BRIEFING PAPER

Development Banks and Mozambique

Assessment of the Pros and Cons of Development Banks

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Mozambique is entertaining a proposal to establish a development finance institution (DFI), a public sector second-tier lender that could work with a number of lending agencies. What must policymakers keep in mind in evaluating the risks and benefits of a DFI? An overview of the purpose of DFIs and experience with them in developing countries can help answer this question.

Purpose of Development Finance Institutions

The support of enterprise depends on a range of institutions and the existence of a real economy that can sustain debt. Rarely a major element in a country's overall structure for financing enterprise, DFIs provide credit to underserved but deserving economic sectors by supplementing the panoply of banks and nonbank financial institutions such as cooperatives and lending, leasing, and factoring companies. Industrial development banks, which provide long-term capital to industry, were among the first and largest.[1] Other banks focus on agricultural production, housing, and small enterprise.

Many development banks in industrial countries are privately owned. They typically gain their funds on a long-term basis by selling bonds or providing long-term savings facilities. This corresponds to the long-term lending they often conduct. Experience with DFIs in industrial countries is mixed—many have failed or require continued subsidization and their contribution to national growth is controversial. In developing countries they have enjoyed considerable vogue, especially as promoted by the World Bank.

[1] One of the most prominent, the Credit Mobilier, wreaked havoc on the French economy in the 19th century but seems to have made its promoters' fortunes.

Experience in Developing Countries

Donors, and the World Bank in particular, promoted specialized banks in the 1960s and 1970s. Most of these banks, whether devoted to industrial or agricultural development, encountered serious difficulties and many failed. As Gerard Caprio and Ash Demirguc-Kunt recount,

> attempts to cure the alleged scarcity of long-term credit in developing countries have been plentiful and expensive. By the early 1980s many DFIs were experiencing significant portfolio problems. A 1974 World Bank study of delinquency rates in agricultural credit institutions reported that the average arrears rate was 41 percent. A 1983 report indicated that 39 percent of all DFIs had serious portfolio problems, many of which became more severe in the late 1980s and resulted in a wave of failures of DFIs… Long-term directed credit failed to reach the intended beneficiaries. Once these directed credit programs were established, governments found it politically difficult to reduce support for them, regardless of their cost and efficiency.[2]

Though 60 percent repayment may seem acceptable to some, it is lower than any bank can survive with.

In the last decade, interest in development banks has revived, often with private ownership and a focus on microlending. Some development banks, including those in the public sector, have become big and successful commercial banks—losing their original specialization in project or development finance as well as their social focus. The Development Bank of Singapore is among the successes. In India, the ICICI has become a leading commercial bank and the IDBI will follow suit. Agricultural finance is reserved for the highly subsidized NABARD and small enterprise finance for the SIDBI. Both are recognized to be extremely inefficient and serve only a small part of their potential clientele. Critics allege that they block the entrance of financial institutions that could compete with them, pointing to the effective role of informal lenders in serving these potential clients.

The Bank Rakyat Indonesia (BRI), a developmental if not a development bank, has only done well in its smallest microlending (loans under $5,000), which accounts for a third of its total. Most of its larger lending was in arrears and the government had to recapitalize it.

Experience with Brazil's Banco Nacional de Desenvolimento Economico e Social (BNDES) seems generally positive, though it has taken criticism in recent years for crowding out potential private project finance institutions and funding sources. Nonetheless, it has been honest and only moderately politicized, and enjoys a relatively low level of arrearages while making a lot of small loans.

The experience of state-owned banks in Africa has been worse than in Asia. The Zambian government cannot find a buyer for Zanavac. Malawian and Tanzanian public development

[2] The Role of Long-term Finance: Theory and Evidence. *The World Bank Research Observer* XIII, 2 (August 1998), p. 172.

banks have reduced their lending to relatively low levels. Many countries have small DFIs with heavy donor input and subsidy providing a small portion of their total credit.

As elsewhere, the BNDA in Mali is reputed to be doing well as a second-tier funder of NGO microfinance village banks, as is the newly privatized Tanzania National Microfinance Bank.[3] Closer to Mozambique, the South African provincial development banks are still in difficult straits (2002), as shown by the Strauss Report, though Ithala in Kwazulu-Natal reorganized and is doing better.[4] The well-reported Botswana Development Corporation is not a bank and serves primarily larger enterprises. Like BRI, it has only survived by concentrating on microfinance.

The Development Bank of South Africa, primarily an institution for funding local and municipal infrastructure in default of adequate bond markets, has begun to diversify into international lending to support the expansion of South African enterprise in the SADC market. Although its financial ratios are probably sustainable, they are too low for any commercial bank to sustain using only private funds and equity and without government support. In Mozambique, many thought that the DFIs were disasters and insisted on their liquidation. In general, DFIs that performed well went upmarket and become universal banks, or went downmarket and are engaging in microfinance. In both cases they are frequently privatized.

