DEVELOPMENT BANKS IN THE FINANCIAL SYSTEM

By

V.V. BHATT

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Development Banks in the Financial System

1. The capital market is must be imperfect in the sense in which economists use this term; for it involves a relationship in time between the lender and the borrower in the context of uncertainty. However, it does get progressively integrated, widened and deepened with economic and financial evolution. The crucial variable in this context seems to be transaction costs (both administrative costs and default risk). Financial innovations - whether autonomous or policy-induced - reduce these costs and thus lower the costs of lending and borrowing (quite often inadequately represented by the interest rates) and narrow the interest rate differentials among various existing credit instruments. (Of course, a new credit instrument devised for financing an economic activity for which no credit is provided through the existing instruments may bear a higher interest rate; but then it has to be compared with 'infinite' or 'prohibitive' interest on an existing instrument.) This has saving, investment, output and distribution effects. 1/

2. The establishment of a development bank in a number of LDCs represents a policy-induced financial innovation. The question to be discussed in this Seminar is whether this innovation has tended to integrate the capital market.

3. The characteristic features of saving and flow-of-funds in the LDCs are presented in Section I. The logic of the innovation of development banking is discussed in Section II. The impact of this innovation on capital market integration is analysed in Section III. The role of a development bank as a catalyst is indicated in Section IV. The critical role of the Central Bank in initiating a process of capital market integration is discussed in the final section.
I. Characteristic Features of Saving and Flow of Funds

4. Saving and flow of funds analysis brings out the major characteristics of capital market transactions. For this purpose, the economy is divided into four real sectors: Government, Corporate, Household and the Foreign Sector. If detailed data are available, the government sector could be divided into government sector proper and government enterprises, while the household sector could be sub-divided into non-corporate farm enterprises, non-corporate non-farm enterprises and the household sector proper. The sub-sectors of the financial sector are the banking system, social security institutions, specialised financial institutions and the securities market; the financial system for the purpose of this paper comprises the first three sub-sectors.

5. Surplus and Deficit Sectors: The government sector and the corporate sector are generally deficit sectors in the sense that their resource requirement for investment exceeds their own saving; their deficits are financed by the household sector and the foreign sector.

6. Among the domestic sectors, the household sector is the only surplus sector; its saving exceeds its investment and constitutes more than 50 percent of overall domestic saving. Its surplus finances the deficits of the other two sectors. Its saving is invested partly in physical assets like equipment in non-corporate farm and non-farm enterprises, residential buildings and inventories of goods and partly in the form of financial assets. Of course, there is lending and borrowing by individual units of the sector through what are known as informal credit markets; its borrowing from the financial system is negligible and probably finances about 15-20
percent of its investment.

7. Its surplus saving - about 50 percent of its total saving - constitutes financial saving or saving in the form of financial assets. About 80 percent of this financial saving is in the form of currency and deposits and claims on social security institutions like life insurance and provident funds and the remaining 20 percent is in the form of securities issued by the government and the corporate sectors. Thus the securities market mobilises only a small part of the household sector's financial saving, the major part being mobilised by the banking system and the social security institutions.

8. **Pattern of Household Sector Financial Saving:** It is through the acquisition of financial assets that the household sector finances the deficits of the other two sectors. It directly finances their deficits when it purchases claims - bonds, shares, etc. - of the government and corporate sectors; this is called direct financial saving, which is a small part of its total financial saving. It finances these deficits indirectly - the indirect financial saving - when it purchases claims on the banking system and the social security institutions, which then finance the resource requirements of the deficit sectors.

9. It appears from the structure of flow of funds that the household sector prefers to hold its saving in the form of financial assets which (a) are relatively liquid in the sense that they can be converted into money either directly or through borrowing against them, (b) have low transaction costs, (c) are simple, convenient and easily intelligible, and (d) earn a net real return (not necessarily represented by the interest rate) comparable to that on private lending, which involves very high transaction costs and
represents a relatively illiquid form of saving.

