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RETHINKING NATIONAL DEVELOPMENT BANKS

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**RETHINKING THE ROLE OF BANKS AND OF SUB-REGIONAL
AND NATIONAL DEVELOPMENT FINANCE INSTITUTIONS
IN AFRICA**

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ACRONYMS

ADB:	Agricultural Development Bank	DFCU:	Development Finance Company of Uganda
AFD:	Agence Française du Développement	DFI:	Development Finance Institutions
AfDB:	African Development Bank	DFS:	Decentralized Financial System
BCEAO:	Banque Centrale des Etats d'Afrique de l'Ouest	DSP:	Divestiture Sequence Plan
BCP:	Banque Centrale Populaire	EADB:	East African Development Bank
BDA:	Banque de Développement de l'Angola	EIB:	European Investment Bank
BDC:	Botswana Development Corporation	ERP:	Economic Regional Program
BDEAC:	Banque de Développement des Etats d'Afrique Centrale	FDES:	Fonds de Développement Economique et Social
BDET:	Banque de Développement Economique de Tunisie	FDI:	Foreign Direct Investment
BEAC:	Banque Centrale des Etats d'Afrique Centrale	FfDO:	Financing for Development Office
BEE:	Black Economic Empowerment	FODEX:	Fond de garantie et d'expansion des entreprises
BHS :	Banque de l'Habitat du Sénégal	FSA:	Fond de Solidarité Africain
BIRD:	Bank for International Reconstruction and Development	FC:	Finance Company
BMAO:	Banque Marocaine pour l'Afrique et l'Orient	GDP:	Gross National Product
BMS:	Banque Malienne de Solidarité	GEF :	Global Environment Facility
BNA:	Banque Nationale Agricole	Hilltown CDC:	Hilltown Community Development Corporation
BNDA:	Banque Nationale de Développement Agricole (in Mali)	ICDC:	Industrial and Commercial Development Corporation
BNDE:	Banque Nationale de Développement Economique	IDC:	Industrial Development Corporation of South Africa
BNDT:	Banque Nationale de Développement Touristique	IMF:	International Monetary Fund
BNT:	Banque Nationale de Tunisie	KfW:	Kreditanstalt für Wiederaufbau
BOAD:	Banque Ouest-Africaine de Développement	LNDC:	Lesotho National Development Corporation
BOT:	Build Operate Transfer	MFI:	Microfinance Institutions
BRS:	Banque Régionale de Solidarité	MHC:	Malawi Housing Corporation
BTS:	Banque Tunisienne de Solidarité	NDC:	National Development Corporation
CBB:	Construction and Business Bank	NEPAD:	New Partnership for Africa's Development
CEMAC:	Communauté Economique et Monétaire d'Afrique Centrale	NGO:	Non-Governmental Organizations
CDG:	Caisse de Dépôt et de Gestion	NHC:	National Housing Corporation
CMDT:	Compagnie Malienne de Développement Textile	RDB:	Regional Development Banks or Regional Development Finance Institutions
CNCA:	Caisse Nationale du Crédit Agricole	SADC:	Southern African Development Community
DB:	Development Bank	SAP:	Structural Adjustment Program
DBE:	Development Bank of Ethiopia	SPC:	Specialized Finance Companies
DBSA:	Development Bank of Southern Africa	SME:	Small and Medium Enterprises
DC:	Development Corporation	SMI:	Small and Medium Industries
DEG:	Deutsche Entwicklungsgesellschaft	STB:	Société Tunisienne de Banque
		UEMOA:	Union Economique et Monétaire Ouest Africaine
		VIPC:	Very Indebted Poor Countries
		VSE:	Very Small Enterprises
		ZF:	Zone Franc

EXECUTIVE SUMMARY

Historic Introduction to Development Banking

1. From the 1950s to the 1980s, Development Banks (DB) were the primary actors in providing finance and assistance to achieve national development objectives. Though these institutions were called “banks,” strictly speaking, they were not; the two main differences between DBs and banks were that (i) DBs did not accept deposits, and therefore could not create money, as banks do; and (ii) DBs offered a wider variety of services, financial and non-financial, which commercial banks could not.
2. The underlying concept for development banking was that government should intervene in the economy in order to promote optimal conditions for development, notably by setting fixed interest rates and using directed-credit programs to increase investment in particular economic sectors. The mobilization of national savings was not emphasized, and DBs instead relied on concessionary funds received from international donors to on-lend to domestic clients.
3. By the end of the 1980s, many Development Banks were facing internal problems due to high percentages of non-performing loans in their portfolios. At the same time, and perhaps more importantly, a new economic framework was being put forward by the Bretton Woods institutions that called for financial liberalization. These two trends led to the fundamental rethinking of Development Banks.

Financial Sector Reforms

4. During the 1980s and 1990s, the Bretton Woods began to reform financial sectors across Africa to reduce government intervention or “financial repression,” through Structural Adjustment Programs and through loan and grant conditionalities. These reforms had important consequences for Development Banks.
5. First and foremost, one of the goals of financial liberalization was to create a unified financial sector, functioning according to market-based mechanisms to provide finance to worthy (profitable) ventures. Through this process, DBs began to lose their *raison d’être*, as their development-oriented operations did not align with the new market-based approach.
6. Secondly, new banking laws, more rigorous than the former, were introduced, along with Banking Commissions that would supervise the banking sector and all institutions receiving deposits from the public. At the same time, Development Banks were advised to diversify their activities,

usually by engaging in short-term credit and savings programs. This meant that they would come under the supervision of the banking authorities, and be forced to comply with the stricter regulations and ratios. Also, it meant that their performance was to be evaluated in future according to short-term criteria, despite their original mission to provide medium and long-term finance.

7. The main result of these reforms was that DBs as financial institutions had to either adapt or face being shut down; and development finance was dramatically reconfigured.

Varied Financial Landscapes Across Africa

8. Financial sector reforms had two important consequences on development finance: on the one hand, it opened up the domain to other actors in the financial sector apart from Development Banks (including commercial banks, specialized finance companies, and even non-bank, non-financial organizations like NGOs); on the other hand, the reforms did not ensure that all services formerly provided by DBs were redistributed in the post-reform context. Thus, certain financial service gaps have since become apparent.

9. In general, the notable trends in the three regions reviewed can be summarized as such:

- Zone Franc countries: This region is primarily characterized by the elimination of traditional development banks, which were replaced by a new concept of “universal banks,” a category that includes commercially-oriented and development-oriented banks, both of which must comply with banking laws. Additionally, the two regional development finance institutions (BDAO, BDEAC) play major roles in providing development finance and assistance in the region.
- Non-Zone Franc countries in Sub-Saharan Africa: The pre-reform financial sectors in these countries were generally more diversified than in Zone Franc countries. Thus, in the post-reform environment, these countries had a broader range of financial institutions to use to fulfill the roles of DBs. In particular, Development Finance Institutions (DFIs), which are non-bank financial institutions established through legislative acts to provide development finance to different sectors – housing, agriculture, industry, etc. – either took over for DBs or continued to exist. Development-oriented banks also played a role, but to a lesser extent than in the Zone Franc.
- Morocco and Tunisia, the financial systems were quite developed before the financial reforms took place. Commercial banks had already begun to provide term finance, which meant

that they could more easily take over some of the development-oriented activities of former DBs. Today, as in the Zone Franc, DBs are almost entirely inexistent: in the Morocco, the last two DBs are the process of merging with other institutions, while in the Tunisia, all DBs have either been absorbed by state banks, transformed into commercial banks, or simply closed.

10. As mentioned above, since the 1990s other types of non-bank institutions also started to play a role in development finance across the Continent, including specialized finance companies (providing leasing, consumer credit, etc); microfinance institutions; foundations or NGOs or other non-financial actors; and financial markets.

11. Despite this financial sector widening, not all of the operations formerly carried out by DB were effectively redistributed to these new actors, and financing gaps persist.

12. DBs can be said to have five fundamental tasks – providing term liquidity, covering medium to long-term risks, carrying out promotional tasks (feasibility studies, brokering partnerships, etc.), providing Technical Assistance, and coordinating different actors. While new development finance actors took over some of these aspects, several important finance needs are still unsatisfied. Recurring themes in financial gaps (listed below) are mainly due to the inherent difficulties related to the medium to long-term nature of these projects: (i) liquidity shortages; (ii) risk-covering difficulties; and (iii) the relative inexperience of these institutions in financial engineering. These are:

- Financing for customers with particular risks (MSMEs, artisans, women, etc.)
- Financing for low-income housing developments
- Financing for infrastructure, especially at the local level
- Financing for renewable energy operations
- Financing the social economy (NGOs, mutual insurance companies)
- Rural finance
- Financing for agricultural-related projects

Elements of an Action Plan

13. The formulation and the implementation of national development finance policy in each African country seems inevitable and necessary considering the number of financing needs that are still unmet, particularly in sectors which are imperative for promoting the country's future economic growth and poverty reduction. To form a coherent and effective national development plan, countries must take account of current economic and social difficulties as well as the current capacity of existing financial infrastructure.

14. Several initiatives would help countries in this task:

- Development finance must first be recognized by the international community as being a legitimate form of economic intervention and placed on the political agenda, which was not done during the 1990 financial sector reforms. Legitimacy for development finance will be reinforced by accepting the idea that the government may (temporarily) intervene in sectors that are normally regulated by free markets, in order to correct certain perversions or market failures, to facilitate eventual private sector, market-based participation.
- Second, it is necessary to recognize all of the potential actors that can provide development finance as such and to view them as legitimate participants in achieving development objectives. In particular, Regional Development Banks in the Zone Franc, and national DFIs for other African countries deserve to be reinforced and, if necessary, recapitalized in order to play the role needed of them. Relations within and between these institutions and other actors providing development finance would greatly benefit from being formally organized through periodic meetings.
- Third, development finance will only be provided on a sustainable basis if national banking structures increase their capacity to provide term finance. In order to do so, banks need to increase their capacity to perform transformation of short-term resources. This process must be strongly encouraged and supported throughout Africa, notably by initiating partnerships between national and regional DFIs, donors, and universal banks.
- Lastly, it will be useful to collect a representative sampling of experiences of development-oriented banks with regard to financing development initiatives, from which best practice can be identified. This will be particularly helpful for banks to understand how to manage the high risk levels associated with development finance and, at the same time, ensure sustainability and adequate profit margins. Also, recommendations could be made concerning modifications to the legal framework governing these types of banks that could help facilitate banks' participation in development finance.

