

DEVELOPMENT FINANCIAL INSTITUTIONS IN THE CARIBBEAN – THE NEED FOR RE-ORIENTATION

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Development Financial Institutions or development banks (DFIs) have been in existence in the Caribbean region for well over forty years. In the main, these institutions were initially established to provide technical and financial support to specific sectors of the economy that would not normally be serviced by commercial banks. Almost every country in the region has at least one DFI and generally, these institutions were owned by the Governments of the different territories, although over time, a few have been privatized or set up with private sector and multilateral institutional support, for instance in Jamaica and Trinidad and Tobago.

The concept of driving development through DFIs is well established across the world, both developed and developing, though the experience presents a mixed bag of successes and failures. DFIs also range in size and stature, from the likes of the World Bank to the small sector specific DFIs operating within the confines of a country or even a state within a country. Yet, despite this diversity of size or culture, an examination of the factors which have contributed to these successes or failures will show remarkable similarity.

With the global economic environment undergoing rapid changes, particularly over the last three decades, DFIs all over the world have been confronted with the accompanying challenges. In all domains, while some have undergone successful metamorphosis and adapted, many more have been left struggling, and unable to run compact and stand-alone viable operations. The Caribbean is no exception and one finds a sizeable number of such institutions, facing existential issues, trying to remain relevant, stay competitive, and ultimately carve out and maintain a viable business model.

Problems Areas

In the realm of development banking, it has been increasingly commonplace to question the role for DFIs, with almost the implied suggestion that none exist any more. However, to dismiss the issue as such, peremptorily, based only on the manifestations of ailing health may be doing a disservice to the topic of development finance and what these institutions have accomplished in the past. More importantly, to do so, one also risks ignoring some of the lessons which lie in the diagnosis of the problem, applicable for financial institutions as a class.

Inability to Adapt to the Changing Environment

On the funding side, Caribbean DFIs have had to endure the declining trend in the level of concessionary assistance they receive from traditional sources, both external and domestic, the emergence of international capital markets, the deregulation of national

financial systems and ultimately the increased competition for funding from new players in the financial system. The fact that DFIs are not usually deposit-taking institutions has compounded this challenge.

On the lending side, the DFIs have had to face increased competition from commercial banks and non-bank financial institutions that have, in some measure, developed strategies and products to enter the long-term financing market space that was hitherto exclusively occupied by development institutions.

Again, the above issue is a generic problem faced by DFIs the world over and examples abound in the developing world, in East Africa, Korea, Thailand and India. This only underscores the need to constantly track the environment, adapt the business model and usher in the necessary changes to the organisation, including skill development, in order to sustain a viable business model.

Poor Management and Political Interference

DFIs have long been used by their Governments as instruments to pursue their development objectives, mainly in sectors such as agriculture, infrastructure and industry and even education and housing. While this is synchronous with the mandate of development banking, the problem has been that over time, the funding and policy support which is needed to go in tandem with such mandated lending, has dwindled. It is also common knowledge that given the significant Government ownership structure of these institutions, many of these institutions have suffered from malefic political interference in the management, with a view to support political gains rather than any genuine development cause. Belize is just one case in point, where the recent problems faced by the Development Finance Corporation came about as a result of the many uneconomical projects that were funded by the Government through this institution. This ultimately led to the Government having to restructure the institution and try to reschedule the now unsustainable external debt that accumulated.

Weak Risk Management Systems and Practices

As with many DFIs in the emerging world, Caribbean DFIs, have also historically, tended to embrace weak risk management, loan follow-up and collection systems. This has led to poor project selection and poor identification of weak or non-productive assets, which in turn led to the manifestation of poor quality portfolios, characterized by high incidences of arrears and defaults. The lending practices, technology and information systems and research capabilities of these DFIs have in most cases not kept pace with changes in the business environment. While very few DFIs, like the Development Finance Limited in Trinidad and Tobago, with support from multilateral shareholders, have restructured operations to become commercially focused and viable, most others still lag behind and are constantly buffeted by the competitive pressures in the market.

Lack of Commercial Focus

As government institutions, development banks have traditionally been viewed and perceived as the poor man's bank with a benign approach to lending. Political influences and development objectives have got mixed up over time, and with DFIs rarely pursuing hard recovery measures, this has served to create a situation where loans by DFIs are treated almost like grants, with borrowers attaching no priority to their debt servicing. An analysis of those DFIs that have provided education loans underscores this point. Over time, many Caribbean DFIs have almost developed a culture of poor commercial focus in the name of development banking, manifesting in adverse loan selection and lax monitoring and controls, leading to asset losses and capital losses.

Even where DFIs have tried to follow reasonably good lending practices, a development mandate which has driven them to lend to segments which are inherently unviable, without adequate continuing support from the Government has led to balance sheet problems. For instance many DFIs that lend to the agriculture sector in the islands of the OECS, have provided loans and advances to subsistence level farmers and borrowers who under normal circumstances would not survive without the institution's assistance, and who have limited scope in developing/growing beyond their current level of operations. This has impacted the loan portfolio quality of these institutions and in many instances has necessitated a shift in focus.

Need for re-orientation

While the inherent risks in development banking are undeniably higher than in commercial banking, it is not per se unviable, as is often made out to be. It is also important to accept that development lending is neither synonymous with lending at cheap rates nor adopting benign loan recovery measures. To drive success in this sector, we need a holistic approach, which recognises the true costs and benefits of development finance and balances Government's development priorities with the development of a supporting institutional infrastructure and a healthy lending culture. Japan's financial system which has continued to support development finance successfully, through a system of redefining sectoral development priorities from time to time, and allocating requisite resources through the financial system, provides several valuable lessons for policy makers.

