



Tecnical document

ROLE AND FUTURE CHALLENGES OF DEVELOPMENT FINANCIAL INSTITUTIONS

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ROLE AND FUTURE CHALLENGES OF DEVELOPMENT FINANCIAL INSTITUTIONS

The challenges faced by development financial institutions (DFIs) are multiple and diverse, depending on the country's objectives and the nature of each institution. However, a common trait is the fact that DFIs must experience permanent change, namely:

DFIs as public policy instruments are very attentive in order to change and be effectively relevant. **That change has to do with the ability to generate innovations in the market or, otherwise, to operate counter-cyclically in order to avoid becoming irrelevant.**

To that effect, they must identify new areas or sectors to be developed. Who can better serve as an antenna and perceive in which direction the business opportunities and markets are going, than a Development Bank? It is to the DFI that entrepreneurs come when they have a novel project or product.

Agents of change. By being in a privileged position, identifying cutting-edge sectors that allow our countries to compete in the future, they can induce an environmentally-friendly development model and develop the potentialities of youngsters and entrepreneurs, making it possible for their ideas and projects to translate into business.

ALIDE, the Latin American Association of Development Financial Institutions, as the **"community of financial institutions that generates solutions**

in banking for the development of Latin America and the Caribbean" with more than 49 years of existence, whose goal is the cohesion and strengthening of the actions and participation of financial institutions in the economic and social process in the region, supports, through various means, their adaptation and permanent change in the face of new situations.

In a survey conducted by ALIDE on the detection of needs and lines of action of the DFIs, four large areas stood out in general terms, toward which the DFIs' actions would be targeted in the coming years:

1. Financial inclusion and digital banking.
2. Economic and social infrastructure.
3. Technological innovation and development.
4. The environment and climate change.

Also, in the future, DFIs must pay special attention to aspects such as:

1. Advice in public policies for investment and business opportunities intelligence.
2. Funding.
3. Balance between institutional sustainability and social objectives: impact and efficiency.
4. Banking regulation and supervision.

I. Financial inclusion and integration and digital banking

■ **Promoting mid- and long-term financing; participating in financing schemes that are more vast together with bilateral and multilateral credit institutions, public, private and mixed trusts, and achieving a structural dynamism through technological phasing in different productive sectors.**

■ Channeling financing for the creation of knowledge, systematization and dissemination of technological platforms, such as Fintech. Investment in these initiatives exceeded US\$ 12 billion in 2014 and US\$ 20 billion in 2015 (source: BBVA Innovation Center, 2015).

■ **Ability to adapt to the advances in new technology.** In Latin America and the Caribbean (LAC), 35% of banks consider that they do not meet the needs of millennials, who represent close to 30% of the population of LAC, and 71% admit

to not being able to adapt rapidly to the advances in technology. Nonetheless, in the coming years this age segment will be the main consumption and work force (source: a study conducted by the GMix program of Stanford University and Technisys, 2015).

■ **Operating through digital media.** The new generations are more inclined to using digital media and the internet. So, a tendency in the financial sector is to migrate toward digital channels to provide their services. Operating without branches means 50% less cost and 90% less staff requirement. 75% of banks expect to increase their services through Internet Banking, Mobile Banking and ATMs (source: a study conducted by the GMix program of Stanford University and Technisys, 2015).



Support to SMEs and employment



Support to the improvement of management and access to financing by smaller-sized businesses in order to accompany their growth and improve their insertion into international markets and in more sophisticated links of the global value chains.

Job creation. The loss of jobs due to technological advances is not circumscribed to the financial sector, but has also affected sectors that were apparently labor-intensive, such as the farming sector. The robotics and artificial intelligence market is expected to reach US\$ 153 billion in 2019 (source: Bank of America Merrill Lynch Global Research (2016)). Therefore, small businesses, who create 4 of every 5 jobs, have a significant relevance, especially innovative businesses, which constitute the businesses of the future, and they are the ones that will create the new jobs that will compensate for those that are lost along with the traditional production modes and technologies.

Support to the adoption and use of information and communication technologies with SMEs. The business models and the connection of businesses with the domestic and foreign markets are changing radically. In a world that is more and more connected, where the number of consumers with internet connections has increased from 167

million in 2005 to 2.710 billion in 2015, of which more than 78% were mobile connections, e-commerce, which in the last year was 994 billion and increases at a rate of 15% per year on average, is not being taken advantage of by the vast majority of SMEs. This landscape is not restricted to less-developed countries, but is also found in developed economies.

