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INVESTMENT BANKING AND DEVELOPMENT BANKING

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INTRODUCTION

If ever there was any doubt about the important role of domestic capital markets in ensuring balanced economic growth, the history of the 1980s to date must surely dispel it. The chronic problems of country and corporate overindebtedness have brought home the dangers of combining too much short-term debt with too little long-term equity. The resulting crisis has produced the biggest setback to economic development in many decades.

For too long, policymakers in many countries have tended to think of total flows of savings in a macroeconomic sense and have paid insufficient attention to the form or quality of those savings. A more balanced pattern of financing would not perhaps have prevented the international debt crisis. But stronger domestic and international securities markets would have left the financial system much less vulnerable to economic recession. The adjustment paths of debtor countries, and debtor companies, would have been substantially less painful.

The International Finance Corporation is an international development institution which was established in 1956 to promote the growth of private investment and business in developing countries. It is an affiliate of the World Bank. Capital is provided by the 127 member countries that are its shareholders.

IFC provides financing for worthwhile ventures in the 105 member countries which are classified as developing. It also helps to mobilize funds, technical assistance, and management expertise from other sources to aid these ventures. IFC has long experience working in developing capital markets. It is therefore particularly timely that it has chosen to make its experience available to a wider audience through this new Capital Markets Series of Occasional Papers. They cover not only investment banking and development banking, but also securities markets, leasing, and venture capital. These papers will prove indispensable for policymakers and analysts alike.

Investment banks and development banks are often closely associated in developing countries. Development banks can play an important role in promoting investment banking, especially in countries with weak securities markets. But the two businesses are fundamentally different. Investment banking is primarily concerned with designing and underwriting new securities, and selling them to ultimate investors. It requires an innovative, market-based approach. By contrast, development banking is concerned with making long-term loans; it requires a different mentality, one concerned with analyzing long-term creditworthiness. One is a trading business; the other an asset-accumulation business. Both are important in developing a country's financial markets, but their problems (and opportunities) differ. For this reason they are discussed separately in this paper.

Development Banks

The New Challenges

Development banks are facing a period of unprecedented change. Their traditional sources of funds are drying up as governments everywhere are preoccupied with cutting public spending. Many developing countries are under pressure to cut their budget deficits so as to reduce inflation and repay heavy foreign debts. At the same time, external assistance is declining. In the industrial countries, aid budgets have proved popular candidates for cutbacks, since they lack the support of powerful political lobbies. The oil-exporting countries, whose aid spending rose dramatically in the 1970s, reined back their largesse as oil prices fell.

All this has profound implications for development banks, many of which were weaned on a diet of government loans. Although they account for no more than perhaps 15 percent of any country's financial assets, in the smallest and poorest countries development banks are often the only source of long-term loans. Even in the more advanced developing countries, they account for as much as one-quarter of the total. How are they to continue financing this vital role as providers of long-term development funds?

One answer is to look for money in the commercial market. But that, too, poses difficulties. Since the international debt crisis broke in mid-1982, commercial banks have been trying to cut back on their lending in general—and on their lending to developing countries in particular. International bond markets, which at times during the 1970s were open to the better-rated developing-country borrowers, have all but closed their doors to them.

The problem of ensuring an adequate supply of funds is compounded by the growing range of economic and financial uncertainties that development banks face. Interest rates, exchange rates, prices, and government policies—all are subject to sudden and unpredictable shifts to an extent unthinkable fifteen years ago. Stability is not about to return. Therefore, in order to meet different contingencies, planning is important as never before.

To meet the challenges they face, development banks must take a hard look at what they do and the way they do it. If they are to borrow commercially, they must meet international private-sector credit standards. This means debt-to-equity ratios must be sound—not just their own but those of the companies to which they are lending. Their independent auditing and financial reporting systems must be efficient. Mismatches between fixed and floating interest rates, between different maturities of assets and liabilities, and between different currencies must be rigorously controlled with the fundamental objective of avoiding such mismatching completely.

On top of this, development banks must look carefully to see whether they are making the most of their own domestic financial markets as a source of funds. This is an area they have neglected in the past. But as governments recognize the importance of equity finance and healthy securities markets, domestic savings are becoming more easily accessible. In short, development banks are going to have to exercise greater inventiveness and imagination in organizing their business and in marketing themselves if they are to continue playing a key role in stimulating economic change.