15. In general, the authors forward that development finance should be conceptualized as a means to correct market failures. A market failure-based approach justifies (temporary) public intervention, using any number of the available channels (banks, DFIs, SFC, MFIs, etc.), to correct this suboptimum allocation of resources. The point is not to return to a system of public interventionism, rather this approach promotes a spot-treatment for specific market distortions, in order to facilitate eventual private-sector participation.

1. Introduction

16. Within the framework of the International Conference on Financing Development (Monterrey, 18-22 March 2002) and the Resolution 58/230 voted on 23 December 2003 by the UN General Assembly, the Financing for Development Office (FfDO) within the Department of Economic and Social Affairs has organized a cycle of Consultations on the topic "*Rethinking the Role of National Development Banks.*" This cycle began with an initial Consultation in New York in December 2005, where participants decided to initiate a series of seminars on the subject in different regions around the world. One of these has been organized by the Agence Française de Développement to be held in Paris on June 27th and 28th.

17. The present work was undertaken as the background document for the Paris consultation. As its title, "*Rethinking the role of national and regional Development Finance Institutions in Africa,*" denotes, this paper examines the specificity of not only National Development Banks, but all types of Development Finance Institutions (DFIs) in Africa. There were several reasons for choosing to enlarge the subject from National Development Banks to all types of DFIs: first, in most African countries, there are very few traditional National Development Banks left whose roles may be reconsidered. Second, in certain countries, the traditional role of Development Banks is today carried out by non-bank financial institutions, such as Development Corporations, as well as by other organizations which are neither banks, nor financial institutions. Third, in some countries, universal banks can provide finance for development activities. And lastly, the role of regional DFIs is often as important as national institutions in providing development finance, and should not be overlooked.

18. The fact is that today, development finance is no longer provided exclusively by specialized agencies, as was the case in the past. Whereas, from the 1950s - 1990s, Development Banks (DB) were often the sole institution for transmitting development finance, today resources are provided by a number of different channels that are often interconnected. Therefore, in order to properly understand the dynamics of development finance, the issue must be examined holistically, rather than using an institution-based approach. This paper therefore examines the various channels through which development finance is made available today – DFIs, financial markets, commercial banks, NGOs, etc. – in order to formulate reforms that could make development finance more effective.

Methodology

19. The analyses and conclusions of this study stem from information drawn from different sources. The authors primarily relied on the dossiers provided by the AFD and the EIB on the institutions under review. This information was supplemented by publicly available information, such as annual reports and official internet sites, about the institutions. Also, field
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missions were made to three institutions – the Malian Banque Nationale de Développement de l’Agriculture, the Banque de l’Ouest Afrique de Développement, and the Industrial Development Corporation in South Africa – in order to better understand their particular approach to development finance.

20. The study also used research that had been done in 2001 for a similar study undertaken by the African Development Bank (AfDB), entitled “Rethinking Development Finance Institutions in Africa.” This report considered the development finance systems in 14 countries across the Continent. Its conclusions were presented at an international conference organized by AfDB in Abidjan, in November 2001, and were subsequently presented at one of the preparatory meetings for the Monterrey Summit, which was organized in New York in December 2001 by the French delegation to the United Nations.

2. Historical Approaches to Development Finance

21. Up until the end of the 1980s, development finance was nearly exclusively provided by Development Banks (DB). In this period, African DBs, as in other developing countries, operated within a protected environment: in particular, they benefited from having privileged access to the financial resources of the state and maintained a special relationship with international donor institutions. Furthermore, they operated outside of the normal regulatory framework for banks, which meant that they were not constricted by financial management protocol imposed on commercial banks. Though these institutions were called "banks," strictly speaking, they were not, as they did not accept deposits, and therefore did not have the capacity, as normal banks do, to create money. This task was reserved for institutions registered with the Central Bank and operating under its supervision.

22. During this period, Development Banks were public institutions created by the state, with equity capital frequently provided by international donors. According to the needs and specific context of the country, these institutions could play a number of roles: they could be involved in the promotion and evaluation of development projects, the financing of specific sectoral policies, or the implementation of governmental policies and projects (World Bank, 1976). Their principal objective was to provide term finance to economic agents, since banks did not have sufficient resources to supply medium to long-term finance otherwise. DBs did not only finance development-oriented projects, but also provided Technical Assistance for project preparation, implementation, and follow-up, services which commercial banks could not supply either.

23. DB operations were based on a financial analysis of the project that calculated its expected economic rate of return (ERR), which differed fundamentally from the financial analysis used by commercial banks. Whereas banks evaluate the capacity of the potential borrower to repay his or her debts, DBs chose projects by calculating its long-term profitability.¹ Since DBs did not provide short-term finance, companies often had to open accounts at both commercial banks and development banks to meet all their financial needs, each institution managing its account according to its own internal logic.² However, due to the absence of inter-institutional relationships between banks and DBs, any eventual financial difficulty faced by a project or company, which would initially be detected by its commercial bank, would only be known by the DB much later, often when it was already too late to

¹ The main difference between the analyses employed by Commercial Banks and DBs concerns the way in which each deals with risk. DBs based their approach on the potential success of the project itself as opposed to making the borrower (the project's promoter) responsible for the loan's reimbursement, as banks do. This can lead to a lack of accountability for the project's promoter.

² Certain DBs provided both long-term and short-term finance, like the Banque Camerounaise de Développement or the Crédit de la Côte d'Ivoire, but the majority of DBs only provided term finance and/or venture capital (World Bank, 1976).

intervene. The informational dissymmetry created by the lack of communication between institutions served to severely handicap DBs' effectiveness.

24. Development Banks were chosen as the principle means of providing development finance based on the notion that development had a "direct linear relationship with the amount of capital made available to local economic agents." (Bruck, 1999, p.1). In countries characterized by a lack of national savings and low export revenues, capital for development-oriented activities needed to come from external sources. This was achieved through the creation of *national Development Banks*. These institutions, modeled after international institutions like the World Bank, would channel donor funds into the country to finance long-term development projects. Similarly, this type of economic approach advocated that local banks implement *directed credit programs*, in order to encourage lending towards certain sectors – agriculture, industry, craftsmanship, etc. – to meet national development objectives.

25. Simultaneously, governments implemented import-substitution policies as well as capped interest rates, in the hopes that lower rates would facilitate lending. This approach to financing development therefore excluded the financial sector from the development process. One theory at the time forwarded that financial sector development *followed*, rather than preceded the expansion of economic activity, specifying that economic growth through the increased activity of productive companies would come before the demand for financial services (Robinson, 1952). Robinson's analysis was based, in part, on the theories of Keynes, which affirmed that the financial sector played a neutral role in the economy as a simple channel of transmission for resources. For this reason, the concept of Development Banks was that they were responsible for transmitting resources obtained through external sources to domestic development projects, while banks followed the same policy, on lending resources through directed credit programs.

26. However, the Development Banks' privileged position gradually began to disappear as the predominant economic theories began to evolve. At the same time that the theoretical framework was changing, DBs had also begun facing internal difficulties as domestic economic situations declined and financial management challenges grew. By the end of the 1980s, it was clear that African States needed to critically re-examine their methodology for promoting national development. In fact, these questions concerning development finance and financial sectors in general were brought up during the preparation and implementation of Structural Adjustment Programs (SAP).

3. Changing the Development Paradigm

The liberalization of the financial sector (McKinnon and Shaw)

27. The conclusions published in the works of two economists, R. McKinnon and E. Shaw, in 1973 served to radically change the approach to financial sectors and, in particular, their role in development. Based on research concerning the financial sector reforms in Taiwan during the 1950s and Korea during the 1960s, McKinnon and Shaw formulated a theory that went against that established by Keynes earlier. Their recommendations were eventually accepted by the Bretton Woods institutions, particularly the International Bank for Reconstruction and Development (IBRD) and the International Monetary Fund (IMF), which incorporated them into SAPs, or made them conditionalities in loan or grant agreements. Towards the end of the 1980s, African countries began to see the first consequences of this change in approach.

28. Prompted by the situations in Latin America and Asia, where strict financial controls seemed to have had negative effects on the economy – provoking capital flight in the former case and an increase in the informal economies and inflation in the latter (McPherson and Rakovski 1999) – McKinnon and Shaw recommended the elimination, or at least a sharp decrease, in what they termed “financial repression,” or government interference in the financial sector. The analyses of the two economists supported that the liberalization of the financial sector, especially with regard to the interest rates, would have a positive effect on the economic growth rate, as higher interest rates would incite economic actors to save more, mobilizing greater domestic savings for investment.

29. To eliminate financial repression, the economists called for the removal of interest-rate ceilings, which they asserted were reducing national savings and the accumulation of capital, by allowing nominal interest rates to be determined by the market. Previously, common practice had been to maintain low interest rates in order to encourage borrowing for investment. The primary difference between the two approaches was the role of money: in the former approach, money was neutral; for McKinnon and Shaw, it was not. They argued that whereas before weak interest rates which provided little or no return had caused economic agents to keep their money out of banks, positive real interest rates would serve to mobilize more savings. With greater mobilization of savings, banks could finance more, both quantitatively and qualitatively (see below), and therefore increase economic development. When, on the contrary, interest rates remain low, economic agents who do not wish to see their assets attacked by inflation, tend to direct their surplus resources towards additional consumption instead of saving.