For example, in Canada 51% of the population shop online and 47% of businesses purchase goods and services through this means; however, only 41% of SMEs have their own website and, of these, 13% sell their products over the internet. SMEs state as the main reasons for not moving ahead in this direction, and using this sales channel for selling their goods and services, that they don't need it for their business (61.9%), that they don't know how to use it (8.2%), that there is a lack of safety and it is expensive (1.8%). Working on this line of support to the adoption and use of information and communication technologies with SMEs in order to expand their markets and to have a greater exposure to the world, as well as improving the quality and competitiveness of their goods and services, is another of the great challenges for the development financial institutions (source: presentation of the Business Development Bank of Canada at ALIDE 45, Cancun).

Internationalization of businesses so that they may access non-traditional markets or new markets, mainly those with which we have signed sales agreements or which are attractive due to their economic situation. Other DFIs, for their part, seek to increase or improve the international competitiveness of their production of goods and services that have greater value added so that they are more dynamic and integrated into the world market.

In that sense, the majority of DFIs offer a diversity of products and programs oriented toward supporting the internationalization of businesses (74.1%), among which stand out the programs that finance exporting SMEs (20%), the diversification of the exportable offer (16%) and the logistics infrastructure (11%). SMEs use pre- and post-shipment credit as financial instruments for the provision of these programs (25%); credit for investment in activities domestically or abroad (23%), and guarantees (18%). Also, these instruments rely mainly on initiatives that provide training (25%) and technical assistance (19%), linked to the exporting sector, and, to the same extent, they promote partnership and the integration of the value chains of the exporting businesses (19%) (source: ALIDE Survey, 2015).

For entrepreneurs, using a variety of financial and non-financial instruments that support the business owner at each stage of maturation of their business; in the production of added value and the insertion into global value chains; in order to improve their productivity and competitiveness, achieving their internationalization and with innovation and development of their endeavors. Thus, we can cite financing with non-reimbursable resources of co-financing for productive linkages, business innovation and connectivity; and non-reimbursable co-financing resources for open innovation, corporate endeavors or business spin-offs, risk capital and seed capital, business

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training, provision of information, among others. Though not all of the DFIs (67%) have a specific program for financing entrepreneurs, they do finance new projects but which are quite related to traditional endeavors, and others contemplate incorporating specific programs for innovating endeavors. The majority of DFIs that have programs provide support to promote the education and training of entrepreneurs (20%) and drive the integration of these entrepreneurs into production chains (12%). Without leaving aside the facilities that they provide to the businesses for the participation of entrepreneurs in fairs, business development centers, forums and meetings, and the financing of business ideas from youngsters (12%). The financial instruments that are most widely used for providing this support are credit in 36% of cases, mainly mid and short term, and guarantees in 17% of cases (source: ALIDE Survey, 2015).

II. Physical and social infrastructure

- **Go deeper in the financing of infrastructure works** and in boosting the energy sector. In order to reach the world average, LAC need to increase investments in infrastructure from 3.5% to 6.2% of GDP by 2020, compared to 2012. This means some US\$ 320 billion, a figure that the States in the region cannot match. Hence, the importance of mobilizing private capital and promoting the public-private partnership schemes, as well as other financing sources, such as infrastructure bonds.
 - **The new infrastructure must have a particular feature in order to optimize the use of the resources:** convergence with the technological advances and an intelligent nature.
 - **They must continue to develop instruments and programs for financing the infrastructure that are linked to the objectives promoted by the country.**
 - **Supporting the development of national infrastructure programs.**
 - **Maximizing and facilitating the mobilization of private capital into infrastructure projects.**
 - **Taking risks that the market is not willing to take.**
 - **Making viable projects that have social profitability or economic profitability.**
 - **Obtaining or improving the conditions of long-term financing for the development of projects with the granting of guarantees.**
 - **Playing a key role as a catalyst of projects for the structural transformation of the region, such as financing intelligent infrastructure,** which contributes in the long term to modernize and increase the efficiency of the economic sectors, achieving a sustainable development and contributing to the environment.
 - **Supporting the development of funds from capital markets with emphasis on infrastructure projects.**
 - **Seeking the complementarity of private resources for financing this type of projects, syndicating credits for them.**
- 70.4% of the Latin American DFIs finance the development of productive infrastructure and basic services. Mainly, of sectors linked to the construction of means of communication (land, air and sea) (38%); water and sanitation works (22%); power generation (17%) and distribution and logistics (storage and refrigeration systems) (10%). The financing modality most widely used has been direct credit to private individuals (26%), mainly for small- and medium-sized projects, such as those for generating renewable energy, followed in size by loans through sub-national governments (municipal, regional or state), with 24%, and those granted by second-tier banking, with 22%. Here, mid- and long-term credit, together with trusts, are the most widely used financial instruments for this type of financing (source: ALIDE Survey, 2015).

