At a Glance

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Developing the ‘Real’ Financial Sector

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The contribution of the financial sector to economic growth depends on how well it deploys its risk, skills, and information capital. This Note offers a framework for improving the way countries deploy these resources. If they succeed, capital should be able to support more investment at manageable risk levels. This framework guides World Bank support to financial sector development.

Overview

Economists typically treat the financial sector as being distinct from the ‘real’ economy. The principal reason for this is that most financial assets and liabilities of real sector enterprises—like cash on deposit and outstanding loans—are reflected in a mirror image format on the balance sheets of the banks and other financial institutions with whom they do business. Thus, in accounting for national wealth or productive capacity, it is necessary to net out such entries on financial institutions’ balance sheets.

While this simple construct is valuable in avoiding double-counting it can also lead one, consciously or not, to overlook the impact of real actors in the financial sector on economic growth and development. Evidence of the financial and economic danger of such oversights was especially clear during the last decade: the savings and loan collapse in the U.S.; commercial banking crises in several OECD countries; and costly bank rescues throughout the developing world. The cost of these lessons is striking enough in terms of fiscal drain and economic instability, not to mention the uncounted losses in terms of allocative inefficiency.

These lessons have also been evident in the context of World Bank operations. The Bank has often extended loans through financial intermediaries but focussed its attention entirely on ‘real sector’ borrowers. It has neglected the condition and operations of the banks or specialized financing institutions through whose balance sheets the credit flows. Many of these financial institutions (and their borrowers) failed. It became clear in these situations that serious sectoral adjustment and financial institution building were required, and many such remedial operations have been undertaken since the late 1980s.

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Actors in the 'Real' Financial Sector

How do we explain the impact of 'real' financial sector actors? We do so by recognizing that the balance sheets of financial institutions are not exactly mirror images of those in other sectors. In fact, we must look to the quality and quantity of their residual assets (i.e., those beyond the level necessary to balance against financial liabilities) to explain financial institutions’ potential cost or contribution to economic growth and efficiency. In a word, those residual assets are *capital*, which takes three main forms:

- risk capital;
- human capital; and
- information and technology capital.

Deploying these different forms of institutional capital is what the 'real' financial sector is all about. So, too, are the dynamics of financial markets, in which intermediaries and instruments bring investors and borrowers directly together. Developing the capacity of real actors in the financial sector—including banks and capital market participants—allows capital to support increasing amounts of investment with manageable risk.

Bank “capital”

Banks are the predominant actors in the financial sector. They typically retain on their balance sheets significant amounts of financial liabilities (like deposits) and financial assets (such as term loans). The returns on their invested capital are the result of net profits on the cash flows generated by these financial liabilities and assets. In addition, banking institutions offer a variety of other essential services such as the processing of payments to support commercial transactions.

However, like actors in other ‘real’ sectors, banks cannot deliver their products without necessary skills and capital resources. As lenders, the banks’ most critical asset is *risk capital*. Banks must be in a position to share the risks of their borrowers, on whose repayment capacity they depend. Risk capital resides on a bank’s balance sheet to cover the potential decline in value or dissipation of their loan assets. Moreover, capital must be maintained to withstand possible losses which result from any mismatch in terms (such as maturity or currency) between bank assets and liabilities.

The effective deployment of risk capital depends on the quality of banks’ *human and information capital*, which support the extension of credit. High-quality human and information capital are essential to an efficient process of qualifying prospective borrowers, establishing lending conditions, and conducting ongoing management reviews. This process, in turn, promotes repayment capacity. In this way, banking institutions deliver financial and management discipline—along with funds and other services—to their borrowers, thereby reducing risk and extending the banks’ capacity to lend.

Building bank “capital”

For these reasons—because the economic health of banks determines the quality of services they provide—a principal focus of the World Bank has been to help strengthen banking institutions. First, at the broader level of the banks’ business environment, three kinds of measures are typically needed:

- improvements in macroeconomic policy and restructuring of enterprises to ensure that they become healthy and productive borrowers;
- reform of interest rates and uneconomic credit-allocation schemes; and
- upgrading of the financial sector infrastructure including the legal, accounting, and regulatory framework.

At the individual bank level, financial restructuring is often necessary to isolate and tackle nonperforming assets. Reforms of bank management and procedures are required to prevent the reemergence of asset and other problems. Once banks are overhauled, it is vital to strengthen the institutions and processes of bank supervision so that a recurrence of asset problems is prevented to the extent possible and dealt with expeditiously when they arise. Given
that the process of bank restructuring is a long and arduous one, it is vital that supervision is intensive for several years.