30. As a consequence of McKinnon and Shaw’s recommendations for financial liberalization, banks had to fundamentally change their operations and policies. In a directed credit system with capped interest rates, banks did

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not really need to assess the projects that they would finance (as they often did not have the choice) or develop tools to cover the associated risks. With the liberalization of the financial system, instead of allocating credit through government-directed credit programs, banks had to set up a true credit policy, using financial analysis to assess risks, and use the now uncapped interest rates to cover those risks.

31. Another intended consequence of financial liberalization was that the quality of investments would increase. With higher interest rates, entrepreneurs could no longer launch projects with little or no profitability, but rather, in order to reimburse their loan capital and interest, had to ensure that their projects had high rates of returns. Financial liberalization therefore would have a positive effect on the selection of projects, encouraging quality investment in the country.

32. Finally, financial liberalization would in theory allow for a more nuanced approach to monetary policy management, using interest rates as opposed to legal reserves. Such reserves, which had a strong negative impact on bank profitability, could be removed or lowered, as the Central Bank could manipulate its monetary policy by increasing or lowering interest rates.

33. At the end of the 1980s, the World Bank and the IMF began to put into practice many of the recommendations of McKinnon and Shaw and others (Feldstein and Horioka, 1980, Krugman 1979). Significant restructuring of financial sectors began in countries across the Continent, as SAPs and other liberalization programs were put into place. As part of these reforms, the banking laws changed, central banks and banking commissions were reinforced, and new management standards were imposed on banks. Non-performing loans in banking institutions' portfolios were identified and separated.

Impact of the Reforms on Development Banks

The loss of the *raison d'être* for Development Banks

34. With the implementation of liberalization programs, the theoretical basis on which Development Banks had been built was seriously weakened. Before liberalization, the inability of commercial banks to provide finance for national development projects allowed the government to direct financial flows towards separate specialized institutions, such as Development Banks. The new approach, based on the theories of McKinnon and Shaw, opposed this sort of financial sector partitioning, contending that, once the uncapped interest rates served to mobilize national savings, banks would be in a position to adequately finance projects themselves. With the elimination of financial repression, banks would be free to finance development activities; there would no longer be a need for ad hoc DFIs, such as Development Banks, with fixed interest rates and which did not serve to mobilize national savings.

35. The gradual disappearance of Development Banks was therefore linked not only to bad management within these institutions, but more importantly to the new economic framework in which they worked. Liberalization policies contested the compartmentalization of financial sectors, and sought to establish neutral and more effective *market-based mechanisms* to determine interest rates, as well as credit recipients. These mechanisms allowed institutions to replace the discretionary decisions of economic agents (governments, presidents of DBs, international donors, etc.), whose limitations had been revealed. Thus, while this approach did not directly oppose institutions like national DBs, its objective to “de-compartmentalize” financial sectors caused DBs to lose their particular statute and placed them on the same level as banks. Given this new pressure stemming from liberalization reforms, the Development Bank concept that had reigned in previous decades began to disappear: the result was that DBs as financial institutions had to either reform or face being shut down.

Diminishing Margin of Maneuver for Development Banks

36. The reforms in favor of liberalization were implemented during difficult economic conditions for the majority of African countries. In such sub-optimal conditions, liberalization often exacerbated inflationary trends and led to increased government borrowing and spending (Pill and Pradhan, 1995)³. For the banks and the DBs which had not previously made lending and credit allocation decisions according to traditional banking criteria (risk, etc.), the new deregulated environment posed a great challenge (Pill and Pradhan, 1997).

37. New banking laws, more rigorous than the former, were introduced (Dhumale 2000). These laws also called for the establishment of Banking Commissions that would supervise the banking sector and all institutions receiving deposits from the public, ensuring that they respected management and governance guidelines as defined by these laws, particularly in regard to prudential ratios. These guidelines were especially concerned with short-term finance.

38. Thus, in “de-compartmentalizing” the financial sectors, the new approach structurally linked development finance to the newly liberalized financial sector. This linkage served to place the entire issue of development finance under the control of the banking sector authorities (Central Bank, Banking Laws, and Banking Commissions), which were primarily interested in monitoring and ensuring short-term savings and credit operations. The problems of development finance – essentially term finance – were therefore handled by the banking sector, whose experience primarily focused on managing short-term funds.

³ Also, see McKinnon 1982, 1993 on the order of liberalization reforms.
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39. The situation of DBs worsened when they were authorized, and often encouraged, to mobilize savings or to lend short-term funds in order to diversify their portfolios and to ensure their survival (Epstein, 1996). DBs had no previous experience with short-term risks and did not possess the needed institutional organization to mobilize deposits or to allocate short-term loans. Thus, DBs rapidly came up against two obstacles: (i) once they began accepting deposits, they automatically came under the supervision of the state's banking authorities, which created new constraints and caused them to lose their specificity vis-a-vis banks, and (ii) their performance were to be evaluated in future according to short-term criteria, despite their original mission to provide medium and long-term finance.

40. At their inception, Development Banks in Africa had been designed to be institutions that were not regulated by banking laws, or, as in certain states, were regulated by the laws but received special dispensations.⁴ The new approach created two possibilities: either DBs decided not to comply with Banking Laws, in which case they would disappear as "banks," or comply with the laws, in which case their role in development finance through the provision of term finance would sharply decline. The difference in the evolutions of Development Banks between countries is thus related to the degree to which new banking laws were applied.

41. Another important difference in the evolution of DBs across the continent is due, in part, to the type of legal system in place: whether the country's judicial framework was based on the Continental European model or on *common law* (Tsuru, 2000). In the former, the financial system is not very diversified, primarily centered on banking institutions, whose activities are more or less limited to savings and loans, without offering much in the way of customer assistance. During the reforms therefore, the DBs in these countries did not have a choice, and were forced to transform into a bank or be eliminated. In countries based on the British legal system, the financial system was more diversified. Whereas banks must comply with banking regulations, other non-bank financial institutions operating in parallel, provide credit as well as, for some, technical assistance. Thus, in the majority of countries based on the common law legal framework, non-bank institutions, such as Development Corporations, were often already involved in providing development finance or could be created to replace former Development Banks.

The new point of reference: the banking law

42. Today the principal point of reference for the issue of development finance is thus the banking law. For an institution that provides development finance, the fundamental question is whether or not it must comply with banking laws. Is the institution approved as a bank? If so, to what extent must it comply with banking regulations and ratios? Compliance necessarily

⁴ Grameen Bank in Bangladesh is a good example of how it was able to grow as an institution in large part thanks to the fact that it remained outside of the jurisdiction of the country's banking laws.

limits the range of activities the institution can carry out in favor of development-oriented activities. If it is not registered as a bank (meaning that it does not collect deposits and, usually, does not have the word "bank" in its title) the institution is generally free to set its own rules and ratios, which allow it to intervene in national development projects as it sees fit. However, in this second case, without external supervision, the institution's financial health and stability may be put into question.

43. Setting the banking law as the primary point of reference meant that the reforms of the 1990s focused almost exclusively on the short-term aspect of banking. One of the reasons for this was that the banking laws were adopted during a time of important financial distress across the Continent. The severity of their provisions and the strictness of their application can be understood in light of significant abuses that forced governments to close numerous commercial banks, in addition to development banks, throughout the continent. The banking laws were reformed in order to provide a solid base for financial systems; however, they did not provide specific provisions relating to long-term financing needs for national development.

Today: the Need for a Specific Terminology

44. The discussion above shows the importance of adopting precise terminology with regard to institutions providing development finance, in order to avoid any confusion as to their statute and hence their managerial constraints:

1. The use of the term "**bank**" must be reserved for institutions registered with the Central Bank as such, regardless of whether or not they finance development.⁵ In point of fact, in the majority of countries, African banking laws recognize one single type of bank, or a "universal bank," having eliminated other classifications, such as "development bank."
2. Non-bank financial institutions which play a role in financing development projects will be called **Development Finance Institutions** (DFIs). From a monetary policy point of view, the difference between banks and DFIs is that banks can create money, collect deposits, and may use the interbank money market to raise funds, whereas in general, DFIs do not create money, do not collect public deposits, and do not use interbank money markets.
3. Non-bank financial institutions that are specialized in providing specific services, either commercially or developmentally oriented (leasing, venture capital, etc.) will be called "**specialized finance companies.**"

⁵ The most banking laws actually prohibit the use of the word "bank" for institutions which have not been approved by Banking Authorities. However, certain DFIs in Africa have kept the word "bank" in their title despite the fact that they are not regulated as a bank.

4. **Non-bank and non-financial institutions**, such as NGOs, Microfinance Organizations, foundations, etc., that provide development finance, will be referred to by their standard name.

Africa: Diverse Situations

45. The financial sector reforms in favor of economic liberalization that were adopted throughout Africa did not have the same consequences in each country. The majority of DBs in operation when SAPs were first implemented and financial liberalization measures were put into place attempted to adapt in order to survive. To do so, they developed new activities, primarily savings programs, to mobilize new resources, as well as short-term lending. These activities caused the institutions to be placed under the supervision of Central Banks and Banking Commissions and forced to comply with the new banking laws. DB portfolios, which had often been weakened by large numbers of non-performing loans, were then inspected by the Commissions.

46. Shortly after the implementation of the reforms, the traditional DBs began to disappear: some declared bankruptcy, others were completely reorganized, and others still were converted into banks.