10. To bring about a progressive integration of the capital markets, it seems essential to promote the rate of indirect financial saving of the household sector. Even in the developed countries like the U.S.A. or Japan, the pattern of the household sector's financial saving has evolved in this direction. In the United States, the major part of the household sector's saving is in the form of financial assets (deposits and claims on social security institutions) and the deficit units of this sector finance their deficits by borrowing from the financial system. In Japan, more than 50 percent of the household sector's saving and more than 80 percent of its financial saving are in the form of deposits.

11. However, mere promotion of indirect financial saving is not enough. By this device it is possible to mobilise saving and improve its allocation pattern. But resource allocation would depend on the allocation policies of the banking system and the social security institutions; if they are biased in favour of certain sectors/forms of financing because of their historical evolution as well as their 'agenda' - which is a function of their philosophy and the information-communication system evolved for decision-making -, the other sectors and projects requiring other types of financing would be discriminated against and capital markets would still remain fragmented.

II

Logic of Development Banking

12. Because of historical reasons, the banks in the LDCs are oriented towards financing inventories in urban trade and industry. Economic development, however, requires financing of specific projects - in agriculture,
industry and infrastructure facilities - which have a fairly long gestation period and the returns of which are spread over a long period of time. The banks, because of their historical evolution and their 'agenda', are not equipped to provide medium-long term credit required for project financing. Their transaction costs for the purpose are much higher than those for inventory financing because of lack of expertise. Hence, even if they did provide long-term finance, they would do so only on terms and conditions - interest, repayment periods and other conditions - that would not be attractive even for otherwise viable projects. (Of course, if the banks were motivated through appropriate policy instruments to extend their 'agenda' to include medium-long term credit instruments - as has happened in some LDCs -, they could reduce transaction costs of such lending; in principle, a new institution is not essential to perform this function.).

13. Of course, the banks do finance indirectly fixed investment; by providing working capital finance, they make it possible for enterprises to use their own resources for fixed investment. However, it is only well-established businesses that generate internal resources who can finance fixed investment thus. The new enterprises would not be in a position to finance their fixed investment in this way.

14. There is thus a gap in the financial structure relating to the provision of medium-long term finance for new enterprises and this gap is being filled by the development banks.

15. The logic of this innovation of a new financial intermediary can be briefly stated. It relates largely to economies of specialisation and scale in the provision of medium-long term finance for new enterprises. Specialisation in the tasks of project appraisal and supervision would
reduce the transaction costs of lending and thus lower the cost of borrowing for the enterprises. To be effective, the transaction costs of lending for fixed investment should be lower than those of the banks.

16. How this logic would work out in practice is indicated illustratively in terms of a hypothetical cost-structure in the following paragraphs. The transaction costs, annual interest and annual profit rates, are presented as a proportion (percent) of total assets and on the assumption that the inflation rate is lower than 3 percent per year. These magnitudes, though illustrative, are based on data of several countries.

17. The banks' transaction costs for financing fixed investment are of the order of 5.5 percent—comprising 2.5 percent for administrative costs and about 3 percent for risk. Their cost of funds is about 6 percent and if 1.5 percent profit margin is added, they cannot afford to lend at interest rates below 13 percent for financing fixed investment in new enterprises. The banks' transaction costs of lending for providing working capital finances are much lower; administrative costs are of the order of 1 to 2 percent, and default risk of the order of 0.5 percent. Thus they do provide working capital finances at an average interest rate of about 9 to 10 percent per annum.

18. The development banks can reduce their transaction costs in a number of ways—all relating to economies of specialisation and scale and spreading of risks. They could recruit staff with expertise in project appraisal and supervision. They could establish links with Technical Consultancy Service Centres (TCSCs) for the purpose of critically examining the complex technical choices relating to a project. Again, they could avail themselves of the services of Management Consultancy Service Centres (MCSCs) for supervising complex and risky projects. They could spread their risks by financing a
large number of projects and a wise choice of their portfolio. Thus they could reduce both their subjective as well as their objective risk. Their administrative costs need not be higher than those of the banks - say less than 2 percent - while they would be able to reduce default risk to 1 percent as against the banks' 3 percent. If we add 1 to 1.5 percent profit margin, the difference between their average lending rate and the average borrowing rate could be about 4 to 4.5 percent as against the banks' 6.5 percent for financing fixed investment.