Some Basic Considerations Regarding Financing

If a development bank is to exploit financing opportunities to the full, it must get four basic variables right: debt versus equity; matching maturities; direct versus indirect financing; and domestic versus foreign financing.

Debt versus equity. A development bank's equity base should be important to it for two reasons, whether the bank is privately owned or government controlled. First, a strong equity base is essential to provide a cushion against possible defaults. Lenders will look for a strong equity base before they lend the bank money—especially if their loans are not to be guaranteed by the government. Second, the development bank should be in a position to make equity investments itself. Such equity investments should not exceed the bank's net worth, and individual equity investments should be no more than 10 percent of it. So to make investments of a meaningful size, a development bank must have a solid equity base.

Matching maturities. How far should a development bank engage in "term transformation"—borrowing short and lending long? This is a breach of one of the fundamental rules of banking. Some maintain that the rule should be interpreted flexibly, since a certain portion of demand and savings deposits tends to be reasonably stable even in periods of uncertainty. Even so, an individual bank can still be vulnerable to damaging runs when depositors lose their confidence—as happened in 1984 at a large commercial bank in the United States. Such mass withdrawals of deposits can force government intervention, which may be financially expensive as well as damaging to long-term confidence in a country's banking system.

Direct versus indirect financing. Development banks tend to concentrate on raising money by selling their own financial instruments. This direct method of financing is the quickest, easiest, and frequently the cheapest. But it is dependent on each bank's creditworthiness and (sometimes) on government policies, which can limit the amount of money that may be raised.

Indirect financing is also possible. Techniques include revolving the bank's portfolio more quickly; bringing in partners to share the funding of new projects; and helping companies to finance themselves partially from the capital markets. Using such indirect financing methods has the added merit of helping to strengthen the domestic money and capital markets.

Domestic versus foreign financing. A development bank can often borrow foreign currency which its customers could not raise on their own account. But the bank must then protect itself against the foreign-exchange risk it has incurred. Ideally, it should limit its borrowings to the foreign-exchange portion of projects which generate sufficient foreign-currency income to service the debt. It may often seem financially attractive to borrow abroad; but one of the lessons of the international debt crisis is that what seem like attractive terms and manageable risks can quickly become unmanageable when overvalued local currencies are suddenly readjusted. A development bank which takes (or allows its own borrowers to take) substantial foreign-exchange risks can only jeopardize its overall credit rating.

Diversifying Sources of Capital

A development bank's sources of capital can be diversified in two ways: by persuading the government to increase the size and efficiency of the country's capital markets, and by trying to exploit the existing capital-market structure more effectively. In either or both cases, adding new domestic and foreign shareholders, besides building the capital base, can also bring added support and new business to the bank.This is especially the case if private commercial banks, insurance companies, and industrial companies are included.

Improving the Financial Markets

A number of problems may hinder the development of a country's financial markets. Development banks—and investment banks—can help address these problems by focusing government attention on them. The principal issues are likely to include controlled interest rates; taxation policy; investor protection; and institutional development.

Controlled interest rates. Controlled or subsidized interest rates distort the pattern of investment. They are often accompanied by artificially low deposit rates, which inhibit saving and lead to capital being smuggled abroad. Development banks should encourage more reliance on market forces, with positive real interest rates for savers. Market forces tend to produce higher interest rates on long-term savings (i.e., a positive yield curve), giving savers an incentive to invest in longer-term instruments.

Taxation policy. Next to inflation, the tax system is the most important influence on the flow of savings. Ideally it should be neutral, that is, it should treat all financial instruments equally for tax purposes. Unhappily, this is frequently not the case. Interest from government bonds or bank deposits is often tax free, whereas interest on private-sector instruments or capital gains made from investing in equities are often taxed more heavily that "earned" income.

Such a system only discourages savers from investing their money in equities and negates the beneficial effects of making sure that (pretax) interest rates are positive in real terms. In expanding, market-oriented economies there may even be a case for using the tax system to discriminate positively in favor of equity investment, since it encourages the development of the capital market and makes more money available for long-term investment projects. Both Brazil and the Republic of Korea have tried such schemes (see the IFC Occasional Paper titled *Securities Markets*).