47. The landscape of financial sectors throughout Africa, and particularly in regard to institutions providing development finance, is highly varied:

- In countries belonging to the Zone Franc (14 countries in Central and Western Africa), the concept of development banking entirely disappeared: the only category of banks currently recognized by the two banking commissions present within the Zone is that of "universal bank."⁶ Other than commercial banks, the following types of organizations exist:
 - **Development-Oriented Banks**, including former development banks converted into universal banks, new specialized banks, new "solidarity" banks, which have, alongside their commercial activities, a certain number of development-oriented objectives
 - **Specialized finance companies** that are often linked to banks
 - **Two regional development finance institutions**, which still function using the former DB model and thus do not comply with banking laws and were not affected by financial sector reforms

⁶ The notable exception is the Banque de Développement des Comores, which, though not very active, has maintained its statute as "Development Bank," and is not regulated by banking laws. This is probably due to the fact that unlike the other Zone Franc countries, the Comoros does not belong to a regional banking commission.

- **Foundations, NGOs, and other non-banking/non-financial organizations** that finance development initiatives
- In the Non-Zone Franc countries of Sub-Saharan Africa, the financial sector is very diversified:
 - Non-bank financial institutions (NBFIs) can finance development through Development Corporations, which have often taken over the function of Development Banks.⁷ These will be referred to as **Development Finance Institutions or DFIs**.
 - Newly created financial institutions modeled after former Development Banks, based on similar principals with similar missions, shall also be referred to as DFIs.
 - **Development-oriented banks**, which are usually, as is the case in the Zone Franc, former development banks that have maintained certain development objectives after their transformation into commercial banks
 - **Foundations, NGOs, and other non-bank and non-financial** organizations which work in the field of financing development
 - In Morocco, former DBs are gradually disappearing - one has been absorbed by commercial banks, while the other two are in the process of merging with other institutions. Besides these developments, Morocco's financial landscape resembles that of the Zone Franc.
 - In Tunisia, former DBs have nearly entirely disappeared. Some were absorbed by a state bank, others were transformed into commercial banks that maintain certain development objectives (Bank Tuniso-Koweitienne de Développement), and others simply closed.

48. The differences in the evolutions of the financial landscapes in Sub-Saharan Africa can be partly understood by examining the specificities of the two multi-national Banking Commissions that exist in the Zone Franc in comparison to the Banking Authorities in the rest of Africa.

- In Non-Zone Franc countries, SAPs served to reform and restructure the financial sectors, strengthening the Banking Authorities. Unlike the multinational Banking Commissions of the Zone Franc, these were national institutions, and therefore

⁷ However DFIs and former DBs do have a fundamental difference in approach, which will be discussed in the following chapters.

had greater latitude in evaluating the effectiveness of institutions such as DBs, using broader criteria (i.e., not limited to pure financial analysis). National institutions could thus be more flexible in their analyses, and allowed, among other things, certain institutions facing severe financial difficulties to survive regardless (Morocco), or permitted national legislatures to create new public financial institutions that would neither be under the supervision of the banking laws or the Banking Authorities (Namibia or Angola).

- The Zone Franc, by contrast, has two multinational Banking Commissions that were in many ways held to enforce banking laws to the letter in order to ensure the perception of equal treatment between Member States. The application of banking laws was thus stricter and far more uniform in these countries than in Non-Zone Franc countries, for example.

4. Assessment of the Financial Reforms

49. Nearly two decades have passed since the first financial sector reforms in Africa were implemented: what kind of assessment can be made? The liberalization of financial sectors had a positive influence on growth (Mkandawire and Soludo, 2002). At the same time, it seems clear that liberalization did not provide a viable solution for development finance needs, as reforms have left a certain number sectors, which typically experience economic and social difficulties, without access to finance.

50. Criticisms related to financial sector reforms of the 1990s focus on two main points: First, the underlying theoretical analyses of McKinnon and Shaw have been re-examined in light of the financial crises, notably in Latin America, which seemed to have been triggered by economic liberalization reforms. In reaction to these adverse consequences, in 1993 McKinnon wrote *The Order of Economic Liberalization*, in which he identified the proper order and pre-conditions necessary for the successful implementation of liberalization measures, in order to avoid situations such as hyperinflation. Second, other critiques pointed to economic success cases where reforms favoring economic liberalization were not instituted. Some governments, such as South Korea and Taiwan, maintained interventionist policies and succeeded in promoting investment and industry, before beginning to liberalize their economies. (Harris, 1998; Rodrik, 1999; Lagging, 1990; Amsden 1989).

51. In addition, the question of whether it was necessary to entirely liberalize the financial sectors was discussed, or if instead there was room for other complementary approaches that could be used to target certain economic sectors for support.

52. In this chapter, the difficulties engendered by financial liberalizations will be discussed briefly, as well as the new financial landscape that resulted from these reforms.

Difficult Financial Reforms

53. Financial reforms implemented by the Bretton Woods Institutions did not always generate positive results. The elimination or lowering of interest rate ceilings, for example, often drove banks to drastically drive up lending rates, which greatly reduced the number of clients that could borrow, and which made credit reimbursement much more difficult as well. In certain countries, banks faced greater difficulties as default rates increased.

54. The post-reform situations in many countries led some analysts to criticize McKinnon and Shaw for having founded their recommendations on seemingly atypical case studies. Others remarked that recommendations concerning financial sectors had been established on models for political liberation from the 1960s. The latter suggested that eliminating financial

repression from the financial sectors had used the same model as that proposed to eliminate political oppression from the political systems.

Contrasting Case Studies: Korea and the Latin America (Chile, Argentina)

55. In Korea, financial liberalization was a success. The financial sector reforms were implemented within a solid monetary and macroeconomic framework, which allowed nominal interest rates to stabilize at acceptable levels. A certain amount of economic intervention was sustained in order to ensure that sectors that the government esteemed useful for the economy were not deprived of necessary financial flows.

56. On the other hand, financial liberalization undertaken in situations of uncontrolled inflation, as was the case in several Latin American countries, created serious financial crises in these countries. In situations of high inflation, uncapped rates can sky-rocket just to create real positive rates; this can lead to "adverse selection" at banks, attracting companies with high-risk, high-return projects, in which case the number of non-performing loans increased and weakened banks' portfolios. The crisis accelerated due to bank privatization policies, currency devaluations, and capital flight.

The case of Africa

57. Financial reforms in Africa have changed the Continent, situating it somewhere between Asia and Latin America. Because of the strong donor presence, African countries have been obliged to continue restructuring national financial and monetary policies. This has created a relatively favorable context for financial sector reform. However, at the same time, financial sector reforms have not led to the simplification or rationalization of the institutional landscape as it did in Korea.

58. The policy reforms had different results across the Continent. In each country, the operations carried out by former DBs were to a greater or lesser extent taken over by other actors, operating in the new financial landscape. As has already been stated, certain sectors would nevertheless remain without access to finance.

The Post-Reform Financial Landscape in Africa

59. The post-reform financial landscape of Africa was characterized by: (i) the arrival of new actors; and (ii) the redistribution of operations formerly carried out by DB among other institutions.

New actors

60. The primary outcome of financial sector reforms in Africa was to divide the financial sectors into two sub-sections:

- One sub-section of "banks" regulated by the Banking Laws, which underwent many subsequent reforms that supplemented the initiatives undertaken in the 1990s
- One subsection of various financial institutions that can be called "non-bank financial institutions" focused primarily on providing development finance, but, due to its heterogeneity, which are neither recognized by Governments, nor by international donors.

61. One of the effects of the financial sectors reforms was to merge both non-bank financial institutions as well as non-bank, non-financial institutions under this same section of "non-banks"; the common point consisting of their mutual commitment to providing development finance.

62. After two decades of reform, the new financial landscape in African countries looks as follows:

Under the Sub-Section of Banks:

1. Traditional commercial banks, which are today referred to as "universal banks:" though these banks do focus on commercial activities, they can participate in development-oriented projects, provided that they have a sufficient return.
2. Development-oriented commercial banks: within this category are former DBs that have maintained certain development objectives despite having been converted into universal banks regulated by Banking Laws. Additionally, new banks have been created for financing low-income housing needs (Mali, Burkina Faso, Gabon) or for providing "solidarity" financing (Banque régionale de solidarité dans l'UEMOA, Banque malienne de solidarité, Banque tunisienne de solidarité). These banks are characterized by an exclusively public shareholding, and are willing to take on more risk in regard to development projects than commercial banks to achieve their social objectives.

Under the Sub-Sector of "Non-Banks:"

3. Multiple types of finance companies specialized in providing development finance, are collectively considered DFIs: Development Corporations, Housing Corporations, new "development banks", etc.
4. Regional DFIs, including the BOAD and the BDEAC in the Zone Franc, and the EADB for Eastern Africa. These institutions have maintained their organization as it was at their creation. One of their main characteristics is that they do not comply with Banking Laws.

5. Finance companies which are generally created by, or in partnership with, commercial banks, to provide venture capital, leasing, consumer credit, etc.
6. Microfinance institutions (MFI) began to appear in the middle of the 1990s.
7. Foundations, which exist in all fields of development, are non-financial actors that contribute important funds to finance development.
8. Financial markets are also important to mention as they provide long-term finance.

Redistributing Former DB Operations

63. The quasi-disappearance of traditional DBs deeply affected national capacity to achieve economic and social development objectives. The tasks and operations formerly undertaken by DBs were not entirely redistributed to other institutions after the reforms.

64. DBs had five fundamental functions, which can be classified under two main categories: financial functions and non-financial services.