19. Their actual lending rate would depend on their cost of borrowing. Since the mobilisers of resources are the banks and the social security institutions, the development banks would have to borrow from them. The banks' average cost of funds depends on the maturity pattern of their deposits, the interest rates associated with this pattern, and the administrative costs of mobilising them. This average cost is unlikely to be less than 5 percent. With a profit margin of 1.5 percent, the banks and the social security institutions can afford to lend to the development banks (by way of loans or purchase of their bonds) at a rate of 6.5 to 7 percent, provided of course that the development banks' securities do not involve much risk. On this basis, the average lending rate of development banks could be 10 to 11 percent against 13 percent of the banks.

20. Thus, this new intermediary specialising in medium-long term finance can be financially viable and able to grow and diversify its functions if it can lend at 10 to 11 percent to new enterprises. For this to be possible, the projects to be financed should have an expected internal rate of return exceeding 15 to 16 percent; for, without a 5 percentage point margin between the expected rate of profit and the cost of borrowing, the enterprise would not be motivated to take the risk of investment. And from the economy's point of view,
it is essential to choose only such projects that have an internal rate of return of more than 15 percent to have a growth rate in industrial output of 8 to 10 percent (which is the objective of many LDCs). It is assumed, of course, that such projects can be identified and formulated, given an appropriate incentive and institutional structure and that the supply of funds to the banks would be fairly elastic, within a certain range, at the given interest rate.

21. This logic of development banking does not require the establishment of a separate institution. The same functions can be performed by a specialised department of a commercial bank. If this is possible, the total costs of lending could be further reduced at least by 1 percentage point for several reasons. The commercial banks have a greater familiarity with the enterprises who maintain accounts with them. This additional information could reduce both costs of appraisal as well as supervision. They would be able to pool risks much more than the development banks because of the diversity of their portfolio. Finally, they are in a position to mobilise resources at a cost lower than the development banks.

III

Development Banks: Review of Performance

22. The development banks - or specialised development banking departments of commercial banks - can, in principle, narrow the interest differentials, as argued in the previous section, and thus bring about a greater degree of capital market integration. The question then is: Have the development banks, in fact, performed this role?

23. The broad consensus with regard to the performance of the development banks in the LDCs is the following:
(a) They have, by and large, provided finance to well-established and well-entrenched business houses;

(b) They have failed to play the expected catalytic role of promoting new entrepreneurs and new enterprises;

(c) They do not have much impact on the promotion of small-medium enterprises;

(d) They have failed to mobilise domestic resources on their own by establishing the necessary links with the banks, the social security institutions and the other financial institutions; and

(e) Their profit performance on the whole is good.

24. Briefly, they have provided finance, by and large, to such enterprises which would have been able to obtain the required finance even from commercial banks. That is, they have not been able to reduce the real resource costs of lending to new entrepreneurs. For existing entrepreneurs, they have been able to lend at an interest rate lower than that of the commercial banks, not so much due to their lower real resource costs as due to the supply of funds to them by the government at a subsidised rate.

25. The major reason for this performance seems to be the interest rate policy of the development banks. Their lending rate has been fixed at around a level which is similar if not lower than the interest rate charged by the commercial banks for short-term loans. Their lending rate has been on average 8 to 9 percent. Given this parameter, it is obvious that they could not have mobilised domestic resources to any sizeable extent from the other financial institutions. Hence, their reliance on government funds and international institutions could not be reduced. Assuming an average cost of funds from these sources of 6 percent, they had to reduce their transaction costs to about 2 percent to have a profit margin of at least 1 percent.
26. To have their operations at this level of transaction costs, they have to choose such projects that can be financed with minimum of administrative costs and default risk. Obviously, such projects can come only from well-established profit-making business houses which have the resources and expertise to formulate projects in a manner acceptable to the development banks and have adequate assets as collateral.

