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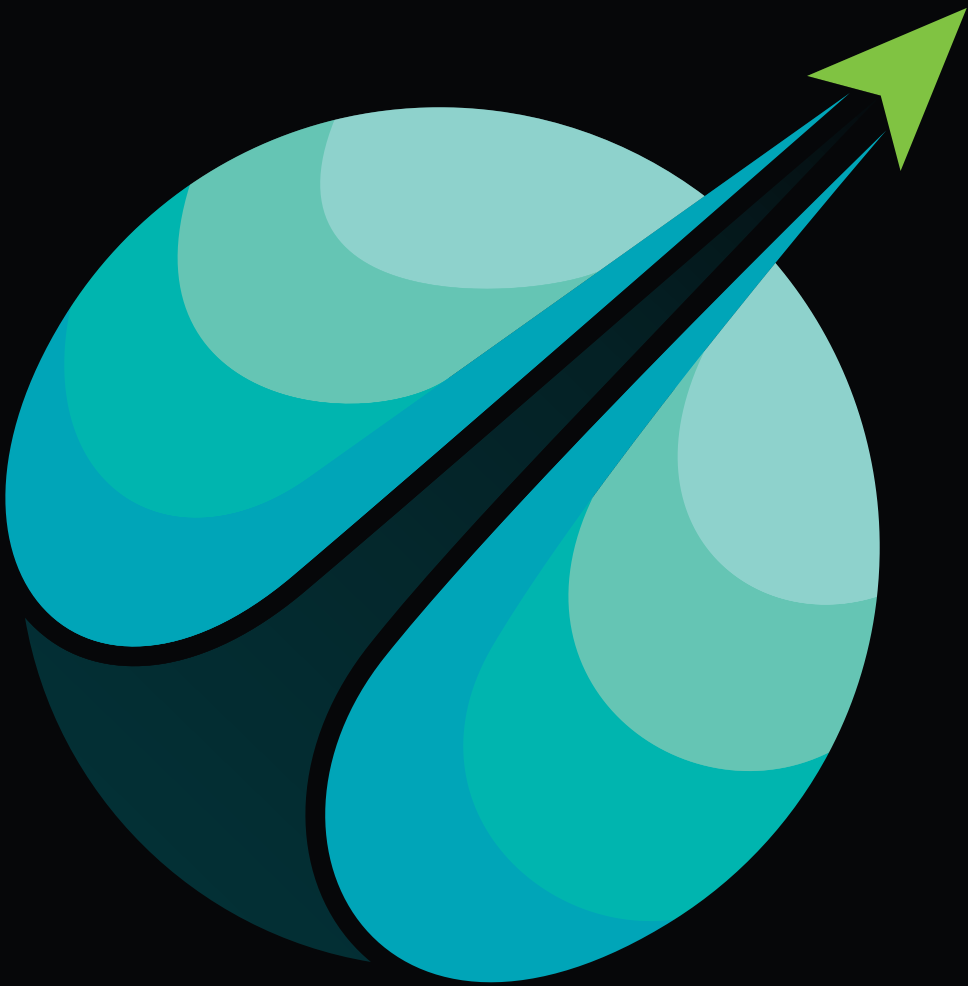


Developmental Financial Institutions
Strategic choices to build a sustainable operating model

MAKING AN IMPACT THAT MATTERS since 1845

During economic disruption caused by Covid-19, DFIs have emerged as a source of finance and preferred vehicles to deliver financial stimulus support provided by the governments. This has bought into focus the importance of well-functioning DFIs to the overall development of economies.