III. The environment and climate change

One field in which DFIs have pioneered, both in LAC and in Europe, is in the fight against climate change. In this respect, all the more so in light of the Paris Accord, we see that greater investments ought to be mobilized for climate-change adaptation projects. Currently, 45% of development banks have some environmental financing program, line or initiative, or they have some investment component for these purposes in their regular programs. For example, Fondo Amazonía, managed by BNDES (Brazil), supported by the government of Norway in order to reduce deforestation and the degradation of forests. In the first stage, the support was US\$1000 and in the second stage the investment is expected to be of US\$ 600 million, with subsidies from the Norwegian government.

In order to enable these financing operations, the DFIs are expanding their financing sources to the capital market by issuing green bonds. They also have the opportunity of becoming first-rate players in order to channel resources for investments in adaptation and mitigation projects from the Green Climate Fund (GCF) and the Global Environment Fund (GEF), entities charged with running the financial mechanism of the United Nations Framework Convention on Climate Change Conference of the Parties. For example, NAFIN, which issued the first Green Bond in local currency by the end of October of 2015 for US\$ 500 million, as well as Banco Nacional de Costa Rica, which placed US\$ 500 million in green bonds in April of 2016. The institutions that mobilized the most resources for

climate in the region were national DFIs, with 48% and multilateral banks, which account for 39%. According to the destination, 87% of the resources were allotted to climate change mitigation. The focus of the projects was energy generation from renewable sources and transport, with close to 40% and 27%, respectively, of the total resources from the national and regional banks (source Cepal, 2017).

The DFIs have a great capacity for dissemination in the local credit markets; they make viable the identification and generation of public-private projects and the necessary coordination among the relevant players within the national agendas on climate change.

Providing second-tier funding that incentivizes risk-taking on the part of the financial intermediaries.

Granting partial guarantees for credit, syndicated financing with financial intermediaries and national agencies with ad-hoc funds.

In the event that there are concessional funds, providing support that allows to reduce costs, non-reimbursable technical assistance granted by local or foreign entities for the structuring of projects.

IV. Technological innovation and development

Developing innovation ecosystems that facilitate the emergence of startups, technology-based businesses, formation of clusters in cutting-edge and TIC sectors and generating in the mid term a local venture capital industry that meets the demand for this type of resource.

Supporting the goal of making the producers more productive so they yield more revenue through financing focused on technological packages validated for specialized institutions, as well as technological support for specialized technical assistance in high productivity and reduction of production costs.

Developing innovating products and services in accordance with the needs of the customers and forming strategic alliances with specialized entities. For example, partnering with national science and technology funds that have resources, in order to share the functions, the bank having to manage the resources, conducting the financial evaluation, and the science and technology entity having to certify that the project is innovative. On the other hand, with the programs developed and operated with own resources, providing guarantees for innovating businesses. Among the financial support, it is worth

mentioning: 1) concessional credit with ample grace periods and amortization adequate for SMEs with no risk capital and oriented toward modernization projects with low technical risk (renewal of product lines, human resource training) or purchase of capital goods; 2) direct subsidies: non-reimbursable contributions, seed capital for startups and business incubators.

Taking advantage intelligently of the weight that the State has as a demander of goods and services to support the development of innovating or high-technology industries, which, in their final stage, lack the necessary experience, prestige and sufficient confidence so as to become providers in international markets. It is the State's commissionings in their first years that allow these businesses to experiment, develop knowledge and gain the necessary experience and prestige. On the other hand, since the main asset of this type of business are the intangibles, which are barely used for leveraging financing, and which also cannot be easily translated into guarantees for backing commitments or contracts, it is also necessary to have the intervention of the State or its financial institutions in order to provide them.