Financial functions

1. Term liquidity: DBs were the principal source of term finance. Typically, long-term funds were received at concessionary rates from international donors and then on-lent to clients. At the time, commercial banks did not have the financial structure needed to provide term finance, and therefore did not compete with DBs on this product. Post-1990s, with the disappearance of DBs, the sole provider of term finance became universal banks, which were not able to completely meet national needs, nor do so on a sustainable basis, despite donors' willingness to open medium to long-term lines of credit as they had done with DBs.⁸ The reason for the failure was two-fold:

- Even development-oriented banks did not concentrate their activities on meeting development needs, as the former DBs had done. Lines that were opened were only useful in so far these banks had an interested client base, which was not often the case.⁹
- The question of sustainable provision of term finance by universal banks was not posed in the same manner as it had been for former DBs. For the banks, the fundamental consideration is its capacity

⁸ The situation was somewhat different in the Maghreb where banks did begin to develop medium and long-term portfolios.

⁹ Many APEX programs that provided credit to SMEs made the error of trying to reproduce the DB model using universal banks, believing that providing commercial banks with a medium-term line would be a sufficient incentive for banks to finance medium-term projects.

for transformation, as opposed to its on-lending of external lines. Transformation is the process through which banks finance medium or long-term commitments with short-term resources. This process requires banks to be able to identify short-term resources that are stable enough to be used to cover longer term commitments. Banks' capacity for transformation is built up over time as it develops its capacity to mobilize resources in order to create a stable core of short-term funds. Until this process is well underway, banks will not be able to lend on the medium or long-term.

2. Medium and Long-Term Risk Coverage: This includes providing credit for new entrepreneurs or economic agents that did not previously have access to finance, assisting economic agents in the initial stages of new projects (providing venture capital, equity), providing assistance in the restructuring or reorganization of projects already underway, etc. These types of activities, which entail covering higher risks for longer periods of time, are fundamental for development promotion, and therefore, are some of the most important aspects of former DBs. With the dismantling of DBs, these functions were not completely taken up by other institutions. Given the state of public finances today, even the successors of DBs – development-oriented commercial banks and DFIs, which both have the state as a majority shareholder – cannot by nature assume development risks as high as their predecessors, DBs.

Non-financial services

3. Feasibility studies, project promotion, brokering partnerships: These activities relate to the initial stages of project formulation, including the formation of the project's basic concept, brokering the deal, and searching for suitable domestic and foreign capital investors.

4. Post-Implementation Technical Assistance: Once the project has begun, Technical Assistance is provided to project promoters throughout the life of the project.

5. Project management, coordination of operations during crisis: These activities relate to DBs' role as catalysts for multinational projects or in crisis situations where the coordination of different actors is necessary.

Incomplete Post-Reform Redistribution of Operations and Services

65. In general, the operations and services formerly provided by DBs were not entirely ensured by actors and institutions in the post-reform financial landscape.

66. The table below shows how the operations and services were redistributed unequally and only partially within the three different zones of the Continent (Zone Franc, non-Zone Franc, Morocco-Tunisia).

DB Functions and Services	Non-Zone Franc	Zone Franc	Morocco-Tunisia
Medium to Long-Term Liquidity	- DFI - Development-Oriented CBs - Financial Markets	- Development-Oriented CBs - Regional DBs - Financial Markets	- Universal Banks - Financial Markets
Medium to Long-Term Risk	- DFIs - Specialized Companies - Financial Markets	- Regional DBs - Financial Markets - Specialized Companies	- Financial Markets - Specialized Companies
Financial Engineering for Development Projects	- DFIs - Foundations	- Regional DBs
Feasibility Studies, Project Promotion, Partnership	- DFIs - Foundations
Technical Assistance, Project Implementation	- DFIs - Foundations
Project Management, Crisis Management	- DFIs - Foundations

67. With regard to medium to long-term liquidity:

- In Non-Zone Franc countries, this function was primarily taken over by DFIs, such as Development Corporations. Development-oriented commercial banks play a secondary role in this regard. Medium to long-term liquidity continues to be problematic even today as DFIs must work with external resources that are not always granted due to their unstable financial standing, and many banks have not yet built up the capacity to provide much term finance through transformation.
- In Zone Franc countries, this task is carried out by both Regional DBs and Development-Oriented Commercial Banks, as well as, to a lesser extent, financial markets. Despite BOAD loans and the medium to long-term refinancing windows at the two central banks, term finance remains problematic.
- In general, not enough effort has been made to develop banks' transformation capabilities in sub-Saharan Africa, which would permit them to provide term finance on an independent and sustainable basis.
- In North Africa, the only institutions that have been able to take up the financial functions of former DBs are universal banks, financial markets, and the one remaining development-oriented bank.
- In the absence of DBs, new sources of medium to long-term liquidity for development finance are illustrated by the table below:

	Term Finance Source	Comments
Former DBs	Lines of credit from donors	Very easy
Banks	Lines of credit from donors	Difficult to use
	Lines of credit from RDBs	Easy to implement
	MLT Refinance Window at Central Banks	Very selective
	Transformation	Little capacity
	Financial Markets	Difficult to use
DFIs	Lines of Credit from Donors	Relatively easy
	Financial Markets	Difficult to use
	Insurance companies	Relatively easy
	Companies (BOT)	Difficult to implement

68. With regard to medium to long-term risk coverage:

- In the Zone Franc countries, post-reform risk coverage was undertaken by (i) the State and Donors through their capitalization of development-oriented banks, and (ii) through the creation of national, regional, and Continent-wide guarantee funds, such as GARI, FAGACE, FSA, and FODEX. The success of these funds was disparate.
- In the absence DBs, the new risk covering mechanisms can be seen in the following table:

Risk-Covering Mechanism	Actor Involved	Comments
Legal Mechanisms	Institutions' internal capacity	Inexistent
Capital and reserves	State and Donors	Insufficient
External Guarantee Funds	State or Donors	Experiencing Difficulties
Mutual Guarantee Funds	Beneficiaries	Not yet fully implemented
Internal corporate governance	Organization	Depends on the case

69. With regard to non-financial services:

- Financial sector reforms in both the Zone Franc and the Maghreb stripped institutions in charge of development finance (banks) of the non-financial services that accompanied project development. While there are publicly-owned institutions that provide assistance and promotional services for entrepreneurs, these are not structurally connected to those institutions providing financing.
- Non-Zone Franc countries, on the other hand, do have institutions that continue to play this role.

Unsatisfied Finance Needs by Sector

70. Financial sector reforms generally encouraged the stabilization of financial portfolios through the identification and removal of non-performing

loans; however, the process also left certain economic and social sectors without sufficient access to finance, such as:

- a. Financing for customers with particular risks: MSMEs, artisans, women, etc.
- b. Financing for low-income housing: From construction to the renting or sale of residences
- c. Financing for infrastructure, especially at the local level
- d. Financing for the production and consumption of renewable energy, financing for environmental protection
- e. Financing for sectors of the social economy: associations, mutual insurance companies;
- f. Rural finance
- g. Financing for agricultural-related projects

71. The financing needs listed above are not easily satisfied by banks, even those with that are development-oriented, or by DFIs because of the inherent difficulties related to the medium to long-term nature of these projects: (i) liquidity shortages; (ii) risk-covering difficulties; and (iii) the relative inexperience of these institutions in financial engineering.

Conclusion

72. The assessment of the reforms of Africa's financial sectors can be summarized in the following four main points:

1. The specificity of development finance was not recognized and therefore not taken into account in the reforms. Instead, the working hypothesis was that banks, as "universal" financial institutions, had both the vocation and the capacity to finance every type of project. Today, the specificity of development finance must be fully understood so that development policies can be based on a solid conceptual foundation. In particular, questions pertaining to long-term liquidity and risk need to be further discussed.
2. The reforms on the 1990s left bank portfolios stabilized and stronger, as they identified and removed non-performing loans. However, the reforms did not address the non-bank components of the financial sectors, nor did they address the non-bank, non-financial institutions providing development finance, though these organizations were already playing increasingly important roles in providing development finance and support. In order to strengthen

and stabilize these institutions as well, it may be advisable to include these sectors in future reforms.

3. The products and services provided by former DBs were only partially redistributed to the remaining financial and non-financial institutions. Therefore, certain deficiencies exist, which may be different according to the particular national financial landscape of a given country. The way in which today's actors can widen their intervention in financing development should be reconsidered in order to identify possible solutions.

4. Several key sectors for national development as well as in the fight against poverty still suffer from limited access to finance, despite the presence of new actors specialized in development finance, in addition to banks. Reflection is needed to develop an overall strategy that can facilitate access to finance in these sectors, particularly in regard to liquidity and risk coverage issues.

73. Future development policies will need to take into consideration these four points in order to properly respond to development finance needs and promote sustainable development projects.

5. Non-Zone Franc Sub-Saharan Africa

74. In Sub-Saharan Africa, outside of the Zone Franc, countries have a diverse financial landscape. Different types of DFIs play important roles in providing development finance. This chapter will review these categories of DFIs and will examine more closely the case of South Africa.

Development-Oriented Universal Banks

75. As was discussed above, development-oriented universal banks are commercial banks which implement specific policies aiming to support the country's economic and social development. This category includes banks which have traced several different historical courses: a great majority of these are former Development Banks that developed their commercial activities, particularly through taking deposits, in line with the implementation of structural adjustment programs; others are DBs which were merged with commercial banks; and, finally some are commercial banks which have launched new activities in support of development initiatives. Whatever their course, these banks all are subjected to the prudential regulations determined by the Central Bank and inspected regularly by the banking commissions.

76. In regard to their assets, these banks can take deposits from the public, and receive lines of credit from international donors that support the banks' development-oriented activities. These activities target sectors which are traditionally difficult to finance, such as agriculture, housing, industry, and tourism. Such banks will intervene using traditional financial instruments - loans, equity, trade finance, etc. - but, unlike typical universal banks, they will accept the higher risks associated with these sectors. An example of these types of intervention is illustrated by the banking structure of Ethiopia (see box 5.1).