Introduction

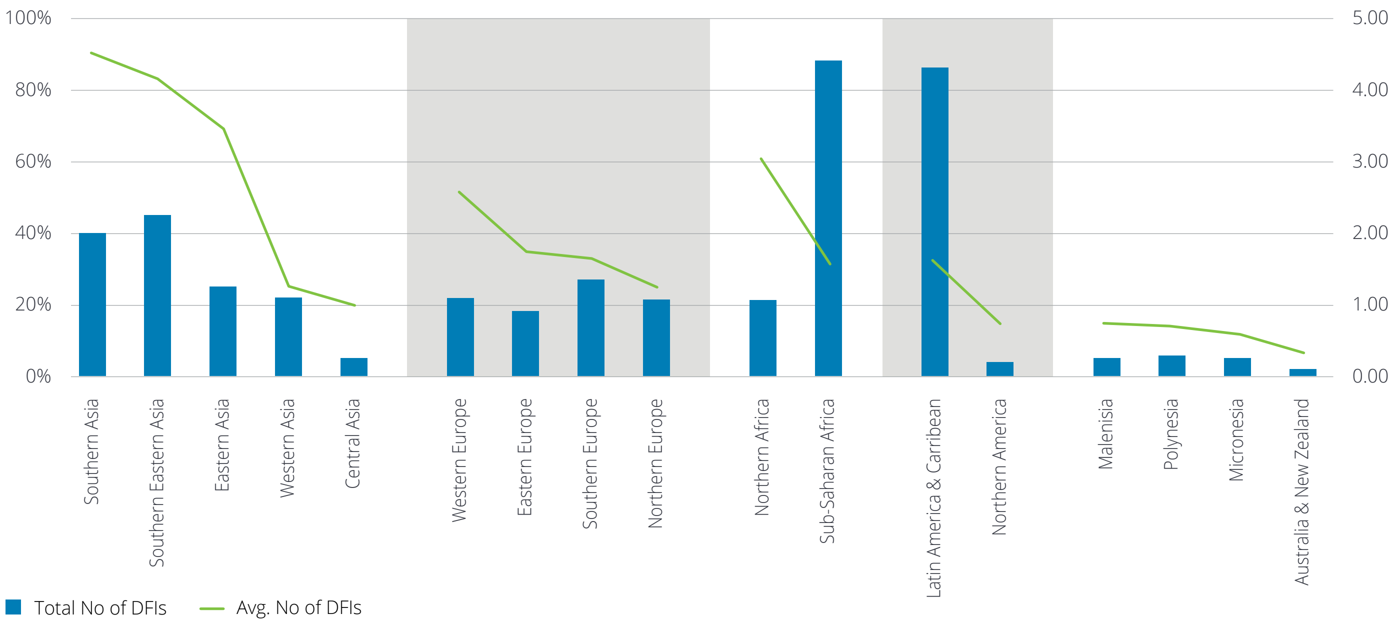
More than 500 Public Development Financial Institutions (DFIs) around the world play an important role for countries and sectors in helping them attain their planned visions. DFIs are specialized institutions aimed at fulfilling certain policy objectives of providing finance to those market segments that are unlikely to be funded by commercial financial sector. Apart from this DFIs are also particularly important to the general market during crises, when they can counteract the pro-cyclical nature of financial markets that constrains credit during economic downturns. The importance of these DFIs has come to the fore due to the economic disruptions caused by Covid 19. During economic disruptions caused by Covid-19, DFIs – on a national, regional and multilateral level – have played an important role in enabling economic recovery. DFIs have emerged as a source of finance and preferred vehicles to deliver financial stimulus support provided by the governments to support struggling industries, invest in necessary infrastructure and lead the way out of a recession. This has bought into focus the importance of well-functioning DFIs to the overall economic development of economies.

DFIs are experiencing an emerging renaissance worldwide

DFIs are experiencing a renaissance worldwide. The policymakers are recognizing the importance of DFIs in playing countercyclical roles, meeting economic, social, environmental development challenges and enhancing structural transformation. As a result, both developed and developing countries alike have recently established or are planning to build new DFIs.

In terms of presence of DFIs across different geographies, DFIs are spread evenly with 25% located in Africa, 20% in Europe, 20% in the Americas, 31% in Asia, and 4% in Oceania. Figure 1 shows that in terms of aggregate numbers of DFIs and average numbers of DFIs by sub region (the total number of DFIs divided by the number of countries in a given sub-region).

Figure 1: National Development Financial Institutions across different regions



Source : Mapping Development Finance Institutions Worldwide: Definitions, Rationales, and Varieties. Jiajun Xu, Xiaomeng Ren, and Xinyue Wu

Illustrative examples of activities focused on establishment and promotion of DFIs

- Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB) have been founded recently with a focus on addressing vast infrastructure financing gaps in developing and emerging economies.
- US has decided to build a new DFI U.S. International Development Finance Corporation (USIDFC) to catalyze market-based, private-sector development
- UK government established British Business Bank (BBB) dedicated to making finance markets work better for small business
- FinDev Canada, catering to entrepreneurship, women's empowerment, and climate change for sustainable development through greener and cleaner investment has been recently established
- The European Union (EU) with an aim to promote establishment of National DFIs has launched Investment Plan for Europe, that emphasizes "effective involvement of National Promotional Banks (NPBs) is necessary to enhance impact on investment, growth and employment due to their particular expertise and knowledge of the local context
- The Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G24) and the Global Green Growth Institute have jointly launched the Infrastructure Finance in the Developing World Working Paper Series in an effort to "play a catalytic role in the creation and success of new development finance institutions"
- Kingdom of Saudi Arabia has recently launched National Development Fund which is a holding company structure for eight existing sectoral development funds aimed at efficiently utilizing capital base of these funds and expand the scope to infrastructure financing.

The renewed focus on DFIs is also broadly reflected across the vast breadth of missions and activities that DFIs engage in. Key intervention areas of DFIs across economies has been across Large infrastructure projects, SME financing, Trade Financing, Agriculture, Housing, etc. Due to the different operational nature of these DFIs and more importantly, risk-intensive sectors they operate in, it is imperative that the DFIs achieve the optimum balance of effectively addressing a policy objective while being operationally sustainable. This paper aims to highlight the key challenges faced by DFIs and the potential interventions that a DFI can undertake to ensure sustainable operations and reduce dependency on Government funding.

Challenges faced by Developmental Financial Institutions

Lack of clarity in DFI mandates: Lack of clearly defined mandate and target borrowers for financing often impede the financial and operational efficiency of DFIs. A myriad of influences such as existence of different authorities, funds and government entities with different developmental agendas can blur the question of "what services or target audience can the DFI service effectively?". This drives complexity and, in some cases, leads DFIs to undertake engagements that they are operationally not geared up for.

Inadequate performance assessment or transparency: Large proportion of DFIs don't follow a structural approach to pursuing goals through concrete business targets, and very few undertake impact assessments studies of their activities. Even when the mandate and targets are clearly defined, it remains difficult for stakeholders to measure performance and target achievement which inadvertently hampers the process of identifying deficiencies and undertaking improvements to mitigate those gaps, or those deficiencies.

Political interference: At times, political stakeholders tend to demand forms of immediate support or special initiatives that do not fit a DFI's mission. As a result, actual activities frequently end up diverging from the mandate, or from the DFI's actual capability to handle or deliver. This often results in below par execution of the mandate as the DFIs lack the required expertise in fulfilling the operations.

Paucity of financial sustainability principles in operations: DFIs are expected to ensure development outcomes take precedence over profitability. There is often a tendency to structure products which enable the credit flow to the target segments but fail to build in a safeguarding mechanism to ensure that the DFIs don't incur losses. Additionally, since majority of the DFIs are set up by the Governments, they receive direct funding from government transfers or have been dependent on government transfers for recapitalization to cover losses or re-alignment of their balance sheet. This availability of on tap source of funding provides an easy way out and leads to lack of motivation on part of the DFIs to ensure sustainability in operations and preservation of core capital.

DFIs often have a tendency to structure products which enable the credit flow to the target segments but lack of suitable safeguarding mechanism such as adequate governance, robust policies and processes and paucity of financial sustainability principles result in losses and jeopardize the sustainability of institution.

Inadequate risk management process and policies: In line with the nature of the institution, DFIs serve a wide range of customers, which are associated with high risks. Given the inherent risks, and lack of adequate supervision it is often observed that policies, processes and risk management framework deployed by DFIs are not commensurate to the risk being undertaken or reflective of complexity of operations.

Lack of governance: The quality of governance and management has often meant the difference between the success and failure of DFIs functioning in the same environment. As DFIs are primarily owned by the state, the board and management of the DFIs is many a time nominated by the Government. Due to this it is often observed that the ownership role of the state creates a potential conflict of interest in the governance of DFIs and hinders the board members and management from being objective and independent.

Way Ahead: Addressing the key challenges

Having identified key challenges that may keep DFIs from realizing their full potential - the paper aims to list below the key interventions that can help DFIs boost their impact across their chosen areas of activity while operating in a financially sustainable manner and be able to generate enough resources to accomplish their mandate.

Establish clear mandates to enable clear specific targets

DFIs should evaluate the current mandate on the following dimensions and identify if there is a need to enhance the mandate further.

- Whether mandate is able to provide clear focused direction for the operations of the DFIs?
- Does the mandate clearly identify the market failure or target sector that the DFIs are most effective in dealing with?