In view of these priorities, the World Bank has developed a strong capacity in the area of prudential supervision and regulation. The Bank also delivers assistance directly to banking institutions, through capacity-building and financial restructuring operations.

Financial market “capital”
The ‘real” financial sector comprises more than just banks or the banking functions of diversified financial institutions. It also includes nonbank savings institutions (like pension and mutual funds, credit unions, and life insurance carriers), capital market instruments (like stocks and bonds), and specialized intermediaries (like security underwriters and traders) who facilitate more direct flows between investors and borrowers. Such flows do not typically remain for a long time on the balance sheets of financial intermediaries, making this aspect of the ‘real’ financial sector even less obvious than is the case with banks.

Financial markets have a key role to play in economic development. They can reduce the long-term demand for risk capital to support the balance sheets of leveraged financial actors. This can help to make credit more available at lower cost, although market development is a complex and demanding process. However, while capital markets can reduce the amount of risk capital necessary to support financial balance sheets, they typically demand more human and information capital. Professional managers are required to oversee pooled investments. And these managers cannot operate without substantial and high-quality information.

Longer-term, higher-risk investments
Financial markets complement banking institutions in mobilizing and delivering investment resources. This is especially true in addressing longer-term, larger-scale, and higher-risk investment demands, which may suit the interests of direct investors more closely than banks. Institutional investors—like pension funds, insurance carriers, and mutual funds—are often prepared to bear greater risks because they are unleveraged, have a longer-term investment horizon (consistent with, say, a retirement plan), and are able to diversify their exposure among many tradeable investments. Professional management enhances such investors’ ability to serve these functions and to instill discipline among borrowers who depend on the market’s willingness to provide continued financing.

Flexibility for new instruments
Financial capital markets have more flexibility than banks because they link borrowers directly with savers. Successful intermediaries help borrowers to create financial instruments representing loans or ownership interests, and to place them with investors. They tailor instruments to special needs. Other market participants also serve vital functions, such as helping investors assess the value and risks of financial assets and providing liquidity for securities trading.

Creating new private investment instruments—such as stocks and bonds issued by formerly state-owned enterprises—has contributed to the significant amount of foreign portfolio investment flowing to selected countries. However, in order to meet the significant investment demands within developing countries—especially in large-scale power, water, and road projects—national investment markets will need to grow. This means increasing local savings pools, and also requires the creation of investment vehicles which allow them to reach prospective borrowers. This is a challenge currently facing retirement fund managers in Chile, for example, who may be forced to invest overseas because of a lack of local financial assets, despite the substantial demand for domestic credit to support Chilean infrastructure development and small- to medium-size enterprises.

Building financial market capital
The public sector can play an important role in helping build these local markets. This job often
starts with support for contractual savings pools which have a natural demand for capital assets. In many cases, it is also possible for the public sector to establish market benchmarks as an active security issuer and to help provide liquidity to the markets. Moreover, it is up to governments to enforce standards of fairness in trading and broad disclosure of information.

Many countries which have realized the importance of strengthening their capital markets are getting World Bank assistance. This typically occurs in countries where the need for basic financial services is being met, but capital is not easily accessible to support the larger, longer-term and local currency-based investment projects of enterprises and infrastructure developers.

Given the importance of investment funds and their role in managing individuals' savings, the Bank is actively involved in providing design advice for pension and insurance institutions and related prudential regulation. Staff have also worked with client governments and key private sector actors to promote sound regulation, credit transparency, efficient clearing and settlement systems, and financial integrity within growing capital markets.

The Bank, among other multilateral institutions, has worked with governments in managing the issuance of their own debt securities and the issuance of equity in formerly state-owned enterprises. Such public issues often play an important role in catalyzing private market development by offering simple structural designs, pricing benchmarks, and liquidity. Bank resources can also strengthen the capacity of governments to promote acceptance and liquidity for securities issued by creditworthy private borrowers, which might otherwise be unmarketable owing to concerns over broad economic policy or government performance.

Over time, private issuers and intermediaries can continue the process of financial instrument design, while investor interests should exert pressure for a stable financial environment and sound corporate behavior.

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"Forthcoming Notes from the Financial Sector Development Department will explain in more detail how to operationalize this framework."

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