Innovative Experiences in Access to Finance: Market-Friendly Roles for the Visible Hand?

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Background

Presentation outline

• Here present evolving views on role of the state about access to finance
• What new view implies going forward
  - State in general
  - Public banks, including development banks
• Important because …
• Consensus on access to finance
  - Not all households and firms have good access to finance
• Lack of consensus
  - Role of the state in promoting access
• Promising new view on role of the state
  - Public banks have important role in increasing access to finance
  - Initiatives in Latin America and elsewhere illustrate this view
Problem of access to finance

• Working definition
  - When a project that would be internally financed if resources were available does not get external finance
  - Wedge between the internal rate of return of the project and the rate of return required by external investors
  - Required rate sometimes prohibitive

• Main causes
  - Principal-agent problems
    • Due to asymmetric information, contract enforcement, etc.
    • Leading to adverse selection and moral hazard
  - Transaction costs

• Can the state tackle these problems to increase finance?
• Different from cases when state subsidizes sectors and firms
Role of the state in broadening access

• Two contrasting, well-established views on the role of the public sector
  1. Interventionist view
  2. Laissez-faire view
• New, middle ground view
  3. Pro-market activism view
• Financial sector view consistent with broader views on role of the state
Interventionist view

• Emerged during 1950s
• Financial sector policy
  - Private agents alone do not overcome market failures
  - Government should mobilize and allocate finance to strategic or socially important sectors
• Public banks
  - Useful vehicle/instrument in this context
  - Selective allocation of credit could also be done via regulation of private banks
    • Administered interest rates, directed credit, refinance schemes
Failure of interventionist view

- Experience with public banks and direct lending not very successful
- Public banks associated with lower financial development, wider spreads, and slower economic growth
  - Though cause and effect difficult to establish
- Incentives and governance problems lead to recurrent fiscal drains and political capture in public banks
- Interventions (direct lending requirements or interest rate caps) have significant costs for efficiency and growth
- Not clear that intervention through public banks are needed, even when policy needs to be implemented
- Thus, public banks useful but not necessary
Laissez-fare view

- Emerged during 1970s and 1980s
- Financial sector policy
  - Government intervention can do more harm than good
  - Role of the state limited to strengthening “enabling environment”
  - Macroeconomic stability, rule of law, property rights
- Public banks
  - They become de-contextualized
  - Privatize or liquidate public banks (at least move to 2nd tier)
  - Remaining public banks in search of new identity
Laissez-faire view: bittersweet experience

• This view brought many benefits…
  - Liberalization reduces financing constraints
  - Positive link between improvements in the legal rules and financial development
• … but also costs
  - Liberalization can induce crises
• Importantly, outcomes have not matched initial expectations
  - Reforms take a long time to mature
  - Still no access to many creditworthy firms and households
**Pro-market activism view**

- Derives from innovative development policies since late 1990s, even when overarching theory still lacking
- Borrows valid elements from previous views
- Main focus of the state is to improve enabling environment …
- … but, in some cases, state intervention can be warranted
- State intervention
  - Only takes place when government has relative advantage
  - Targets underlying causes of problem, not more finance per se
  - Works with private sector rather than displace it
  - Attempts to be cost-effective and sustainable
  - Avoids “one-size-fits-all” approach
Role of public banks

• Public banks could play key role in pro-market activism view
• Not only useful tool, can also be essential
• New roles for existing public banks
  - Mitigate risk for private sector
  - Pool risk from otherwise atomized borrowers
  - Facilitate achievement of economies of scale
  - Solve coordination failures
  - Reduce transaction costs
• To perform these roles, development banks have needed redesign
  - Redefine mandate
  - Adequate governance structure
  - Hard budget constraints
  - New methodologies for evaluating performance
Pro-market activism experiences

- Public provision of market infrastructure
  - BANSEFI’s back office services (Mexico)
  - Correspondent banking (Brazil)
  - NAFIN’s Reverse Factoring Program (Mexico)
- Structured finance
  - Fannie Mae and Freddie Mac (USA)
  - FIRA (Mexico)
- Credit guarantees
  - BBMKB (Netherlands)
  - Federation of Credit Guarantee Corporations (Japan)
  - FOGAPE (Chile)
  - KODIT (Korea)
- Microfinance
  - Banco do Nordeste (Brazil)
  - BancoEstado (Chile)
  - Bank Rakyat (Indonesia)
Case study: FIRA and working capital financing

