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Do We Need a Development Bank?

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The Government of Namibia is considering how to establish a development bank to provide finance for projects which it believes are viable but are not being financed by existing lending institutions. What are the arguments for and against?

An economics professor is walking through the university grounds with a student when they see a N$100 note lying on the ground. The student asks if she shouldn't pick it up but the professor tells her to walk on saying that the note had to be a fake or else someone else would have already picked it up. This old economics joke nicely sums up one of the fundamental issues at stake in Namibia's debate on whether to establish a development bank. Given that we belong to the Common Monetary Area, which has one of the most sophisticated financial services sectors in the developing world, why do so many people believe that the demand for certain financial services is not being met? If there are profits to be made from lending money, why are profit maximising institutions not lending? In short, why haven't the N$100 notes already been picked up?

What is a development bank?

Banks are institutions that take in deposits from savers and lend the money out to borrowers, that is they are *financial intermediaries*. Savers and borrowers may include individuals, households, businesses or government. Banks make profits by charging borrowers higher rates of interest than they pay savers. They play an important role in the economy because they help channel savings to investments. However, they must carefully assess the risks they are taking when they lend because they guarantee the rate of interest they pay to savers. For them to remain financially sound and sustainable, banks must always ensure that the risks they are taking on the lending side of their operations do not endanger their ability to pay interest on the deposit side of their operations.

Development banks are different. Unlike commercial banks, they do not generally take deposits from customers but instead raise money from governments and other financial institutions. With this money they lend to specific projects in both the public and private sectors. Development banks may be funded by shareholders who provide money in exchange for ownership of the bank (equity), by loans which can be on-lent to projects at higher rates of interest (wholesale finance), or by selling debt (bonds and other debt instruments). Shareholders are generally governments or government institutions. Development banks typically get involved in lending to projects that commercial banks find too risky. Because of this, and because decisions are often made on political rather than commercial grounds, development banks often make little or no profit. Many have made considerable losses which then have to be paid for by taxpayers.

Nationalism versus economics

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The arguments in favour of establishing a development bank fall into two categories: the economic and the non-economic. The non-economic argument is essentially a nationalistic one. Namibia is a sovereign state and must establish its own Namibian institutions regardless of the economics. Since other countries have development banks, Namibia should have one too. This opinion piece will not take issue directly with this line of thinking since it is based on value judgements to which anyone is entitled. However, people should bear in mind that setting up a bank on this basis is likely to prove expensive. Instead, this short paper will focus on the economic issues at stake where the application of basic economic principles may help think about the issues and clarify the way forward.

Is there a lending gap?

The first issue is whether there are gaps in the market for lending which are presently not being filled. Talking to business people in Namibia, there certainly appears to be much anecdotal evidence that such gaps do exist. Business people large and small complain that their banks are unwilling to lend to all but the safest bets. It is alleged that entire industries, such as the fishing industry, have grown up despite the lack of support from local lending institutions.

The first point to make is that in any country there are likely to be large numbers of people looking for finance who do not succeed in getting it. However, this may be because their projects are not viable. The mere existence of people saying there is a lending gap is, therefore, not enough to prove that there is.

The second point is that the difference between a viable and a non-viable project is generally less than clear-cut. Some projects may involve greater risk than others. This may be because the borrowers are new business people with only a limited track record of business success. It may be because the project is in a new activity which the lending institution does not know much about. It may be because the returns from the project will only accrue after a long period of time and this causes greater uncertainty and risk.

In theory, dealing with risk is one of the reasons the financial sector exists in the first place. Riskier projects can be funded provided lenders can ask for higher returns. Furthermore, lenders can reduce risk by lending to several projects at once taking into account that a proportion will fail. Provided institutions are allowed to *price risk* and *spread risk* properly, risk should not present a problem.

Should the banks fill it?

Much of the anecdotal evidence one hears is about the commercial banks. The charge is that they are too comfortable and too risk averse to undertake the sort of lending Namibia's business sector requires. They make easy enough profits lending to consumers and providing day-to-day banking services for established businesses. There is certainly evidence to support this. Bank profits in Namibia are high and lending to new projects is limited. The question is would shareholders and depositors be prepared to see more risks taken with their money and do the banks have the expertise and balance sheets to undertaken more risky business lending? Shareholders and depositors are also Namibians and, directly or indirectly, they often represent rather less privileged sections of society than those borrowing money for long-term investments. If profits are too high, this would suggest that competition is limited. If this is so, policy should be directed primarily at increasing competition among the commercial banks.