In CariCRIS' opinion, resolving the problems faced by the DFI sector in the Caribbean and placing them on a viable path, calls for nothing short of a surgical approach followed by intensive care. Given that Governments are invariably the owners of the DFIs, the process has to necessarily start with the political will to embrace the necessary changes to allow management autonomy while providing policy and resource support, recognising that lax lending practices in the name of development lending will destroy rather than create value.

At an institution and system level, CariCRIS believes that the situation can be turned around for most of the struggling DFIs with a combination of the following measures

Surgical Balance Sheet Cleansing

A legacy of substantive accumulated non-performing loans or accumulated losses tends to weigh down any restructuring effort. To address this problem it would be preferable for the Government to enable a surgical cleansing of the balance sheet, by separating the performing assets from the chronic bad assets in the portfolio of the DFI, and recapitalise the institution adequately. This can be done by placing the bad assets into a Special Purpose Vehicle, to explore recovery through other special means on a commission basis, by the DFI itself. This will clean up the DFIs balance sheet to enable it to start on a cleaner footing. To minimise the moral hazard, it is important that such cleansing support be accompanied by inviolable operational covenants and governance structures which will sustain healthy operations.

Focus on Core Competencies

One of the problems faced by DFIs in the Caribbean is that many of them have lost business focus, and compounded this problem by blindly attempting to emulate seemingly successful practices followed by some neighbouring DFIs, without creating the requisite systems and processes. DFIs must now identify their core competencies and develop their business based on their areas of expertise. They need to examine their own operating environment and identify appropriate areas where they can add value. In the OECS for instance, as a result of the threat that the eventual loss of preferential treatment for bananas will pose for many small farmers going forward there is an opportunity for DFIs in this region to leverage their core competencies to identify and provide creative technical and financial development assistance to new/non traditional sectors in these small economies that have the potential for growth and sustained profitability.

Diversification for the sake of diversification can be counter-productive, and it does not serve to be just another player in the market, particularly if they do not have the necessary competencies and if there are others in the market who do the job better. Competing on price alone is a sure way of destroying value for the institution. DFIs also need to adopt a more commercial business approach with a clear eye on profitability even as they serve to channel much needed finance into areas needing development. Often, it is sheer accessibility of finance which counts for development, rather than the cost of finance.

Need to Strengthen Risk Management and Capital Base

A more clinical approach to risk management and risk assessment is needed to ensure that over time loan portfolio quality is improved and that overall financial performance is improved. Risk assessment must be used for risk mitigation and risk management and must be done within the framework of well developed risk management systems and practices.

It is also critical for DFIs to maintain a high level of capital adequacy, higher than what is usually required by regulators for the financial sector, since DFI operations are inherently more risky. Higher capital will also enable the DFI to explore innovative loan products such as partial guarantees and provide them with the ability to pursue development objectives. An analysis of successful development banks the world over would reveal that all high rated banks tend to keep a very high level of capital.

Strengthen Governance Framework

The governance architecture of DFI's need to be strengthened to minimise or even eliminate government influence in operations, beyond the technical aspect of Board. Even so, it would be progressive to appoint a Chairman of the Board who is a professional of relevant experience and reputation of integrity, who is independent enough to resist any political influence. The Board also should have a reasonable number of independent directors. While government appointments to the Board may be unavoidable if there is significant government ownership, appointments to the Board and top management of the DFI should be transparent and largely based on professional merit. These independent directors should include professionals who have relevant experience in areas such as banking, investment analysis, law, industry, tourism etc. The loan approval powers of the Board may also be largely delegated to a sub-committee of the Board, which is comprised mostly of independent directors with relevant credit experience. This may serve to structurally minimise the political influence in lending decisions. Structural improvements notwithstanding, real operational autonomy will depend to a large extent on Government's intentions and the political will to allow such progressive measures. Operationally, within the context of the Company's risk management framework, project selection should be based primarily on their commercial viability, unless there is specific subvention/subsidy available from the Government linked with lending to inherently unviable sectors or projects, which have mainly only social benefits. This will help to ensure that loans of a pure social nature do not compromise the financial performance of the institution.

Innovative Approaches to lending and fund mobilisation

With traditional approaches unlikely to yield significant answers to their problems, Caribbean DFIs need to constantly explore new methods of financing themselves and also attempt innovative ways of fulfilling their developmental mandate and maintain competitiveness in the ever changing environment. They must also portray a more commercial approach in order to be able to enter the domestic and regional capital markets and compete for market funds to offset the decline in funding from traditional providers. New instruments and services need to be developed and tailored to meet the changing needs of their clients and to be able to effectively compete with new entrants to the long-term financing market.

Conclusion

Although DFIs are generally viewed as becoming increasingly irrelevant in the emerging environment, they do not necessarily have to accept the fate to which many have resigned them. There is a clear need for these entities to shift their focus and adopt a more commercial approach to doing business. The reformation has to start with political will in the case of Government owned institutions, so that the DFIs are not hamstrung by the political exigencies. Where development banking appears to be having a role to play, an opportunity to “restart” operations may be provided by the Government, with a well-capitalized balance sheet, cleansed of chronic non performing assets, but accompanied by inviolable operational covenants and governance structures which will support good performance. This shift includes pursuing a more clinical approach to risk management to ensure portfolio quality and minimize losses. Injecting the Board and management with considerable professional expertise is also critical, to make for a forward-thinking, visionary management.

The adoption of these measures will in no small part enable DFIs to identify and pursue new areas of business and offer new products. This will in turn create an entity that can quickly adapt to the challenges that arise and that can effectively and profitably compete in the emerging environment.