Microlending in Mozambique, including in rural areas, has been expanding rapidly. It appears that funds can be available as soon as appropriate financial institutions with administrative capacity expand—so the proposed development bank is not intended to address any lack in microlending. Instead, it is intended to address the problems of long-term ("project") lending, small and medium lending, and lending for agricultural production.

Agriculture and Small and Medium Enterprise

Three things are at issue in market failures in the credit market:

- Project finance, which is usually large-scale and can be funded from international markets;
- Venture finance, which is mostly high-risk and usually done out of equity; and
- Routine, working finance, which a number of banks already handle.

Undoubtedly, the holes in the system need to be filled, but for large-scale borrowers these holes are not necessarily a problem.

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[3] http://www.dai.com/work/project_detail.php?pid=47

[4] Gerhard Coetze and Douglas Graham, "Restructuring Agricultural Development Banks in South Africa," Working Paper 2002-06, Department of Agricultural Economics, Extension and Rural Development, Pretoria

Small and medium enterprises (SME) and agriculture present a different case. The difficulties with agricultural and small-scale credit and the successes with microfinance have been particularly frustrating. In both cases, and for housing finance as well, ways to develop similar successful formats for lending have been investigated.

The effective provision of credit depends on identifying (1) unserved creditworthy borrowers and (2) lendable funds, including from the government budget. The business plan for a new institution needs to identify underserved borrower segments that it can profitably serve. Often, factors other than credit limit enterprise expansion; conversely, if profitable opportunities exist they are usually exploited. And sometimes credit is somehow found for non-creditworthy, unserved borrowers. Perhaps not much effective demand exists for credit at present interest rates. A recent World Bank study suggests that this has been true for small business in Tanzania,[5] but most small enterprises surveyed elsewhere as well were able to find means to respond to entrepreneurial opportunities. Similarly, studies of bankable small borrowers in rural Indonesia show that many have not been interested in borrowing.[6]

Once underserved credit clients are identified, different agencies (e.g., cooperatives, NGO programs, commercial or development banks, and nonbank financial institutions such as leasing companies) need to offer their services, subject to market tests. Being linked to the banking system—to funds borrowed from the general public—requires these agencies to pursue a prudent, financially sustainable credit policy. If they go beyond that, they should draw on their own budgets or on charitable funds and make the concessional element explicit and justified.

Extending the scope of lending through new financial instruments—new ways of providing credit—requires a foundation of prudence as well as

1. New forms of collateral that enable lenders to feel secure. The most dramatic forms include mutual guarantees as in microfinance, but forms that involve leasing, lending on warehousing receipts, shippers' bills, input credit, remittances, or bills receivable have all been effective.

2. Lending that makes use of the production chain and targets those in the chain who are most accountable (e.g., wholesalers, input dealers, shippers).

Bureaucratic state-owned agencies, however, have not proved agile in handling innovative lending. Often the best lenders are those with roles as shippers, traders, or input sources.

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5 But not true in Ghana, Malawi, Senegal, and Mali. See "Small Enterprise Response to Liberalization in Five African Countries," http://www.Worldbank.org/afr.findings/english/find42.htm.

6 *Preliminary Findings: Microfinance Access and Services: Household Survey,* Center for Business and Government, John F. Kennedy School of Government, Harvard University, May 2003 and *BRI Micro Banking Services: Development Impact and Future Growth Potential*, Center for Business and Government, John F. Kennedy School of Government, Harvard University, October 2001. These two studies, in which BRI loan officers assessed a sample of rural borrowers, found that even using BRI's current standards many bankable unserved borrowers exist, though many were uninterested in taking on debt. The rest constituted a potential market for rural, mostly agricultural, lending.

Implications for Mozambique

What has been proposed recently in Mozambique is a public sector second-tier lender that could work with all the potential agencies. Creating a new DFI is risky and, as we have seen, DFIs have a poor record of success. Many preconditions must be met and efforts to form a DFI frequently result in costly failure. The DFI must have funds secured for it; a learning curve for staff and management is understandable. A new public-sector second-tier entity in Mozambique could be nimble, but that is not the usual experience of public agencies—especially since the countervailing danger is that exploitive rent seekers will capture it. It may be preferable to build on various promising existing institutions (e.g., microcredit, rural enterprise, small and medium enterprise). If that proves insufficient, perhaps Mozambique should start out with a small, flexible second-tier fund that can demonstrate its prudence and agility before getting a great deal of money to onlend. Such funds are not unusual in development efforts, though insulating them from political pressures sometimes requires extreme measures, such as operation by an expatriate institution.[7] In any case, if the DFI borrows funds that must be repaid, it must follow tight standards for remunerative interest rates and prompt payment. If not, it will threaten the stability of the financial system—which, as Mozambique knows, can be costly and destructive.

[7] One DFI for Pakistan is physically managed from New York.