- Is the DFIs mandate causing market distortions and crowding out the private investments?
- Does the mandate make provisions for reviewing the DFIs long-term performance?
- Is the mandate given still appropriate and relevant to the current and anticipated environment?
- Does the mandate provide clear objectives and a specific time frame to implement and achieve its mission?
- Does the mandate create incentives for the board of directors and the management of the institution to make proper use of the available resources and manage risks adequately?

The government can consult with external stakeholders including beneficiaries, industry experts and other financial institutions to incorporate their opinions on the past performance of the DFI in fulfilling its mandate and on the future role it will play when the mandate is renewed. This will help in defining clear mandates that will help in meeting the stakeholder expectations and make it more relevant to DFIs and business community at large with which DFIs needs to collaborate.

Building appropriate delivery models complementing the mandate

Development of appropriate instruments/ delivery models is important to ensure that the DFIs are able to meet the targets in a sustainable manner. DFIs should tailor its products to market needs depending upon degree of institutional development of the country, the structure of the financial system and the risk aversion and health of the private players. Accordingly, the DFIs can operate on:

- Direct Lending Model - granting loans to customers directly
- Indirect Lending Model- operating through private financial institutions to which they grant loans or guarantees
- Both (mixed institutions)

Small Industrial Development Bank of India – From Financier to Mobiliser

SIDBI has recognized the importance of the private sector if India is to scale up its investment in SME financing and reach its economic goals. SIDBI has adopted an impact multiplier approach as one of its key principles and has worked towards creating lending ecosystem for SMEs through partnerships with Banks, Non-Banking finance companies and Micro Finance Institutions. Apart from providing direct lending support to SMEs, SIDBI has invested heavily into products and schemes to enable crowd-in effect from other financial institutions and now lists 'mobilisation of funds and development of SME lending ecosystem' ahead of 'amounts disbursed' as its core strategy. Through a combination of subsidiaries focused on providing credit guarantees for SME lending, interest subvention schemes and refinance products SIDBI has been able to achieve a manifold impact of its capital. As a result of this focused approach on achieving crowding in effect, only approx. 11% of SIDBI's asset book of USD 25.6 Billion comprises of direct lending whereas rest of the asset book is utilized in creating enabling conditions for Financial Institutions to lend to SMEs.

DFIs should identify the appropriate model it needs to operate in so that it complements the private funding rather than competes with it. DFIs should also assess whether its internal capabilities in terms of people/processes and systems are commensurate to the complexity of the operating model. DFIs should evaluate which structure would be more efficient to channel higher volume of resources at lower costs.

Defining an annual business plan, outlining key financial, economic and other social targets for the DFIs

It is imperative that the DFIs should define and publish clear annual financial, economic and social targets and measure performance against these defined goals. This will help to focus the management's attention on developing and agreeing goals that are clear and robust enough for sharing with stakeholders as part of annual reports/annual plans and that align with the defined mission. The metrics defined for the assessment of effectiveness of DFIs should not be restricted to conventional metrics. These should also include metrics that help assess the quality of the investment and intervention, contribution to the common good, capacity building, capital conservation, operational efficiency and risk indicators etc. measured either qualitatively or quantitatively. DFIs should also focus on developing internal capacity to assess and show clearly the impacts of their policies and investment decisions. These measures of defining goals and publishing performance against these goals also helps in improving external perceptions of the DFIs transparency and accountability and justifies public support and funding for the DFIs.

Embedding financial sustainability principles in product structures and pricing

No DFI can be viable over the long-term if it cannot diminish the need for recurrent subsidies from the government. The objective is not to maximize profit, but rather to generate enough resources to accomplish their mandate. DFIs should work towards having a clear expression to add economic value to the operations while working towards achieving the mandate. DFIs should undertake an evaluation on following aspects of its operations to assess the maturity in terms of incorporation of financial sustainability principles.

- Does the mandate establish that the DFI shall be financially sustainable over time?
- Does the DFI factor in financial sustainability while designing the products or defining target segments
- Has the DFI identified and factored all its costs of operation and risk premiums and has the same been considered while pricing its products
- Whether the DFI has established adequate policies and processes for development and approval of new products and
- Are there adequate processes and policies in place to differentiate between the riskiness of different borrowers and build in adequate controls

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In addition to effective risk-pricing, it has been observed that some DFIs also provide technical assistance to borrowers. While, this technical assistance can help reducing project risks, DFIs should be cognizant that the technical assistance services should not become the primary concern. DFIs structure and processes should be aligned to their primary mandate of providing finance, whereas technical assistance services, if any, should be carried out as separate service departments or entities under DFI, thus not impacting the focus of primary mandate offerings.