An economic case can be made that taxation of income from equity should be less than that of income from debt instruments—especially from short-term debt: Savers who buy equities are risk takers who are promoting productive investment in the economy. They should be rewarded. Savers who buy short-term debt instruments are avoiding risk and are only very indirectly helping in the process of development. Their rewards should be less. One could claim that, because equity buyers have the possibility of above-average returns through capital gains, they are already being amply rewarded. However, in today's world of very high real interest rates on short-term government paper and bank deposits—from 5 or 6 percent in the United States to over 30 percent in some developing countries—this is no longer necessarily the case. In most cases, the historic long-term, after-tax rate of return on investment has rarely been over 15 percent on average. Despite this, shareholders are usually taxed on dividends and capital gains distributed and often at a higher tax rate than those applied to interest from government paper and bank deposits.

Investor protection. Both business people and bankers tend to oppose the establishment of regulatory agencies and of rules requiring full financial disclosure for publicly quoted companies. But such opposition is short-sighted. Low standards of disclosure generally lead to higher intermediation costs and to insider trading and other serious abuses. As a result, savers are reluctant to put their money into the stock market. Development banks should therefore encourage improvements in investor protection—not just in the national interest, but also because they themselves will find it easier to raise money in a well-regulated securities market.

Institutional development. In many developing countries, the level of savings is low relative to national income. This is partly due to inadequate financial institutions for channeling those savings to borrowers.

The problem is particularly acute in the smaller and poorer countries, where a lack of managerial talent compounds the other problems of discriminatory taxation and inadequate investor protection. But it also applies to some of the more advanced developing countries. Take Mexico: despite a per capita gross national product (GNP) of over $2,000 in 1983, its total financial assets amounted to only some 45 percent of its GNP—much less than Korea, the Philippines, or Thailand, all of which were significantly poorer.

Unfavorable laws frequently cramp the growth of existing financial institutions or limit the establishment of new ones. In some cases, development banks themselves are prohibited from borrowing long term in their local market—a restriction which makes it hard for them to make long-term loans (except from their limited equity capital).

Development banks—and investment banks—can influence governments to change these and other legal barriers to the development of financial markets and institutions. The most successful initiatives have occurred where the development bank has not only promoted new policies and laws, but has also taken practical steps to make use of the new rules. For example, the Industrial Finance Corporation of Thailand helped promote the country's first mutual-fund management company, to encourage investment in equity; it also helped start the first leasing company. A similar role has been played by development banks in Colombia, India, Nigeria, the Philippines, Turkey, and Venezuela, to mention a few countries.

Working within the Existing System

Even if there are no fundamental reforms of the financial system in prospect, there may still be scope for development banks to improve resource mobilization within the country through equity financing; long-term loans and bonds; short-term debt; and indirect financing.

Equity financing. A development bank's equity base should be spread among different shareholders. A broad mix of owners should provide greater financial and business support for the bank's activities and will make its managers focus on earning a good return on capital in order to pay dividends. Financial disclosure will be encouraged. And the bank will be less vulnerable to pressure by big shareholders to make particular loans—especially important where the shareholders are large industrial or financial holding companies.

If the stock market or the bank itself is not yet ready for an issue of common shares, then it could instead issue convertible debt. This gives investors the option of conversion into equity later on; meanwhile, they have the protection of a more secure instrument paying a fixed rate of interest or a preferred dividend.

Even where the bank is wholly government owned, it may be an advantage to split the shareholdings among different government departments. This can help ensure a more balanced approach to running the bank and leave it less susceptible to sudden shifts in policy by a particular ministry or department.

Long-term loans and bonds. Traditionally, development banks have financed themselves largely through long-term loans. But they can also consider issuing bonds, either at home or abroad. Since bonds are readily transferable and therefore marketable, whereas loans generally are not, they appeal to a broader range of savers. In a primitive financial market this may be of little benefit, but where the capital market is in the process of developing—and especially where there are savings institutions such as insurance companies and pension funds—then bonds can be a fruitful new source of money.

The aftermath of the developing-country debt crisis means that the international bond markets are likely to remain closed for some time to all except a few very top-quality names, such as development banks whose shareholders include the governments of industrial countries. Even for them, making bond issues abroad requires high standards of accounting and disclosure, both to obtain a favorable rating from one of the big credit-rating agencies and to satisfy the requirements of supervisory authorities in foreign markets, such as the Securities and Exchange Commission in the United States. Moreover, the administrative costs of issuing bonds in foreign markets can be higher than syndicated bank loans, especially if the issue size is small (less than US$20 million equivalent).

