Transforming the World: Redefining the Role of DFIs in the New Millennium

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DFIs are not only for emerging markets

Many OECD countries have national development banks. Regardless of a country’s GDP, DFIs focus on **underserved markets** or **creating new markets**.

Market imperfections exist in all economies.
Market gaps are different for emerging and mature economies

**Developing economy**
- Mostly indigenous banks
- Few correspondent banking relationships
- Banks making good return on government paper
- Access to credit for MSMEs is limited in general
- Few exporters generating foreign currency

**Emerging economy**
- Some presence of international banks
- Regional banks and indigenous banks
- Limited correspondent banking relationships
- SMEs without collateral are underserved
- New sectors/new markets
- Private equity gaps

**Mature economy**
- Fully developed financial sector
- Globally integrated banking sector
- SMEs without sufficient collateral (e.g. “brain businesses“)
- New markets, such as climate finance
- Private equity gaps
Why do market gaps exist?

- The classic rationale for DFIs is based on the existence of market gaps. Market gaps arise for two reasons:

  - The private sector’s **unwillingness** to accept certain risks that they deem too high or have relatively high transactions costs.
  - The private sector’s **inability** to accept certain risks or to fund certain tenors because of their own internal limitations.
DFIs catalyze supply and stimulate demand to fill market gaps

- This means a constant effort to spur or unlock private sector sources of capital.

- It also means building awareness and capacity with the real economy to create demand for finance/credit products.
Market gaps don’t always justify the involvement of a DFI

- There may be good and valid reasons why the private sector is avoiding providing financial services to a particular market segment.

- The deemed social value of a financially nonviable project does not justify involvement by the DFI.
  - In cases of “national interest,” where costs exceed direct benefits, the government should turn to the national budget for funding.
These may be for structural or temporal reasons

- Generally, the gaps occur on the supply side and exist because there is a lack of financial services being provided by private sector sources.
- Market gaps are not static; they change over time and require regular review and testing.
In a countercyclical role, beware of the “Sleeping Beauty Syndrome”

- The DFI comes alive when the need arises.
- How to keep the staff of a DFI poised to fill temporal gaps, rather than systemic gaps.
- Does this mean competition to keep skills sharp?
DFIs exist to meet a public policy need not met by private financial sector

- For example:
  - Long-term infrastructure projects, due to a funding gap.
  - A strategically important company, such as a major exporter, because of a credit gap.
  - Under-served sectors, such as small and medium-sized enterprises (SMEs) or rural activities in geographically isolated areas.

It is therefore critical to analyse the extent to which the private sector sources of finance and risk capital are unable to meet the needs.
DFIs also need to address non-financial gaps to stimulate demand

- For example:
  - SMEs may need business advisory support, as well as capital, to grow.
  - A DFI that offers training and advisory services to strengthen and build SME capacity could help improve the creditworthiness of the SME and make it more eligible for commercial bank financing.
A particular gap or obstacle which the DFI could address

<table>
<thead>
<tr>
<th>If an obstacle is...</th>
<th>Then a possible solution is...</th>
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<tr>
<td>Knowledge of sector/technology is lacking</td>
<td>Local FI may need to co-finance with another local or foreign lender with prior experience in the area</td>
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<td>Counterparty risk is too high or lacks sufficient collateral</td>
<td>LFI may need a guarantee from a third party</td>
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<td>Transaction size too small or transaction costs too high relative to return for LFI</td>
<td>LFI may need to bundle a package of projects to achieve economies of scale</td>
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<td>Long-term liquidity not available to LFI</td>
<td>LFI may need to access long term funds - in foreign or local currency - to meet project requirements</td>
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<tr>
<td>Transaction size too large for LFI's balance sheet</td>
<td>LFI may need to syndicate transaction</td>
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<tr>
<td>Credit risk limits reached for obligor or sector</td>
<td>LFI may need to transfer risk to a third party to stay within its single obligor/sector limits</td>
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In general, the nature of market gaps needs to be understood

- Is the gap structural or temporal?
- Is the gap narrowly defined by a specific industry, product or segment, or is it more widespread?
- Is the gap due to excess demand or insufficient supply?
- If supply-based, is it because:
  - There is a lack of information to make credit decisions?
  - There is information, but the private financial intermediaries are unwilling to take the risks because of their own financial positions?
  - The administrative costs are too high relative to the returns?
  - There are high opportunity costs for the intermediaries entering those segments (i.e., there are more profitable areas in which to invest or offer credit)?
Market gap analysis should be repeated periodically

- Market gaps change as market conditions and economic policy shift.
- A gap analysis should be done for each new segment identified as a potential market.
- The gap then needs to be precisely defined through detailed interviews with the commercial banks and other private financial intermediaries.
- This is then validated on the demand side to ascertain what types of transactions are currently not being supported and in which specific instances these transactions have been rejected by the commercial banks.
Market gap analysis should be repeated periodically

Market Gaps

As market conditions and economic policy shift, market gaps change

Supply Side Analysis

• Define gaps through detailed interviews with the commercial banks and other private financial intermediaries

Demand Side Validation

• Validate with borrowers as to types of transactions are currently not being supported
A well-functioning DFI will:

1. Define exactly what the market gap is and why it exists,
2. Determine whether it makes economic sense to fill the market gap,
3. Develop a strategy based on this analysis,
4. Regularly update this exercise and integrate the results of this update, in conjunction with “development lessons learned,” in an updated strategic framework.
A healthy DFI is one that finds a **financially sustainable** way to effectively balance the needs of stakeholders—shareholders (governments), clients, private sector intermediaries and taxpayers while accomplishing its ultimate goal, which is meeting its objective of having a positive **development impact**.
National DFIs’ strategies are grounded in SDGs

- National government articulates strategy in line with SDGs
- National development plan inspires the strategy of the national DFI

SDGs

National Development Goals

Strategic Goals of DFI
THANK YOU

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