Namibian banks generally do not see it as their business to lend to risky long-term investments. However, Namibia's banking sector has strong links with lending institutions elsewhere. Critics of the local banks have to explain why profitable opportunities are being overlooked since these sister institutions spend considerable time and energy seeking out profitable opportunities. It is possible that non-Namibian institutions may face additional costs in gathering information and developing relationships with clients in Namibia. Their focus is also likely to be elsewhere so Namibian projects are less likely to show up on their radar screens. Furthermore, Namibian projects may often simply be too small to be worthwhile for larger regional lenders.

Small may be beautiful but is often not very profitable.

Namibia is emerging from a situation where the majority of the population was held back from participating in business in a whole variety of ways. There is, therefore, good reason to believe that a "catching up" process needs to take place. Thus there are good grounds for believing that the demand for lending to new business may indeed be higher than in other countries and that these new businesses are likely to be smaller and more risky. Most successful business people of the future are likely to start small and grow rather than jump straight into large projects.

For many institutions, lending to such small businesses may well be unattractive since the costs of administering and monitoring lots of small loans to new customers are high and default rates higher. To make money, lenders will inevitably have to charge higher rates of interest.

In the case of small businesses, access to regional or international lenders is unlikely to prove much of an advantage. South African lending institutions are hardly likely to enter a market which is unattractive for local institutions with local branch networks. To date this area of small business finance has been left largely to the Development Fund of Namibia and a handful of NGOs. The problem with this is that lending has not been profit driven but subsidised and has therefore been limited by the pot of money available to pay for the subsidies.

Attempts have been made to get round some of these problems. Government has sought to encourage commercial banks to enter the market through the Small Business Credit Guarantee Scheme. Under this arrangement, commercial banks lend money to small businesses and administer and monitor the loans but Government bears most of the risk in the event of default. Commercial banks, however, continue to bear a portion of the risk to eliminate the problem of *moral hazard* – in other words, of the banks not caring whether projects succeed or not because they know Government will pick up the tab. In addition to this, the Post Office Savings Bank is considering entering the market for small business loans. Its branch network is already in place so there may be grounds for believing that the additional cost of providing this service will be lower than for any new institution.

What about the big projects?

Namibia is a small economy with five commercial banks. It may be that certain projects requiring finance are simply too big for these banks to lend to since no bank is allowed to invest more than a certain amount of money in a single project. These *prudential requirements* are designed to stop banks putting all their eggs in one basket. They must spread risk widely so that if one investment fails, the return from the others will ensure a positive overall return is achieved. These larger projects include major infrastructure projects and other large investments. However, this is precisely why it is so advantageous to be an economy open to the rest of the world. By dint of

belonging to the CMA and the global economy, Namibia can source finance from anywhere in the world. By even just South African standards, most large projects in Namibia are manageable within prudential requirements. There is nothing to stop good projects here finding money in South Africa and plenty of expertise to ensure deals are properly structured. Two South African institutions are already active in Namibia. The Development Bank of Southern Africa has already lent to the NDC and Windhoek Municipality while the Industrial Development Corporation is funding agricultural, mining and manufacturing projects in Namibia. At least one private commercial lender is actively engaged in lending to municipalities in Namibia and is busy exploring ways to lend to the private sector.

The only question is one of cost. Generally speaking, if a country can import goods and services cheaper than it can itself produce them, it is of net benefit to the country to import them. Basically, the benefits of cheaper goods and services to consumers outweigh the losses to domestic producers resulting from cheaper competition. Like other businesses competing with imports, if a Namibian development bank could provide finance at cheaper rates than a South African or international lending institution this would represent a net benefit to the economy as a whole. But it is important to bear in mind two considerations. First, how likely is it that a relatively small Namibian institution with no track record will be able to lend more cheaply than larger more established institutions elsewhere? Second, any cost of lending – the interest rate charged - must be viewed against the riskiness of the investment. If the Namibian institution lends at rates lower than that justified by the risk of the investment, the institution will end up losing money or having to be subsidised by Government. It may be better to come to some arrangement with existing South Africa institutions and immediately buy into their credibility rather than start something new and untested.

There may be reasons why a particular project should be subsidised by Government but this cannot apply in general. The danger with this is that money subsidised by Government could discourage businesses from seeking commercial sources of funding. This would have the twin effect of encouraging dependency on subsidised finance as well as harm the profits of commercial lenders through genuinely unfair competition.

Why is no one listing?