77. Development-oriented universal banks can also help another aspect of development – reducing the financial services gap – by improving access to banking services, particularly in rural areas. By establishing a wider network than purely commercial banks, particularly in the rural zones where the poverty of the population does not guarantee the profitability required for the opening of a branch, these banks can increase the access of the population to financial services. This is the case for Agricultural Development Bank of Ghana which established a network of 46 agencies throughout Ghana for this purpose. The emphasis on creating a wide network is also necessary for the mobilization of national savings, which will help the country to be less dependent on foreign resources.

78. Another way in which development-oriented banks have contributed to reducing the financial services gap is by financing microfinance. This is the case of several institutions, like the Development Bank of Ethiopia, the Centenary Rural Development Bank in Uganda, and the K-REP Bank in Kenya.

79. Banks which have typically been commercial banks have also begun to launch activities to support national development. A good example is Barclays International, which recently set up a structure which aims to support and increase the number of SME customers. Barclays in South Africa, Uganda, and Ghana are putting into place a simplified loan-processing structure that caters to the specific needs and constraints faced by SMEs and, additionally, places at their disposal advisory services to strengthen their business plans.

80. Finally, it is important to mention the case of South Africa, where all of the country's banks and other financial institutions have certain development objectives. In August 2002, the country's financial sector came together to write a charter identifying the sector's objectives with regard to the country's overall development goals and, in particular, to identify how to increase South Africa's black population's access to financial services. The charter is part of the Black Economic Empowerment (BEE) initiative, a concept that emerged in the 1990s to empower populations that were formerly discriminated against and incorporate them into the economy. Banks, which have signed the charter on a voluntary basis, thus incorporate certain development objectives into their daily operations.

Box 3.1: Ethiopia's Financial Sector

In Ethiopia, the financial sector consists of 6 private banks and 3 public banks, including the Development Bank of Ethiopia (DBE) and the Construction and Business Bank (CBB). These banks play a role in the country's economic development:

- DBE, created in 1970, began a process of reorganization in 2005. Its activities relate to nearly all the sectors of the economy. It intervenes using various instruments, including short-term and long-term loans, as well as equity participation. The only difference with operation of the universal banks is that DBE also has development-oriented activities; in particular, it refinances microfinance organizations.
- CBB was created in 1994 as a Mortgage Bank. It specializes in the financing of construction, hotels, and tourism, but participates in most other economic sectors as well.

Lessons Learned

81. It is difficult to incorporate development-oriented activities into the framework of a commercial bank. Development-oriented activities are by nature highly risky and profitable often on the long-term; these elements do not mix well with commercial banks' conservative outlook and its short-term constraints, in terms of its provisioning rules, its use of its own capital stocks, the recognition of income from loans, etc.¹⁰ Despite interest shown by

¹⁰ The banking laws determine the provisioning rates that apply to each borrower according to the quality of his or her loan portfolio and the way in which the loan is refunded. The parameters which determine these constraints are fixed in a general way, without exceptions made for particular economic actors. Under certain circumstances, these laws prohibit incorporating income from loans that have defaulted. Finally, they determine the amount of

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Barclays to develop their SME customer base, and the initiative of the South African financial sector to define a charter, this trend still remains marginal among commercial banks. Generally, banks that have an important role in development-oriented activities are public banks whose missions are determined by the Government, and which may also receive certain special dispensations from the banking laws.

82. The Ethiopian institutions mentioned above function like traditional universal banks. The development-oriented activity that the two banks finance is thanks to the fact that the State is their single shareholder, and can compel them to finance certain actions that private banks would not.

83. The main question concerning this category of institutions is whether a private commercial bank can finance development-oriented activities given the constraints of the banking laws. Does the banking law give banks a sufficient margin of maneuver to finance development? Or, on the contrary, does the Central Bank tolerate a certain amount of non-compliance with banking law to allow development finance? If the latter is the case, to what extent? These questions will be reexamined in Chapter 8.

capital that must be retained to support the loan. All of this means that a bank may not find it beneficial to maximize the volume of loans which it can allocate, but would rather optimize their portfolios in other ways.

Development Finance Corporations

84. This category of financial institutions is particular to Anglophone Africa. Development Finance Corporations are non-bank financial institutions that are created to specialize in financing development projects. In most cases, DFCs were founded by a legislative act and fully capitalized by the state.

85. Like former Development Banks, Development Corporations specialize in providing medium to long term loans, but may also provide equity, and other financial instruments that banks in the country cannot. Their role is thus to finance projects that the traditional financial sector will not due to their higher associated risks or their long-term nature, and in many cases, DFCs also provide Technical Assistance. Typically, DFCs are funded by their own equity, income from loan repayments, lines of credit from commercial banks, and lines of credit from international donors. Their development-oriented activities are facilitated by the fact that these companies are generally regulated by the Companies Act, instead of the banking law, and do not have to respect the same ratios as banks, such as the debt-equity ratio.

The National Development Corporation (Tanzania)

86. The National Development Corporation (NDC) in Tanzania is a public institution established in 1962 as the state's economic development organization, aiming to "initiate, develop, and guide the implementation of economically viable projects in partnership with the private sector." As such, NDC is a lead player in identifying and implementing development-oriented initiatives in Tanzania. It is the right-arm of the state, participating in development projects in a way that the state simply cannot given its organization and structure.

87. NDC is involved in multiple aspects of development projects, including project promotion, financial resource mobilization, and implementation. In terms of project promotion, NDC funds pre-feasibility and feasibility studies, and brings together suitable domestic and foreign private-sector partners. For example, recently NDC studied the textile industry to identify a better vertical integration model, and the mining industry to understand how small-scale miners could create economies of scale. Besides investments in the initial stages of project development, NDC can provide equity financing. Finally, NDC acts as the government's executing agency for a number of public development projects. Most recently it has been mandated by government to initiate and regulate the development of Export Processing Zones and the country's Free Ports, and to coordinate the Mtwara Development Corridor, which is a large project that is part of the Special Development Initiative of SADC.¹¹

¹¹ Tanzania National Website, <http://www.tanzania.go.tz/guide.html>.
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Botswana Development Corporation (Botswana)

88. The Botswana Development Corporation constitutes another example of a public institution established by an Act of Parliament in 1970 to provide development finance. Entirely capitalized by the Government, its Board of Directors is also appointed by the Government. BDC's primary objective is to assist in the establishment and the development of viable commercial projects in Botswana. It does so by offering several financial instruments, including equity investments, loans, and provision of competitive rentals of commercial, industrial and residential properties. BDC focuses on business development in the sectors of manufacturing, property development and management, agribusiness, and services.

89. Like the NDC in Tanzania, the BDC is not regulated by the banking laws but voluntarily adheres to international best practice and good corporate governance. Additionally, it has an internal audit group to ensure control and accountability of company affairs.

90. Like other Development Corporations, BDC must pursue its development activities within the framework of a self-financing, profit-oriented company. Currently, the company is in the process of reevaluating the risks of its investment portfolio, which has resulted in a 9% increase in pre-tax profits between 2003-2004, reaching approximately 11 million euros. With the adoption of a new Strategic Plan, ending June 2007, BDC will focus on "aggressive marketing" for its financial products.

Lesotho National Development Corporation (Lesotho)

91. The Lesotho National Development Corporation is a public institution established in 1967, which was reorganized in 2000. Its single shareholder is the State, and its primary objective is to participate in the economic development of the country by promoting trade and industry, to increase per capita income and national employment opportunities, and to facilitate foreign investment.

92. At the end of 2003, LNDC recorded a considerable increase in its activity, thanks in large part to the nine projects of business expansion that it supported, which created approximately 6,000 jobs across the country. Additionally, its marketing techniques attracted foreign investors for several investment opportunities in Lesotho, increasing the country's total Foreign Direct Investment (DFI) figures considerably. With the expiration of the Multifiber Agreement in 2004, the Lesotho textile industry was hit hard by its Chinese competitors, causing the loss of some 4,800 jobs. Given the situation, LNDC has begun to reorganize its investment and provisioning policies, and is planning to begin its organizational restructuring soon.

93. In 2005, LNDC signed an agreement with the Industrial Development Corporation (IDC) of South Africa, which aimed to establish permanent lines of communication and cooperation between the two organizations in order to better confront mutual problems faced within the framework of the South

African Development Community. This agreement includes management training for LNDC by the IDC, which also provides its expertise on certain projects. This should allow LNDC to leverage some of its activities. Additionally, IDC has agreed to open a new line of credit with LNDC.

Industrial and Commercial Development Corporation (Kenya)

94. Industrial and Commercial Development Corporation (ICDC) is an important state-owned financial institution in Kenya. Along with the Industrial Development Bank and the Development Bank of Kenya, it is supposed to provide finance for development projects, namely by providing project, commercial, and equity financing for industrial and commercial joint ventures with local and foreign partners.

95. The privatization policy in Kenya has constrained some of ICDC's activities, and has caused it to sell capital shares in certain companies. The process is promoted by the government in order to attract foreign direct investment. To date, the ICDC sold capital shares in 35 companies.

Lessons Learned

96. Given that banks must comply with international banking laws which create certain constraints in regard to development-oriented projects, this type of non-bank financial institution could represent an ideal type of institution for providing development finance. As seen above, DFCs can play various roles that are integral to economic development, including project identification, promotion, and financing, implementation of national development policy objectives, coordination of actions between ministries, attracting FDI, and acting as a catalyst for national development.

97. At the same time, DFCs are confronted with four principal problems:

1. *Financing*: One of the main challenges is to find stable resources that will ensure the sustainability of the company.
 - Contrary to banks, DFCs do not have access to refinancing through interbank money market or deposits.
 - Some DFCs do have access to capital markets, but this represents a solution only in so far as these markets exist with sufficient depth, and that the DFC has a good rating. The problem DFCs face in terms of financing is thus closely related to the development of national and regional capital markets.
 - Another financing option is to sell private bonds, which requires close relations with national insurance companies.