Short-term debt. Development banks making short-term loans can also consider issuing short-term instruments, such as certificates of deposit (CDs) and commercial paper. Both can be marketable instruments, but commercial paper is not secured against the company's assets. Demand and savings deposits may also be used. Development banks can also lease their own equipment or factor their own receivables.

Whether such short-term instruments are an attractive source of funds will depend on their relative cost. Demand and savings deposits, as well as the factoring of receivables, are likely to involve small average amounts compared with the size of long-term loans or bond issues. Moreover, as short-term instruments they have to be rolled over frequently. This means that unit administrative costs may be prohibitive. On the other hand, CDs may be more viable because they are bought largely by companies and institutional investors rather than private individuals—so unit marketing costs are likely to be lower.

Indirect financing. In most countries there are opportunities for development banks to sell participations in existing loans to third parties, or to sell shares from their equity portfolios. A variation on this theme is to put together unit trusts or investment funds, composed of the debt of a number of different enterprises in the development bank's portfolio, and sell off shares. This offers outside investors an element of diversification and can reduce the costs incurred by selling loans or equity stakes individually.

Investment Banks

The Structure of Investment Banking

The term "investment bank" embraces two very different traditions. European merchant banks are fundamentally "universal" banks: They underwrite all types of securities, give advice on corporate finance, and provide portfolio-management services. They also act as commercial bankers, taking deposits (usually wholesale) and making loans. Some have expanded into leasing, insurance, and venture capital. But they are not big players in the short-term money markets—a function which in the United Kingdom has long been the prerequisite of a separate class of institutions known as "discount houses." Nor do they have strong networks for distributing securities—a business which has been left to specialized brokerage firms.

By contrast, North American investment banks (known as investment dealers in Canada) are legally excluded from commercial banking. But as stock exchange members, they are much more active than the merchant banks in distributing securities, and in market making (i.e., buying and selling for their own account) in the secondary market and in the money markets.

Which of these two models is preferable? The evidence tends to favor the North American version. Investment banks which concentrate on the securities markets can mobilize capital more cheaply and more efficiently than systems where commercial banking and securities-market activities are combined in one form or another. Moreover, the split between money-market and capital-market activities seems increasingly artificial, as the gradual disappearance of independent discount houses in the London securities market demonstrates. In practice, a negotiable money-market instrument is simply a shorter-term capital-market instrument. So it makes sense for investment banks to utilize their skills and facilities more efficiently by dealing in both.

The Activities of Investment Banks

In most developing countries, investment banks have evolved in response to the needs of a developing financial sector or the gaps in existing services provided by commercial banks. In some countries (such as Canada, Hong Kong, the Republic of Korea, and Thailand) their growth has been assisted by the initiatives of central banks and governments.

Investment banks typically provide a number of services to the domestic securities market (international operations are not considered here), including securities underwriting; the secondary marketing of securities; money-market activities; corporate advisory activities; portfolio management; and such other services as venture-capital financing and leasing.

Securities underwriting. Underwriting—raising long-term and short-term capital for governments or companies—is at the heart of the traditional investment-banking business. It includes both private placements (where money is raised from a small group of institutions or wealthy individuals) and public underwritings. But underwriting revenues can fluctuate sharply, depending on broader economic conditions. Government policies can also have a significant impact. For example, measures such as tax concessions to promote wider share ownership can stimulate new issues. Conversely, stricter listing requirements for new companies (such as those imposed in Hong Kong after the stock market crash of the early 1970s) are likely to depress new-issues business.

The secondary marketing of securities. A strong secondary market gives investors confidence that they will be able to sell their securities quickly and cheaply. As a result they are more likely to invest their savings in long-term securities. A strong secondary market is therefore essential in developing the primary market. Investment banks can help promote the secondary market by acting as market makers themselves, as well as brokers.

In developing countries the secondary securities market is often very thin because of the difficulty of matching buyers and sellers. So prices of bonds and stocks can fluctuate by as much as 10 to 20 percent in a single day. One reason for the thin market is the absence of institutional investors, such as pension funds and insurance companies. Instead, the market is dominated by inexperienced private investors, may of whom are more interested in speculation than long-term investment. Another reason may be inadequate financial disclosure by companies. This makes it hard for genuine investors to form an objective view of the value of specific securities.