27. The result has been that well-established businesses could obtain finance from the development banks at a subsidised rate - this subsidy in effect being provided at the cost of potentially viable new enterprises and of the banks themselves. The other result has been that the development banks could not tap the elastic sources of finance to widen and deepen their operations. In sum, they have neither the means nor the motivation to play an innovative development banking role. Thus, instead of integrating the capital market, the development banks have tended to fragment it further; they have not been able to reduce the real resource costs of lending to new enterprises by appropriate financial innovations.

28. Of course, these banks have performed some vital functions. They have extended the time horizon of the capital market by introducing medium-long term credit instruments. Further, they have built skills and expertise relating to project evaluation, appraisal and supervision; they have thus improved the selection process for projects and the potential rate of return on assisted projects. Their accumulated experience in medium-long term financing has had a favourable catalytic impact on the other financial institutions and the securities market. They have, in addition, accumulated data and experience, which are of crucial significance for analysing the impact of government industrial and trade policies and for suggesting, on the basis of such an analysis, modifications in these policies. They have
in a sense acquired the 'potential' for improving the functioning of the capital market. What is essential now is an incentive structure and a policy framework that will induce them to realise this 'potential'. Premature withdrawal of support from the government and the international institutions (like the World Bank) would frustrate their efforts in this direction and result in the atrophy of a very effective instrument for industrial development.

IV

Role as a Catalyst

29. If the top management of a development bank is dynamic, innovative and development-oriented, it would try to influence and modify the aspects of policy environment and framework that are not in tune with its basic objectives. A development bank can serve as a catalyst in several ways in initiating a process of capital market integration.

30. (a) It could make a reasoned case to the policy-making authorities for a change in the interest rate policy. It could point out to them that (i) interest subsidy to well-established business is at the cost of new enterprises; (ii) without this subsidy, its own income would increase and almost 100 percent of this income would be saved and used for supporting new enterprises; (iii) higher interest costs to enterprises would induce them to mobilise more equity capital; (iv) with the corporate profit tax of about 50 percent, a 2 to 3 percentage point rise in the interest rate would raise the effective interest rate by only 1 to 1.5 percentage points; and (v) a higher interest rate would induce enterprises to select more viable projects. Since a development bank has the required data, it could analyse them to show effectively and in concrete terms to the policy-making authorities the adverse impact of their policies on mobilisation and allocation of resources.
31. (b) Even if it were not possible for it to interact effectively with the government or the Central Bank in order to modify the policy framework, it could overcome its adverse impact on its operations and objectives by taking on some commercial banking functions; it could thus mobilise more resources and raise the effective interest rate on lending.

32. (c) If for some reason it cannot assume commercial banking functions also, it could still induce commercial banks to provide a part of the credit for projects that it has appraised and selected for financing; thus, it could mobilise more resources for long-term lending and at the same time raise the effective interest rate. For commercial banks, the transaction costs would be less as their own administrative costs and default risk would be lower for projects which are well appraised by the development banks.

33. (d) Similarly, it could induce the social security institutions and other such institutions to purchase the bonds/equity of projects that it has selected for financing; of course, this would be possible only if the investment pattern of these institutions is not rigidly controlled.

34. (e) It could reduce its own transaction costs and at the same time improve the project design and formulation for new enterprises by establishing on its own or in participation with the other financial institutions a Technical Consultancy Services Centre (TCSC); such a TCSC would work on business principles by charging appropriate fees for its work to the project promoters. The latter would be willing to pay these fees if they could improve the potential returns on their projects.

35. (f) Similarly, it could reduce its transaction costs relating to project supervision by establishing a Management Consultancy Services Centre (MCSC).
36. (g) With such reduction in transaction costs, it could improve its own profitability and this could make it possible for it to issue its own bonds at attractive interest rates in the securities market and thus mobilise additional resources to some extent.