- Finally, these institutions must be capitalized at a sufficient level by the state in order to be able to carry out their development-related operations and activities.
2. *Mandate*: DFCs cannot change or improve the national development policy through their actions. Therefore, governments must carefully choose policies that DFCs can help to implement.
 3. *Governance*: Created by legislative acts, DFCs may receive special dispensation from certain regulatory laws or may not be directly regulated by any law. Often the only constraints on the operations and governance of these institutions are those voluntarily self-imposed.
 4. *Activities*: DFCs participate in activities which are often public-private ventures, necessitating financial analysis both from the point of view of the private sector, including returns and profitability, as well as from the perspective of the public sector, including public benefit and its economic rate of return. This requires highly trained personnel capable of understanding techniques and procedures of public and private financing.

98. Development Corporations are not only present in developing countries, but exist throughout the world. In the United States, many communities have set up development corporations whose objectives are to finance and invigorate the local economic and social environments. These institutions may also help find concrete solutions to non-financial problems such as education, training, and technical assistance. The Hilltown Community Development Corporation is one example that aims to encourage economic development in rural western Massachusetts.

Box 5.2: Hilltown Community Development Corporation

For nearly twenty years, Hilltown Community Development Corporation (Hilltown CDC) has taken part in the development of small communities in rural western Massachusetts. It provides multiple programs to encourage employment, improve housing possibilities, and offer new opportunities to senior citizens and young girls.

Hilltown CDC's primary is job creation, as these isolated communities do not attract much investment. Programs run by Hilltown CDC include: training for local entrepreneurs and technical assistance for local companies engaged in expansion or reorganization. Hilltown CDC also provides medium to long-term financing for local entrepreneurs from \$500 to \$15,000, and makes available terms of repayment based on clients' particular needs.

Hilltown CDC has also set up Housing Programs, which enable residents to have access to loans and personal financial counselors for renovating their houses. Other loans are made available for first-time home buyers who would not otherwise have the means to purchase. A final lending scheme aims at developing home rentals or purchases for low-income families.

Finally, Hilltown CDC provides a number of different programs for senior citizens and girls. The Hilltown Elder Network (HEN) is an outreach program for senior citizens, which assists them in their daily tasks. Additionally, the Health Outreach Program for Elders (HOPE) helps seniors cover medical costs. Girls also have access to programs that aim to enrich their school education, such as after-school arts and crafts sessions.

Housing and Construction Finance

99. The housing sector is a particularly difficult sector to finance throughout Africa given the need for long-term funds. Thus, governments have established Housing Corporations, which are institutions specifically created to meet housing finance.

National Housing Corporation (Tanzania)

100. The National Housing Corporation (NHC) is a public company that was established in 1962 by an Act of Parliament. Amended several times throughout its history, the institution's current mandate dates from the last amendment in 1990, which extended the role of NHC in the Tanzanian housing sector.

101. Currently, the NHC plays a dominate role in the development and management of all the types of properties – including individual residence and commercial building – in Tanzania. The NHC is the nation's first property developer with a presence in all major cities. Once constructed, buildings may be resold at or under market value.

Malawi Housing Trust (Malawi)

102. The Malawi Housing Corporation was created in 1963 by the government. Its primary objectives include housing development, construction, and management. Due to bad management and ineffective targets concerning national housing requirements, the MHC has faced many difficulties and operational problems. Compounded with the country's increasing poverty, MHC has also suffered from low loan repayment rates.

103. While MHC is involved in housing development and construction, it has not always helped low-income families and business access these premises. Therefore, the government recently set up the Malawi Housing Trust Fund, a separate entity from MHC charged with repurchasing MCH-built residences, and providing low-rate loans to poorer families who will purchase them. The Trust Fund is currently funded by international donors, however, it was written in the Trust Fund's founding act that over the long-term it must become financially independent.

104. Though the Malawi Housing Trust was registered in the list of the institutions to be privatized in 1997 as part of the Divestiture Sequence Plan (DSP), privatization has not yet begun.

Lessons Learned¹²

105. From a purely financial perspective, housing finance does not have any particularities outside of those related to medium-term investment for companies. The needs are the same, including access to long-term resources and the ability to cover the associated risks over that period. Thus, the same institutions could serve to finance both industrial and housing investments.

106. In many African countries, however, housing finance and industrial investment are undertaken by separate institutions. There are two main reasons for this: (i) housing finance brings in other issues, particularly those related to land use and acquisition; and (ii) housing finance is more complex than industrial investment since it must reconcile short-term financing and risk-covering mechanisms related to the construction and medium-term financing and risk related to the sale.

107. The main obstacle in housing finance in developing countries is the lack of long-term resources. The solution to this challenge however is not simply creating specialized state-owned institutions to provide housing finance needs, but must also seek to include the banking sector and take advantage of its wider resource base. Thus, providing medium to long-term resources on a sustainable basis necessarily incorporates the cooperation and participation of banks. In particular, there may be a role for DFIs to play in helping banks increase their term resources through the process of

¹² This issue will be examined in greater detail in the section on housing finance in the Zone Franc, paragraphs 168 – 171.
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transformation; this question will be more closely examined in the following chapters.¹³

Recently created institutions

108. Several African countries have recently decided to create new development finance institutions or to restructure existing institutions whose performance was no longer satisfactory.

The Development Bank of Angola

109. The latest development institution to be established was the Development Bank of Angola (DBA) in March 2006.¹⁴ The DBA was created out of the Economic and Social Development Fund, inheriting both its capital and its personnel. It will be capitalized by the oil industry which will contribute 5% of its revenue, equivalent to around \$10 billion. Its primary task will be to promote the country's economic diversification through subsidized lending. Despite its title as "bank," the BDA will not be regulated by the banking law or monitored by the Central Bank.

110. The announcement of the creation of DBA was made during an IMF country visit. IMF representatives warned the government that the creation of a new institution would be a "retrograde step," and that evidence from other countries as well as from Angola reveal how DFIs are prone to mismanagement and moral hazard.¹⁵

The Development Bank of Namibia

111. The Development Bank of Namibia was created in 2001 by merging the National Development Corporation and the Development Fund of Namibia.

112. Namibia also recently created the Agribank, formerly known as the Agricultural Bank of Namibia, in 2003. The Agribank does not accept public deposits except those explicitly authorized by the Government; it cannot be liquidated except by an act of Parliament; it must submit an annual report to the Parliament. Its main objective is to lend to individuals and financial intermediaries.

Lessons Learned

113. As was the case for Development Corporations, the institutions mentioned above were established by an act of legislation. They were usually created from pre-existing financial institutions that were facing difficulties and

¹³ Thus it is the banks in the Zone Franc that finance housing, while DFIs in non-Zone Franc countries provide this service. These two approaches, one based exclusively on banks and the other exclusively on DFIs, will be discussed in greater detail in Chapter 7.

¹⁴ Communiqué du Conseil des Ministres from 15 Mars 2006.

¹⁵ « Angola set up a Development Bank against IMF advice, » Afrol News, 10 avril 2005, <http://www.afrol.com/articles/18798>.

no longer achieving their development objectives. In terms of their regulation, they are not obliged to comply with banking laws nor are they inspected by a Central Bank authority. Though they have used the title "bank," these institutions are not banks in the strict sense of the term, which creates confusion for the general public.

114. Whether or not these newly created institutions represent a "retrograde step" for their respective financial sectors, the fact that they have been established reveals two important points:

- First, it shows that African states have development needs that are not being met by the traditional financial institutions. Given the constraints faced by the latter, states have chosen to set up institutions that act outside of banking laws in order to meet finance needs for development projects.
- Second, the fact that these states have chosen a traditional Development Bank model for their new DFIs reveals the lack of information regarding best practice in development finance provision. The international community and the Bretton Woods Institutions, in particular, have thus far devoted little time to the question of development finance to identify appropriate institutions, practices and mechanisms. States then have no choice but to turn to the past to create development finance institutions based on outdated models.

115. The essential issue for these institutions relates to their ability to self-impose good governance and international best practice to ensure their sustainability, which is a difficult task especially considering that their institutional predecessors were not able to do so. However, it seems that at least for Angola, the question of long-term resources does not seem to be a problem.

A Unique Case: A Mixed-Purpose Structure Combining Development Finance and Banking Activities

Development Finance Company of Uganda (Uganda)

116. The Development Finance Company of Uganda (DFCU) was established in 1964 as the country's Development Bank. After the initiation of the structural adjustment policy in the 1990s, DCFU decided to fundamentally reshape its entire structure: in 1994, DFCU took control of the Uganda Leasing Company; in 2000, DFCU bought out the Sun Trust Bank creating what is today the DFCU Bank. The purchase of the Bank allowed DFCU to diversify its resources and reduce its dependence on international donors. At the same time, as a bank, its activities are now regulated by Uganda's Banking Law of 1993.

117. At present, the DFCU is composed of two distinct entities which are held together in a holding. On the one side, DFCU Bank handles all commercial banking activities, including corporate, SME, and retail, which account for 40% of its total activities; on the other, DFCU Limited and DFCU Leasing handle the development-oriented activities, including providing term finance, mortgages, and leases, which make up the remaining 60% of its activities.

The case of South Africa

118. South Africa has a very unique financial landscape. In addition to the eight main banks, the financial system includes five DFIs – the Development Bank of Southern Africa, the Industrial Development Corporation, the Land Bank, the Khula Enterprise Finance (SMEs), and the National Housing Finance Corporation – each of which was created by a legislative act and wholly capitalized by the State. Each DFI has a charter which identifies the sector in which it will operate, and tries to ensure that the actions of one DFI do not overlap with those of another. The charter is determined by national legislation and is amended periodically to reflect the changing environment and the changing objectives of each institution. Below, two institutions, DBSA and IDC, will be examined more closely.