An additional consideration is that mechanisms already exist through which to raise large sums of money for higher risk projects. The Namibian Stock Exchange (NSX) has helped raise significant sums of money in the past in the form of equity and bonds. At least one large project, Namibian Minerals Corporation (Namco) promised only long-term returns yet managed to raise the finance it was looking for. Stock exchanges are one way money can be raised for large and relatively risky projects. It all depends on how shares are priced relative to the risk involved. The last real local listing on the NSX, Gendor, took place in November 1998, an indication that only few projects exist which are able to take advantage of the stock exchange.

An argument may be put forward that many projects are simply too small for the NSX. There is nothing to stop money being raised which can then be invested in a range of smaller projects. This was the idea behind Namibia Harvest. However, Namharvest raised N$60 million and then sat on the cash for three years. There was a point when it looked as if one foreign mining company was going to raise money on the NSX for a large mining project in Namibia. However, the company was bought out by Anglo American which financed the mine through its own sources of finance. This episode demonstrated clearly that major multinationals have little need for Namibian financial

institutions to finance major investments though they may feel the need sometimes to raise local money so they can claim local money is going into a local project.

We've already tried force

Some years ago Government introduced regulations to force pension funds and life insurance companies to invest more of their money in local assets. These *domestic asset requirements* have now been in place for over six years. There is little evidence, however, that their introduction has led to more productive investment on the ground in Namibia which would otherwise not have taken place. The experience seems to have been that those charged with investing the money, the local *fund managers*, rather unsurprisingly continue to prefer investing in relatively low-risk listed equities on the NSX rather than in higher risk projects. There may be better ways of encouraging more risk taking than the present domestic asset requirements but these need to be investigated.

Who should call the shots?

Governments everywhere have a great tendency to set up new institutions to solve problems of concern to their electorates. The trouble is that governments are not very good at running commercial organisations. This is not necessarily because governments are inherently bad or incompetent, it is because the incentives faced by governments are very different to those faced by private businesses. Governments, as opposed to shareholders, have no very direct interest in seeing something make a profit. Governments have greater difficulties taking decisions which will lead to political problems, such as reducing their workforces, raising interest rates, calling in debts or cutting off funds to ventures that have proven unsuccessful. Governments make lending decisions on the basis of political rather than commercial criteria. The only remedy for this is to insulate decision-making from politics. Yet for any institution owned or partially owned by the state in the name of the people, there is a difficult balance to be struck between efficiency and accountability to the people. Recent developments in Namibia give cause to hope that Government may be prepared to let loss-making ventures fail. But inevitably these become political problems rather than remaining commercial ones.

Discriminating against profit?

A further worry is that existing institutions discriminate against black business people wanting finance. Economists as a rule assume the power of money is greater than the power of bigotry but this may be a little naïve given that it is a matter of empirical fact that apartheid – an uneconomic form of economic organisation in so many ways - existed for so long in this part of the world. The question now is whether institutions are continuing to forgo profits because of racial discrimination. Analytically it is difficult to distinguish between racial discrimination and rational decision-making. Black business people are often new in business and not backed by assets because of past discrimination. That often makes blacks more risky in financial terms. This is an especially important issue in Namibia and needs to be dealt with properly. Without further research it is impossible to determine the extent of discrimination and whether it is holding back lending. If it is, it could equally be argued that there is a significant opportunity out there for new financiers to grasp. Many entrepreneurs, black and white, have already jumped at similar opportunities in the consumer credit market by setting up the much despised micro-credit lenders to lend to people whom the banks refuse to help.

Driving industrialisation

Many people argue that a special financial institution is required as part of Namibia's industrialisation drive. The thinking is often rather unclear but the bottom line seems to be that some kind of lending is required which will only yield a return many years down the road. No one appears very sure of what this might involve – should we be establishing manufacturing plants under some sort of infant industry policy? If so what should we be making and how long are such ventures to remain subsidised infants rather than profitable grown-ups? Why exactly are such initiatives not taking place in any case? Is it simply a lack of finance or are there other reasons? The very great danger here is that Government tries to pick winners and wastes vast sums of money subsidising losers in an open-ended fashion.