37. (h) It could serve as a catalyst for the promotion of small enterprises by inducing the promoters of large enterprises, who seek its assistance, to provide management, technical and financial assistance to small enterprises that are ancillary to their own projects; the real problems of ancillary small enterprises relate to marketing, supply of materials and credit and the large enterprises could provide such assistance, which traditionally in Europe and elsewhere was provided by the merchant during the early phases of development. The development bank cannot directly finance small enterprises; its transaction costs would be quite high. But it can finance them indirectly through the large enterprises.

38. Some development banks have undertaken some of these functions but a large number of them have not diversified their functions in order to play effectively the role of a development bank.

V

Critical Role of Central Bank

39. The critical role in initiating a process of capital market integration is inevitably that of the Central Bank. The financial structure cannot function as a System without a leader and a coordinator. This function has to be performed by the Central Bank; without this function there is no rationale for its existence.

40. Unfortunately, the Central Bank in a large number of LDCs emphasizes only its regulatory function. However, in these countries, the role of
a Central Bank cannot be restricted merely to that of the regulator; for, the institutions to be controlled and the credit system to be regulated have still to evolve to necessitate a regulator.

41. A Central Bank in a LDC has first to assume the function of a promoter of a sound integrated financial system even to perform effectively its role of a regulator. These two functions are inter-related and a Central Bank's function as a regulator is in fact reinforced by its function as a promoter. It is the Central Bank that has to take the lead in evolving credit institutions, instruments and yield-structure that are essential for (a) efficient mobilisation of saving, and (b) allocation and use of resources that are consistent with the basic development objectives. This development function cannot be performed effectively unless the Central Bank is able to maintain close, continuous and active contact with the credit system - the contact which is also essential for the success of its regulatory function. It is thus essential for the Central Bank to do banking business with various parts of the system (including development banks) without inhibitions. Unless the Central Bank becomes not only "central" but also a "bank", it would not have adequate sanctions for performing its functions. It should not be merely a lender of last resort; it has to be a lender of early resort and in some cases a lender of primary resort. This need not mean continuous indebtedness; the financial institutions, however, should feel free to approach the Central Bank for help from time to time. Only then would they have the incentive to listen to the Central Bank's advice with respect.
NOTES

1/ See in this connection V.V. Bhatt, Interest Rate, Transaction Costs and Financial Innovations (World Bank: Development Economics Department, Domestic Finance Studies No.47, 1978).

2/ See V.V. Bhatt, Some Aspects of Financial Policies and Central Banking in Developing Countries (World Bank: Economic Development Institute, EDI Seminar Paper No.11, 1974).


Arrow writes: "In classical maximising theory it is implicit that the values of all relevant variables are at all moments under consideration. All variables are therefore agenda of the organisation, that is, their values have always to be chosen. On the other hand it is a commonplace of everyday observation and of studies of organisation that the difficulty of arranging that a potential decision variable be recognised as such may be much greater than that of choosing a value for it." (p. 47).

"The theme to be presented is that the combination of uncertainty, indivisibility, and capital intensity associated with information channels and their use imply (a) that the actual structure and behaviour of an organisation may depend heavily upon random events, in other words on history, and (b) the very pursuit of efficiency may lead to rigidity and unresponsiveness to further change." (p. 49).


5/ See V.V. Bhatt, Interest Rate, Transaction Costs and Financial Innovations, op. cit.


7/ For the experience of the Development Bank of Singapore in this connection, see V.V. Bhatt, Division of Public and Private Finance: Research Program and Its Rationale (World Bank: Development Economics Department, Domestic Finance Studies No.43, 1977). See also John Hicks, op. cit.


9/ See V.V. Bhatt, Financial Institutions and Technology Policy (World Bank: Development Economics Department, Domestic Finance Studies No.54, 1979).

11/ V.V. Bhatt, Financial Policies and Central Banking in Developing Countries, op. cit.
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# 33. On Monetary Data and Analysis. February 1977. V.V. Bhatt.


