

# Economy of Ghana Network

## ***Private Sector and Capital Market Development: Proposed Forum Discussions***

### **Forum 1: Development Finance: Is there a need for a New Paradigm?**

The concept of a development finance institution (DFI) or development bank (DB) arises out of the perceived need on the part of society to provide mechanisms, which facilitate economic development. It finds its rationale in the appeal to the concept of market failure on the part of existing financial institutions. Development banking has always been at the forefront of economic planning in Ghana. Soon after independence in the need for separate agencies to carry forward this task was realized and the Agricultural Development Bank, Bank for Housing and Construction and National Investment Bank were established to provide medium and long-term credit to the agricultural, housing and industrial sectors respectively.

The basic rationale of DFIs was that the state needed to channel funds to help private initiatives in various economic sectors because of (a) unavailability of capital and (b) the high risk nature of projects to be funded though they were desirable from the society's point of view by contributing significantly to the transformation of the national economy. Since commercial banks did not have long-term liabilities to fill in the gap of long-term finance and the investment banks could not raise household savings of large amounts to fund such high risk (and in some cases low private return) projects, the State/Government set up the DBs which would act as lenders of last resort. Therefore, economics and social appraisal become a distinguishing feature of DFIs, methodology for selecting and supporting private sector projects. In the international context, the development role is fulfilled by the World Bank together with its two affiliated agencies, viz., the IFC (International Finance Corporation) which provides Project Finances to nations as long term loans and IDA (International Development Association) which provides soft loans (carrying lower interest rate and liberal terms of repayment).

Inherent in the role of DFIs is a whole host of public policy objectives, which they are required to fulfill. They include:

1. Speeding up economic growth
2. Rapid Industrialization
3. Rural Development
4. Support to Industry
5. Entrepreneurial Development
6. Housing

In pursuance of these objectives DFIs perform the following functions:-

- Provision of term loans & working capital (traditional function)
- Formulation of project ideas.
- Identification of specific projects to suit to local conditions
- Location of and inducing new entrepreneurs to take up well-formulated projects, and provision of a package of counseling services, including technological and managerial guidance.

A number of factors have had an impact on the overall performance of DFIs; among them is over-exposure to risks in the domestic economy, high transaction costs and a dearth of long term domestic finance and technical capacity. The recent collapse of the Bank for Housing and Construction is a case in point. The government has also been talking about the privatization of the DFIs. As market failure is pervasive in the domestic financial arrangements, the state may need to be more entrepreneurial, by playing either a facilitating or interventionist role. In this sense, therefore, the solution may be to find ways of improving the operations of the development banks.

By the 1980s, many poor developing countries had started facing external debt servicing crisis. Many DFIs had started showing a weakening of financial position since their loan portfolio exposure was mainly to high-risk projects, which also were prone to suffer time and cost overruns, and therefore needed additional finance from DFIs. Governments were finding it difficult to support the DFIs through increased allocation from their budgets. The bi-lateral and multilateral agencies providing aid to support the DFIs were concerned about the financial sustainability of DFIs.

The DFIs had to establish their relevance in modern financial markets. Therefore, they needed to raise substantial amount of cheap funds from the household sector and institutional investors on their own strength. But weak balance sheets (financial soundness and profitability) made it difficult for many DFIs to raise funds in the financial markets without the support of sovereign guarantees. The DFIs had also to search for solutions to their past legacy of exposure to high risk projects. In the process, DFIs were reincorporated under banking laws and became commercially oriented, thus diluting their development mandate.

Today many DFIs are still searching for business model solutions seeking a balance between both developmental and commercial roles. A viable business model by DFIs that would sharply distinguish their role from those of commercial/investment/universal banks in the competitive market place is not-yet in sight.

Proponents of the development finance model believe that DFIs can support development by facilitating business access to finance through a wider range of instruments particularly in the high risk but strategically important SME sector. Under Ghana's Financial Sector Strategic Plan, the following objectives have been established for development finance institutions:

- Establishing a new business model which ensures relevance and sustainability of development finance institutions
- Establishing a new regulatory framework for development finance institutions.
- Restructuring existing development finance institutions

In addition to establishing DFIs, the government operates a number of financing schemes to support the private sector. Government-sponsored financing schemes are similar to development finance schemes in their pursuit of the common objective of providing an

alternative source of business finance in the face of credit market failure. Examples of these are

- Export Development investment Fund (EDIF)
- Venture Capital Trust Fund
- Trade and Investment (TIP) Program
- Concessionary donor-contracted funds for on-lending

In more developed countries, development finance is very active. Examples of successful development finance institutions are the Small Business Administration and FANNIE Mae in the USA and the Federal Business Development bank and Farm Credit Corporation of Canada. For example, it has been established that the largest provider of venture capital in the United States is the Small Business Administration, working through private venture capital firms called Small Business Investment Companies.

Despite the strong presence of development finance institutions in developed countries development finance in developing countries has been rolled back under structural adjustment programs promoted by the World Bank and the IMF since the 1980s (“The Washington Consensus”) which increasingly affirm the role of market forces in allocating resources. Because development finance inevitably implied subsidized finance, it was seen to be creating market distortions and sucking limited state resources. In Ghana the development finance institutions that were established in Ghana have now been converted to private financial institutions and reengineered as commercial banks under the supervisory umbrella of the Bank of Ghana. Yet the problem of directing credit to the poor and the risky SME sector remains unsolved.

The objective of the Development Finance Forum is to elicit views on whether there is a role for development finance institutions in Ghana. Specific questions to be addressed include:

1. Is there a need for development finance?
2. What lessons can we learn from our previous development finance institutions?
3. Is there a need for a new development finance paradigm?
4. How should development finance institutions/programs be structured?
5. What should be the role of the state in development finance?