Other people's money

An important question in the whole debate on finance is always who bears risk. Different sources of money available for lending are able to bear different amounts of risk. But most sources of finance for lending generally come from voluntary savings. Governments can legally oblige people to pay tax but cannot legally oblige people to save. That requires incentives. A large proportion of Namibia's loanable savings are in the form of pension and life insurance funds. Government has already tried to oblige these funds to invest in Namibian assets. By restricting asset choice Government implicitly but inevitably limits returns. It seems harsh to expect Namibia's pensioners to bear the risk of investing in higher risk assets that would not otherwise have been chosen by the managers of their savings. The Government Institutions Pension Fund (GIPF) has created the Development Capital Portfolio, some N$500 million which Sanlam Investment Management is currently managing on its behalf. The portfolio consists of a range of products including hotels, ostriches, grapes, fishing and some manufacturing. There is a widespread perception that returns so far have been disappointing.

If it is to take place, the burden of this sort of lending, deemed to be (rather intangibly) in the country's long-term interests, should most fairly be placed on the taxpayer, the broadest group of people who both have money and represent the country as a whole. However, the problem with using taxpayers' money is that the incentive to achieve a return on investments is very much weakened.

Limited returns

Private lenders want a high return for risky projects. Private lenders will tend to cherry pick choosing only the very best projects and leaving the rest. Should lower return projects be financed? Most people would probably argue that they should but that someone else's money should be used to do it. Government may justifiably feel it is a good use of taxpayers' money to fund such projects because they will bring wider benefits to society than simply the financial return on the investment. If the danger of throwing large amounts of money at proven loss-makers can be avoided, perhaps it should simply be accepted that a development bank is likely to make modest returns but that the longer-term spin-offs in terms of developing a Namibian business sector make it worthwhile. The trouble is that the danger is significant of things going wrong. Private sector involvement does not necessarily solve the problem since business and government are not averse to joining in unholy alliances at the expense of the taxpayer.

Any alternatives?

Instead of setting up an expensive new institution, Government could try and be a bit cleverer about the way it encourages the private sector to invest. Domestic asset requirements could be

reshaped to force fund managers to invest smaller amounts of money but in *real projects* in Namibia rather than in dual-listed shares on the NSX. Government could oblige the banks to get involved in small business lending and extend banking services to the rural areas and the poor. It could increase competition by ending uncompetitive practices and demanding greater disclosure of information. There is already evidence that innovation is starting to take place in the private sector with the setting up of Afminco, a mining fund which finances the pre-production phase of smaller mining projects overlooked by the big multinationals. In all these cases, returns may be lower than the projects the private sector would voluntarily choose to invest in but at least private lenders would try their utmost to make a return from these activities. The trick would be to start with relatively modest regulations and ratchet them up as experience is gained by private lenders.

So do we need a development bank?

This opinion piece has looked at the issue of whether Namibia requires its own development bank. It has done so from an economic perspective in a slightly theoretical way by applying basic economic thinking to the issue for, unfortunately, little solid research exists on the subject. An important starting point centres on the question of whether there is a gap in the lending market, in other words, whether viable projects are failing to find money because no institutions exist to fund them. There seems to be a general feeling in Namibia across government and business that this is indeed the case. However, such a situation represents something of a puzzle for the economist because it would mean that profit-making lending institutions were passing over profitable investments and that the N$100 notes spotted by the professor and his student were not being picked up. This is especially difficult to believe given the competition that should exist for new business and Namibia's openness to foreign lending institutions in the region and the rest of the world.

However, from a theoretical perspective, there may be explanations why such a situation might exist. Many borrowers are likely to be small business people with no track record and little collateral. Namibia is a small economy and is unlikely to be the focus of attention for larger regional or international lending institutions. Some projects may simply be too long-term for local institutions and too small for foreign lending institutions to select. The lack of lending may simply reflection a lack of expertise, competition, innovation and entrepreneurship in Namibia's local financial sector which often lacks the autonomy to make decisions on its own.

Do these theoretical possibilities mean that we should set up a development bank? It is generally easier to be critical and give reasons why action should not be taken than it is to give advice on what should be done. There are ways Government could address problems by pushing the private sector harder to innovate. Yet it appears that the decision to choose the development bank option already seems to have been taken.

From the economic perspective, the case for or against the establishment of a development bank appears at best an open one. Many countries around the world have valuable, often very negative, experience with development banks. But perhaps the fact that so many countries continue to operate such banks indicates that there is a generally accepted need for such institutions. Namibia would be wise to examine these experiences and try and learn from them. There are signs that this may already have been done.

Provided the proposed development bank can bring private shareholders on board, if it can be isolated from political interference and run by professionals, if it can lend at cheaper rates than existing institutions taking risk into account, if it can tackle those areas where market failure is

likely to be most extreme, and if ways can be found to avoid creating unfair competition with commercial lenders then the damage such a institution can do will be limited. It might even do some good.

References

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