As good practice it is imperative that the DFIs benchmark their product development, process and pricing approach principally with commercial financial institutions to ensure incorporation of best practices promoting sustainability of operations.

The returns expectation should be modulated in line with the developmental agenda so as to not prompt the DFI to enter in competition with private sector and crowd out the private sector or focus on tail risks that deliver high returns but become unviable in longer term.

Robust governance arrangements to enable prudent decision making

One of the major concerns with DFIs is lack of adequate governance mechanism enabling independent decision making. Good governance plays an important role in avoiding interest conflicts in credit decisions, as it creates a clear differentiation between the rights and responsibilities of the different stakeholders of DFIs, including the shareholders, the board of directors and the management. DFIs should review their governance structures on some key dimensions listed below to ensure that adequate safeguards have been built in to enable the DFIs to function in an independent manner.

- Is the current ownership structure the most efficient and effective one?
- Are rights and responsibilities of shareholders, board of directors and management clearly defined?
- Does the DFI and the management have sufficient freedom to act and take decisions independently?
- Are the governance arrangements clearly defined and transparent to the stakeholders?
- Are governance processes for making decisions efficient and effective?

Risk Management as driver of sustainable operations

DFIs are differentiated than commercial financial institutions by the level of risk they undertake (such as longer maturities, lower security levels, more flexible repayment terms) or specializing in riskier SMEs with weaker financings and lower collaterals. Due to this these DFIs generally require highly specialized and unique risk management frameworks and processes in place. DFIs involved in direct lending require strong credit underwriting skills at levels similar to the commercial banks. While risk management capabilities for DFIs providing indirect financing need not be as sophisticated as in direct lending operations - DFIs will still need to analyze the risk and risk management skills of the lending institution through which they operate, as the risk assessment of the final borrower may be primarily done by the lending institution.

DFIs should invest heavily in building adequate risk frameworks and structures. Lack of adequate risk management controls can make it difficult for DFIs to achieve sustained growth.

Digital Adoption to improve delivery and enhance operational efficiency

Recent advances in digital technologies and innovative business models represent a game changer that can enable DFIs to digitize their operating models to better reach clients and to optimize internal and customer facing processes. As the broader market and client expectations become more and more digital, DFIs should also undertake the journey to digitize key elements of the customer journeys, internal processes and the way they interact with other market participants including banks and FIs. DFIs should undertake a structured approach to ascertain the aspects of operations where digitization would have the

imSME. - Malaysia's first online SME financing platform

Malaysia's first online SME financing/loan referral platform launched in February 2018, imSME is wholly owned and managed by Credit Guarantee Corporation Malaysia Berhad (CGC), and is supported by Bank Negara Malaysia (Malayisan Central Bank) as well as other participating banks. The platform enables the SMEs to access financing products across Financial institutions depending upon the business details and choose from different options offered by different banks. It has enabled SMEs to:

- Access fast and real-time information on financing/loan options, anytime, anywhere 24/7.
- Search for financing/loan by participating banks at their comfort, hassle-free.
- Apply for loan/financing from a single platform.

There are 26 Financial Institutions including 5 Development Financial Institutions, 3 Agencies and 15 Alternative Financiers participating in imSME with more than 35,000 SMEs registered on the platform.

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Many DFIs globally have voluntarily chosen to comply with certain regulations. Alternatively, in some countries DFIs are regulated by existing financial regulators who while devising regulatory and supervisory framework are expected to take into consideration the unique roles, functions and objectives of the individual DFI.

maximum impact:

- Which elements of the customer journey are unwieldy, experience frequent drop offs and how can they be redesigned to best meet customer needs?
- Are there possible benefits in building digital infrastructure like integrated platforms combining different databases and new digital footprints through market participants?
- Identification of areas where digital intervention can help the DFI improve its internal processes and processes with other market participants to reduce costs and speed up delivery?
- In cases of indirect lending models, how can the DFI aim to bring in efficiencies in terms of sharing of information with partner financial institutions?
- Building new products and services with Digitalization as central theme enabling DFIs to maximize outreach especially in relation to SME and retail focus mandates.