V. Advice and investment and business opportunities intelligence

- Continuing to participate actively in the policy of productive structure change defined by the national governments.
- They must remain alert in order to act in a counter-cyclic fashion and with actions of long-term impact.
- They must be strategic, placing resources in sectors that bolster added productivity, and dynamizing slow-growth economies.
- Aligning with public policies in order to advise governments and acting as identifiers of opportunities for investment, trade, business and public goods providers.
- Playing a key role as catalysts for economically-viable projects that are environmentally sustainable and socially just. The governments are strengthening their roles and functions for the stabilization of the financial systems, the modernization of the industrial structures, technological

innovation, developing markets and incentivizing long-term financing. They take advantage of the knowledge acquired by the DFIs as coordinators of investors in strategic projects and facilitators of public and private cooperation for long-term planning. Promoting financial schemes that dynamize intra-regional businesses, seeking to increase trade and investment inside the Region. The intra-regional trade flow from LAC, in comparison with other regions, is very low. It fluctuates around 16%, while trade in other regional blocs is up to four times greater. Indeed, intra-regional trade in the European Union exceeds 60%; in Asia Pacific it is about 50% and in the Association of Southeast Asian Nations (ASEAN) it is between 25% and 30%.

- In terms of cooperation, the path, going forward, is mutual learning regarding development ideas and practices, mobilization of trans-border funds into economic areas and industrial parks; and the anticipated development of solutions to possible problems according to world tendencies.



VI. Funding

In order to have the necessary capital that allows to finance the investments, the DFIs require to:

- **Raise resources from international financing sources** that complement the national sources, in order to cater to existing infrastructure projects, clean energy generation/distribution projects and energy-efficiency and sustainability projects.
- **Continue with the consolidation of relations with multilateral and development banking.**
- **Maintain the incursion at the international level in order to move forward on the positioning strategies as development banking.**
- **Explore different alternatives for adequate and timely funding for leveraging growth and its diversification potential**, with new products that adjust to the needs of businesses and people.
- **Further their relationship with the local or sub-national governments for investing in urban development projects** that improve the quality of life of the population, which, as we can see, is increasingly concentrating in the cities. Toward 2050, more than 80% of the world population will live in cities, and in LAC it will be 90%.
- **Acting in an integrated fashion inside an organic assembly of measures and actions complementarily with the private sector**, in order to ensure the sustainability of the financing and investment flows.



VII. Balance between institutional sustainability and social objectives

- In order to fulfill their role adequately, development banks must **attain a balanced design that allows them to reconcile their social or promoting role with the preservation of their economic and financial solidity.** The need to move within the margins thus stated poses rigorous levels of demand on the quality of their management, precisely due to the diversity of potentially conflicting objectives.
- **The running or management that validates public banks must be one that respects the guidelines of good corporate governance practices and allows for healthy and well-managed banks.**
- **DFIs must act within a framework of efficiency, transparent management and sustainability in the long term and one of implementation of good corporate governance practices.** Regarding this last point, it provides counterweights and transparency to DFI operations. However their implementation must be prevented, from leading to overregulation, which is already considered to be the case, DFIs being answerable to various State entities. A situation that does not occur with the private financial entities.
- **The definition of indicators for the measurement of your activity's impact must be an unavoidable part of measuring the efficiency of management.** "What is not measured does not exist". In this regard, Development Banking faces a great loophole. Their actions are reported, but not the impact that they have on the national and regional economy, on the businesses and on the people that it supports. Measuring the impact is key in order to know how productive they are in terms of the use of resources.
- **Efficiency. The shortage of resources from the States and the upward trend of interest rates in international markets, as well as greater demand for development resources force them to be more efficient in their use.**



VIII. Banking regulation and supervision

The Basel norms, though they are general, correspond to good practices for financial management. Hence, the impact of norms born under the inspiration of Basel affects all banks. However, it must be considered that all banks are not alike, such as development banks, which even among themselves show a diversity of models, which warrants a different regulation.

DFIs must understand well the new scenarios of disintermediation and must develop within these, **though it would be reasonable for them to have a special regulation, it is up to each country to define the adjustments, but without affecting the basic coefficients that have allowed the DFIs to be currently solid, unlike in the past decades.**





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