Weak infrastructural arrangements can also be a factor. In some countries, brokers or investment bankers are not allowed to act as market makers, or there is no arrangement for them to borrow money to support market-making activities. The establishment of a specialized finance company (e.g., the Korea Securities Finance Corporation) can help overcome such problems.

Money-market activities. Money-market activities include underwriting new issues of and dealing in short-term negotiable instruments. These include treasury bills, government bonds, certificates of deposit, bankers' acceptances, and commercial paper or promissory notes.

Corporate advisory activities. Because information about companies, as well as about economic trends in general, is difficult to obtain in developing countries, corporate financial services are both hard to perform and much in demand. That demand is likely to grow as businesses mature and professional managers take over from the original owner-entrepreneurs. The close relationships with clients and the detailed knowledge of the market which an investment banker develops while providing research helps him to obtain other kinds of business. Relationships are still the key to much investment-banking business; an investment banker who becomes a trusted adviser will be listened to if he suggests that a company restructure its finances or make a takeover. He will also be first in line for new business should the company come up with some fresh financial plans.

Project finance can be a significant source of advisory work. The investment banker can act both as an adviser (identifying project risks, attracting technical partners, and dealing with government agencies) and as an arranger of finance (identifying lenders and structuring the financial package). In countries where commercial banks are reluctant to discuss business with each other directly, investment banks can play a useful intermediary role in organizing a syndicate of lenders to raise large amounts of money.

Portfolio management. As securities markets grow, institutional investors and wealthy individuals will need professional investment advice. As with corporate advice, providing this service successfully depends on undertaking high-quality economic and financial research.

Professional money management in a developing stock market is a hazardous job, since the risk of introducing such a service at a bad time is high. During the first (dormant) phase that most stock markets go through, the fundamental values of shares are normally good but the market is very illiquid. Interest in mutual funds and other types of institutional money management usually emerges during (or even near the end of) the speculative boom which follows. But since stock prices have been driven up to ridiculous levels by then, it is not the time to start offering investment management services. The consolidation phase which follows the speculative boom may be more suitable—but investors' confidence in the market is likely to have been undermined by the precipitous drop in stock prices. However, the boom-and-bust cycle may have convinced the government of the need for greater financial disclosure by companies. The need for institutional investment is also becoming recognized by this stage, and the government may be willing to introduce incentives to promote it. Such changes can prepare the ground for professional investment advice.

Other services. Investment banks are often in a good position to undertake venture-capital financing. Venture capital allows an investment bank to use its skills in corporate restructurings and mergers and acquisitions. Successful new companies also provide investment banks with profitable future clients. But there are high risks involved, so only a small fraction of an investment bank's capital should be devoted to venture capital. And investment banks must be willing to stick with their investments. Experience shows that even those venture-capital investments which prove to be winners (and they are a minority) take a long time to mature.

Leasing is another area for diversification. Its advantage is that it provides a steady stream of income which can help an investment bank through the inevitable lean years. Leasing is also complementary to other investment-banking activities, especially for big items of capital equipment (such as aircraft), for which financing can be arranged in conjunction with other investors. In such cases, leasing is simply another technique for long-term project financing.

(Both venture capital and leasing are dealt with in separate IFC Occasional Papers.)

Investment Banking in Developing Countries

The keys to success for investment banks operating in developing securities markets include a broad range of services; high-quality management; research; communications; marketing; and good administration and control.

A broad range of services. Offering a broad array of services is important. Immature money and capital markets make it difficult to sustain profitability simply by concentrating on one or two services, because demand for them may fluctuate unpredictably. Underwriting is a classic example of this. A sudden turnaround in market sentiment can send previously dormant stock markets soaring—a change which is often accompanied by a boom in new issues. By the time investment banks have increased their staffs to deal with the increased business, a stock market decline has set in and the new-issue business evaporates for lack of buyers.

High-quality management. The need to spot quickly new opportunities for business points to the second key factor—management. Investment banking requires particular attributes. Whereas commercial bankers tend to be risk avoiders, investment banking places greater emphasis on growth, management, and cash flow. So to sell new ideas to their clients, investment bankers need to be ready to take calculated risks and have confidence in their judgments. Since much of the work that investment banks do hinges on accurate timing and pricing in the securities markets, investment bankers also need acute market senses. This is just as important as formal qualifications.