Deriving benefits from a customized supervisory regulatory framework

There is also a case for bringing DFIs under the regulatory framework as it is often observed that a lack of supervision often results in slack in the risk management and governance structures. Many DFIs globally have voluntarily chosen to comply with certain regulations – especially pertaining to capital adequacy, governance, risk management, etc. to help understand and implement leading industry practices. Alternatively, countries have placed the responsibility for regulation of the DFIs with either the existing financial regulators of banking in country (typically central banks) or with specific institutions. These institutions while devising regulatory and supervisory framework are expected to take into consideration the unique roles, functions and objectives of the individual DFI. Generally, it is observed that the DFIs are regulated through a separate supervisory framework enabling the regulator to monitor the activities and financial performance of these institutions.

Development Financial Institution Act: Malaysia

Malaysia has created a separate legal regime for DFIs by enacting the Development Financial Institutions Act. Before this act was enacted, acts applicable to other private or public financial institutions governed DFIs. The act redefined the roles and mandates of each DFI, gave Bank Negara Malaysia the authority to regulate and supervise six DBs (referred to as DFIs), included provisions to facilitate proportional regulation of DFIs, and clearly stipulated the role of the Ministry of Finance as owner of some of these institutions.

Targeting private funding sources

DFIs should consider issuing debt instruments to investors seeking low yield, low risk, and long-term assets. Since the DFIs are backed by the sovereigns, it enables them to access the capital markets for issuing debt or borrow in similar terms to that of the Government. As getting rating externally is generally a pre requirement of raising external debt, it provides incentive to DFIs to improve upon their internal processes, systems and governance. External ratings also provide helps in improving perceptions of the DFIs transparency, accountability and provides a conformance of adequate governance and processes in place. Though private financial sources help in reducing dependence on Government funding, DFIs should maintain the right balance between utilizing public and private sources of finance. Over reliance on fixed income markets, might force DFIs to meet certain market return expectations which can lead to a deviation from the mandate.

DFIs- Well begun is half done

DFIs continue to play a leading role in addressing market gaps especially in counter cyclical times. The varied mandates and programs run by DFIs warrant that each DFI should be looked at its own merit and unique context to identify actions that are best suited. With that being many DFIs face similar fundamental challenges which can act as harbinger to change and convert these into opportunities. The need of the hour for DFIs is to become financially sustainable through a focused approach on addressing the key challenges. Combination of robust mandate, effective governance, right pricing and risk adjusted methods of lending can enable DFIs to make the leap from dependency on government aid to achieving sustainability in operations. Adopting this approach will enable DFIs to better utilize their resources and amplify their long-term impact on the economy.

New Development Bank

Clear mandate linked to operational capabilities: NDB's Articles of Agreement mandate that it will mobilize resources for infrastructure and sustainable development projects in BRICS and other EMDCs. NDB has identified sustainable infrastructure development as core of NDB's operational strategy and the Bank has clearly defined in mandate to dedicate about two-thirds of financing commitments in its first five years to this area. NDB believes that it can best achieve the goals set by its members not by attempting to copy the universal style of traditional MDBs that cover a huge variety of activities and sectors, but rather by focusing its energy and finance on a group of sectors that is more limited in scope, while still broad enough to provide ample room for finding and implementing viable projects.

Risk based approach of analyzing projects: The Bank is using a risk-based approach to project approval and oversight that mandates more intensive ex-ante reviews for complex, risky projects, while low-risk projects go through a more streamlined procedure with ex-post checks. Staff performance indicators and incentives have been oriented towards risk evaluation, disbursement and performance, rather than just approvals. The Bank has put in place a robust set of financial and risk management policies and systems. Prudent leveraging, a conservative level of loans as a ratio to equity, strong liquidity buffers, and a diversified, well-performing portfolio have been identified as key elements to enable NDB to quickly build a reputation as a trustworthy multilateral development finance institution.

Accessing financial markets: New Development Bank has identified strong finances and access to capital markets at good terms as crucial for NDB to succeed in its mission. The Bank intend to fund its operations through regular bond issuances in member countries and international capital markets, including in local currencies. In accordance with a strong focus on sustainability, NDB intends to tap the growing market for green bonds to support its operations.

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