Functioning of Scheme

- **OCEAN GARDEN**
  - Loan for working capital $100
  - Supply Agreement

- **SHRIMP PRODUCERS**
  - Payments
  - Feed

- **SHRIMP FEED SUPPLIERS**
  - Payments

- **TRUST FUND**
  - Transfer of credit rights
  - $100

- **BANKS**
  - Participation certificates
  - $100

- **FIRA**
Case study: FIRA and working capital financing

Functioning of Scheme in Case of Default

- OCEAN GARDEN
- SHRIMP PRODUCERS
- SHRIMP FEED SUPPLIERS
- FIRA
- BANKS

Guarantees:
- Global guarantee (up to 25% of total fund value)
- Individual guarantee (9%)
- Individual guarantee (15%)
- Individual guarantee (9%)
- Second loss guarantee (46%)

Default on supply agreement
Remaining questions

• All these experiences very telling, apparently making a difference
• But many questions linger
• When is state intervention warranted?
  - Why is the private sector not taking advantage?
  - Can the state improve over private outcomes?
• What is the optimal intervention?
  - How to compare among novel interventions?
  - Should the state be a lender?
  - Risk sharer?
  - Coordinator?
• How can interventions be evaluated?
  - How are social objectives quantified?
  - How to compare firms’ behavior with and without the initiative?
Remaining questions

- How to minimize unintended consequences of interventions?
  - How to balance social objective with financial sustainability?
  - How to avoid political pressures?

- Can idiosyncratic experiences lead to more general policy guidelines?
  - What are the key features that make interventions work?
  - Can they be replicated in other sectors and countries?

- Is there a role for pro-market interventions in the long-run?
  - Is direct intervention necessary once a good environment has been achieved?
  - What is the future for successful experiences?
Thank you!
Additional slides
Case study: FIRA and working capital financing

• FIRA is a Mexican development-oriented financial institution
  – Provides financial services to the rural sector

• Shrimp producers had limited access to working capital finance
  – Lack of collateral
  – Costly and difficult to screen and monitor small producers
  – Price uncertainty

• FIRA created a structured finance program, involving Ocean Garden (large shrimp distributor), shrimp producers, shrimp feed suppliers, and private banks

• Ocean Garden signs supply agreements with individual producers and advances working capital finance

• Credit rights are then transferred to a trust fund and sold to banks
Case study: FIRA and working capital financing

- Transaction helps to deal with information problems
  - Ocean Garden provides know-how in screening and monitoring producers

- Pooling of debt obligations allows banks to diversify their risks and avoid exposure to a specific producer
  - Banks do not face Ocean Garden’s credit risk (SPV is bankruptcy remote)

- Pooling also reduces transaction costs

- To align incentives all industry participants provide liquid guarantees to cover initial credit losses
  - Producer and feed suppliers provide guarantees for specific loans covering initial credit losses up to a certain level
  - Ocean Garden provides a general guarantee covering initial credit losses up to a certain level
  - Once these guarantees are exhausted investors start facing losses
  - FIRA provides a guarantee that covers second losses
Case study: FIRA and working capital financing

Functioning of Scheme

- **OCEAN GARDEN**: Loan for working capital $100
- **SHRIMP PRODUCERS**: Payments
- **SHRIMP FEED SUPPLIERS**: Feed
- **BANKS**: Transfer of credit rights $100
- **FIRA**: Participation certificates

TRUST FUND

Supply Agreement

$100
Case study: FIRA and working capital financing

Functioning of Scheme in Case of Default

- **TRUST FUND**
  - Global guarantee (up to 25% of total fund value)
  - Individual guarantee (9%)
  - Individual guarantee (15%)
  - Second loss guarantee (46%)

**Entities**

- **OCEAN GARDEN**
- **SHRIMP PRODUCERS**
- **SHRIMP FEED SUPPLIERS**
- **BANKS**
- **FIRA**