Experience shows that the type of manager who makes a good investment banker will only be attracted by high earnings. It is also important to give each manager a financial interest in the performance of the firm. This can be done either through bonuses, based not just on the firm's overall profit targets but also on the manager's individual performance, or—ideally—by allowing managers eventually to acquire a stake in the firm through a partnership structure. Development banks thinking of establishing investment banks should bear this point in mind. There is simply no point in saving on salaries because if an individual performs well, he will earn revenues for the firm of between five and ten times what he is paid. There are many unfortunate examples of investment banks set up by other financial institutions which have been hobbled by an insistence that the salary structures be the same as in the parent company and that share ownership stay with the parent. This may lead to mediocre managers; or, if the managers are good, they will depart to set up competing, independent firms.

Research. Good economic and securities research is fundamental in providing high-quality investment banking and brokerage services. In most developing countries, financial and economic data are scarce. Publicly listed companies are a small minority, and entrepreneurs are less than enthusiastic about disclosing details of their business to outsiders, fearing that they may give away information to competitors or to the tax collectors. This makes research difficult. It is also expensive, since good analysts earn high salaries. At the same time such obstacles make good research all the more valuable—not just to existing companies but also to newcomers who may wish to enter the market. Knowledge of the business sector puts the investment banker in a strong position to provide information on markets, industries, or the feasibility of new projects.

Communications. A successful investment bank needs good communications. It is no good generating original research unless it can be transmitted fast to potential customers. The investment bank must also keep abreast of securities prices minute to minute. If it acts as a market maker, then the bank must be able to make quick decisions on whether to commit its own money in buying or selling securities. The premium on speedy reactions applies not just to the big investment banks in major capital and money markets but also to those operating in small and less developed markets. In both cases, the institutions that will succeed are those that have the best ideas and are capable of executing them faster and cheaper than the rest.

Marketing. It is said on Wall Street that "securities are sold, not bought." This points to the fifth key to an investment bank's success: marketing. Marketing is closely linked to communications, since without a good communications system it is virtually impossible for the investment bank to market itself. This is most obvious in the biggest capital markets, where the main buyers and sellers of securities are sophisticated institutional investors. Investment banks need the latest telephone and telex systems to keep in touch with them. Their counterparts in developing countries are likely to rely on the more traditional—though still very successful—method of calling on potential customers by phone or in person to solicit business. Effective, well-paid salespeople are needed to do this job well.

Good administration and control. Good internal administration and control are needed, both to maximize profits and to avoid undue risks.

Most well-run firms use a profit-center approach. In its simplest form, this might divide profit centers into corporate finance (underwriting, private placements, and other corporate advisory services); secondary markets (brokerage activities, market making, and portfolio management); and money markets (primary and secondary markets). Support services should likewise be divided into cost centers (e.g., research, communications systems, and administration.) Each profit center should be allocated a certain portion of the firm's capital, and its profits should be measured monthly—both gross profits (revenues less direct expenses) and net profits (revenues less direct expenses and an arbitrary share of the expenses of the cost centers). This allows the firm to recognize quickly the businesses which are generating the best returns—a pattern which can change fast because markets are volatile and investment banks work on narrow profit margins. Capital and staff can then be reallocated so as to maximize profits. Since support services are so important, the bulk of an investment bank's costs will generally be fixed costs. As a result, profits are very sensitive to the volume of transactions that the bank undertakes. Only a small change in gross revenues can transform high profits into large losses. The bank must make sure that its business does not become dominated by the level of overheads, since this can drive it to take on business which is unacceptably risky simply to maintain volume and cover costs.

Risks must also be controlled directly. Mismatches between assets and liabilities, whether they be in terms of maturities, currencies, or interest rates, must be monitored and controlled. This demands an effective reporting system within the bank, together with strict limits on the positions which individual traders may take in any kind of security. In developing securities markets such limits will need to be very tight, since investment banks will not be able to hedge their risks through the sophisticated financial instruments (such as futures, options, etc.) available in the big capital- and money-market centers. Investment banks must also monitor and stick to the ratios laid down by the bank regulators. (See Box 1.)

