fulfill social mandate

- ***Concessional or market funding?***

✓ Both. Concessional funding enables to maintain acceptable rates to risky borrowers and do long-term lending.

✓ But market funding brings much needed market discipline and hardened budget constraint.

- ***Subsidized or market interest rates?***

✓ Subsidized rates as an exception, not a rule. For firms without credit or only short-term, access is subsidy in itself.

✓ Risky businesses should not pay corporate prime rates, because of:

(a) *Steep administrative costs from lending small amounts to unknown firms*

(b) *Contingent fiscal cost,*

(c) *Subsidized DB loan rates may lead CBs to focus on big clients away from SMEs*

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