Promoting Investment Banks

Development banks can play an important (and potentially profitable) role in promoting investment banks. One of the most important is to convince government policymakers of the importance of equity finance and healthy securities markets to the efficiency of the economy and the stability of the financial system. For regardless of how professionally an investment bank is run, it cannot operate in an environment which is fundamentally hostile to its objectives.

Development banks can also provide finance and facilities for the establishment of investment banks. But they must be aware of the important distinctions between the two types of banking. Investment banking needs less capital than commercial or de-

Box 1. Liquidity Rules

Making sure investment banks do business prudently poses special problems for investment bank regulators. The wide variety in the quality and liquidity of assets which investment banks may own requires sophisticated rules which take account of the differing degrees of risk. But at the same time investment banks need flexibility in order to operate effectively. The rules must not stifle them.

The answer to this dilemma is to focus on liquidity, which should be an investment bank's first concern. Bank regulators usually start with the concept of "liquid net worth." This is calculated as the investment bank's book value, less all its assets that cannot be quickly and easily turned into cash. These include fixed assets (such as office equipment and buildings), intangible assets (such as goodwill), and investments in other businesses (such as leasing). The resulting figure, liquid net worth, measures the amount of capital available for use in the bank's day-to-day business.

A bank may use its liquid net worth as a "cash margin" to support loans, to make underwriting commitments, to finance its customers' transactions, or to hold securities as part of its business of market making. Investment bank regulators lay down a notional cash margin ratio, that is, a level of cash that must be kept on deposit against possible adverse price changes, which is to be applied to each of these commitments. The less liquid the commitment, the higher the ratio needs to be. So holdings of short-term treasury bills, which are very easy to sell because the market in them is highly liquid, may carry a margin of only 1 percent. At the opposite extreme, shares in unlisted companies might carry a margin of 100 percent. Customers' outstanding balances (i.e., transactions which have been agreed on but not yet settled) might require a 10 percent margin to allow for the risk of default. The firm must measure the total of these cash margin requirements every day. It must make sure that when this total is subtracted from its liquid net worth, the resulting figure (known as "free net worth") must always be positive.

velopment banking, but the risks—and the financial rewards—are greater. Investment banks and their managers thrive in an atmosphere which encourages individual enterprise and risk taking and discourages stifling bureaucratic procedures.

This need for a separate investment-banking "culture" means it is hard to establish a successful investment bank within the bureaucratic framework of a development bank. A more promising strategy is to set up the investment bank as a separate affiliate which can, over time, develop its own identity and ethos.

Conclusion

Thriving investment banks and successful development banks are both important in promoting healthy capital markets and a more efficient economy. They are essentially different types of institutions with different problems, and in the end they need to be developed as separate institutions. But in several respects their roles are highly complementary.

The challenge for development banks is to learn to diversify their sources of funds—in other words, to manage the liabilities sides of their balance sheets—as they have not had to do before. In the past, lending policies were virtually all that counted. Now, funding strategies are equally important. If development banks are to tap new sources of money in the commercial markets, they are going to have to learn new and innovative ways of tackling their problems. They need to apply some of the ingenuity which is the stock-in-trade of successful investment banks.

Investment banks need a healthy securities market in which to operate; development banks can help promote policies to ensure this. Development banks can also provide the seed capital and equipment necessary to get an investment banking business off the ground. Moreover, development banks, with their access to small and growing companies, can be important sources of future clients for investment banks.

The benefits that both types of bank can bring are clear. Development banks are an essential mechanism for long-term lending—especially in the smallest and poorest developing countries. Investment banks strengthen the financial markets in more advanced economies and widen the opportunities for new investment, output, and jobs. Thriving investment banks can also provide borrowers and lenders with a window on the growing opportunities in international capital markets. The benefits of both types of institution repay many times over the efforts needed to establish them.

For Further Reading: Background Papers Prepared by IFC on Investment Banking and Development Banking

The Role and Funding Strategies of Development Finance Institutions in a Changing Economic and Financial Environment (1982)

Funding Economic Development: The Need for Tapping New—Chiefly Commercial—Resources in the Next Decade (1982)

Diversification of Development Finance Institution Services (1980)

Development Banks and the Mobilization of Financial Resources (1979)

Copies of these papers and further information may be obtained from:

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