The Development Bank of Southern Africa

119. Created in 1983 by the DBSA Act, the Development Bank of Southern Africa plays a role in the region's economic and social development specifically by financing economic, social and physical infrastructure projects. Revised in 1993 and again in 1997, the DBSA Act has been modified to take into account the changing environment in which the institution works and to incorporate principles of effectiveness, equity, transparency and responsibility into its mandate.

120. Today, DBSA is still 100% state-owned. It has three main roles as financier, advisor, and partner in regard to South Africa's economic, social, and physical infrastructure. To fulfill its missions, DBSA works mainly with public-sector clients, including districts and municipalities to complement funds and services offered by the State. They also seek to catalyze private-sector involvement in infrastructural projects by acting as an investment partner in joint-ventures. In addition to infrastructural development, recently DBSA has begun providing short and medium-term finance to rural areas, which have the greatest development needs and the least institutional capacity.

121. DBSA's current strategy consists of broadening its investment in infrastructure to finance less viable projects. The idea is that given DBSA's several years of solid profits that Government would like the institution to

“invert the conventional financial risk - reward relationship and leverage its strong financial position to achieve its targeted development impact.”¹⁶

122. As was discussed above in regard to Development Corporations, the challenge for these institutions is to combine its development-oriented activities with its need to be a self-financing and profitable institution. This challenge is further complicated by the staff's areas of expertise, which in DBSA's case, are more oriented towards development than financial analysis. This dilemma of profit vs. development impact touches nearly every aspect of DBSA's ventures, including identification of new markets, projects, priorities, and geographical distribution of projects. As mentioned above, the Government hopes to see DBSA emphasize its role in the country's development.

Box 5.3: DBSA and Infrastructure Development

DBSA's recent activities include the refinancing of the infrastructural projects in Msunduzi, as well as the co financing of two Development Committees operating in Durban. After the floods, the institution took part in rebuilding Kruger National Park. It has several projects in the pipeline, including the development of a tourist site in Letsatsi and providing services to develop the urban and agricultural zones near Buffalo City.

Industrial Development Corporation¹⁷

123. The Industrial Development Corporation (IDC) was created in 1940 in response to a lack of financing in textile and agro-alimentary industries. Its objectives have, like DBSA's, evolved over time with South Africa's changing environment. Until 1997, the IDC limited its activities mainly to agricultural, mining, industrial and property sectors. Since then, however, IDC has extended its activities to many sectors, which it believes will help it better achieve its three primary objectives: job creation, SME development, and the acceleration of Black Economic Empowerment (BEE).

124. The institution is self-financing and is not subjected to the Central Bank. It is, however, regulated by the Companies Act, pays taxes, and pays out dividends to its shareholder. It is under the supervision and control of the Parliament, to whom it must submit a corporate plan as well as a performance assessment for approval.

125. Since 2000, IDC has expanded its mandate to include activities throughout Africa. At present, it has 89 projects throughout 28 countries for a total portfolio value of about 2 billion Rand (around € 262 million).

126. The IDC is divided into several "Strategic Business Units" (SBU), arranged by sector of activity, including chemicals, textiles, manufacture, wood and paper, agro-industries, mining, among others. The expertise developed within each SBU makes it possible for IDC to better evaluate the

¹⁶ DBSA official website: www.dbsa.org.

¹⁷ One of the field missions was carried out at IDC.

project's inherent risks, allowing the institution to take risks which commercial banks would not. It must be noted that commercial banks often participate in IDC projects.

127. IDC tries to be a leader in development by financing those sectors that commercial banks will not, and in this way avoiding competition with banks. IDC prefers to pioneer involvement in a new sector and eventually guiding the private sector to take the lead, freeing up its resources (financial and human) for other activities and other sectors. In fact, IDC often finances projects in partnership with commercial banks, offering different instruments (guarantees, equity, quasi-equity, LT loans) that those offered by commercial banks in a particular project.

128. The IDC has recently begun to offer capacity-building measures, both for its national population and among its peers. In 2006, it established the IDC Academy which aims to improve the capacity of South African entrepreneurs to manage their financial affairs. Other capacity-building initiatives seek to connect emerging Black entrepreneurs to more experienced operators. In this case, IDC may add particular conditions to the contract to ensure that there is a transfer of expertise from the experienced operators toward black entrepreneurs.

129. IDC has also participated in capacity-building measures for other DFIs, by signing Technical Assistance agreements with other institutions, particularly in the fields of governance and management. As mentioned above, IDC has formed a partnership with Lesotho National Development Corporation, providing technical assistance. Additionally, South Africa has taken up an important role within "New Partnership for African Development" (NEPAD); the State uses IDC as its main arm of intervention to accomplish NEPAD objectives both in South Africa and in other countries.

130. The IDC maintains that it is independent from government since all project-financing decisions are made internally. However, its executives are named by the government, which seriously limits the extent of its independence. Also, IDC must submit a shareholder's compact, summarizing the previous year's performance, and a corporate plan outlining performance targets and objectives for the following year, to the Department of Trade and Industry, its sole shareholder, for approval annually.

Lessons learned

131. The Development Finance system that has been established in South Africa is indeed an exception rather than the norm within the African continent:

- First, the DF system made up of five complementary institutions shows that South Africa has long considered its national development problems holistically. This has been confirmed recently by the policy outlined by the Minister of Finance in 1999.

- The economic environment of the country is both that of a developing country with unmet development needs as well as that of an advanced economy with a strong industrial base and a dynamic financial sector.
- The great diversity within the country has driven the government to concentrate not only on national needs but to encourage development on a local level as well to respond to varying individual needs.
- The country benefits from a highly diverse and deep financial sector, including traditional banks, micro banks, cooperative banks, NGOs, and public and private lending entities, which altogether create nearly 10,000 agencies across the country where people can receive credit.

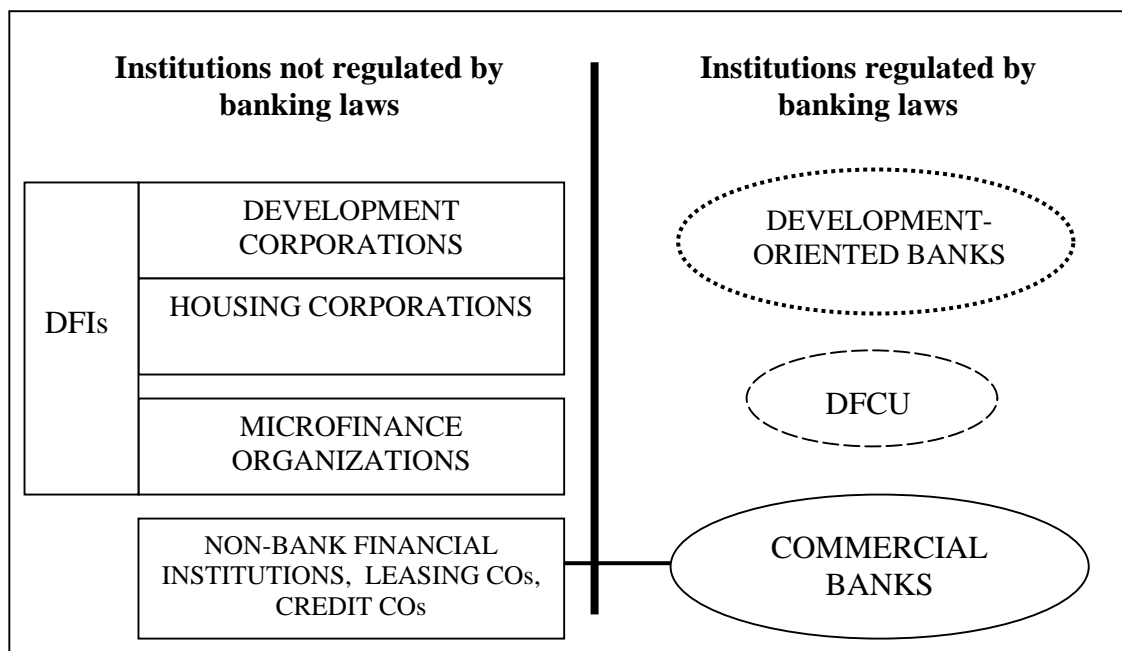
132. Despite the exceptional character of the South African economy, is it still possible to export the South African DFI system model to other countries? In terms of the macro-economy, no other country in Africa has financial markets with the same breadth and depth as those in South Africa, which are needed to ensure the refinancing of DFIs. Similarly, though they may face similar development problems as South Africa, no other country has the same industrial and financial base as South Africa.

133. If the South African DFI system is not easily transposable onto other African countries, certain aspects could be used. It is a source of innovation and experimentation for development finance mechanisms. Additionally, it provides an excellent model for good corporate governance as well as a model for cooperation between government and DFIs. Finally, it could act as a source of Technical Assistance for other DFIs in the SADC region.

Conclusion

134. The situation in the sub-Saharan African countries for countries outside of the Zone Franc could be diagrammed in the following figure:

Financial Infrastructure in Non-Zone Franc



6. DFIs in Morocco and in Tunisia

135. The cases of Tunisia and Morocco are interesting to analyze with regard to development finance. For many years, the Development Banks continued to operate despite the adoption of stricter banking laws. The pressure to comply with banking laws increased as commercial banks began to increase their term finance capacities and began to finance certain sectors that had previously been the sole domain of DFIs. In the end, all of the Development Banks disappeared, not without leaving a certain number of financial services gaps related to development finance.

Morocco

136. Following Morocco's independence in 1956 the basis of the country's banking sector had already been established. The Bank of Morocco (Bank Al Maghrib) was inaugurated on June 30, 1959 to replace the State Bank of Morocco and to serve as the country's Central Bank.

Specialized Financial Companies

137. In 1967, a law relating to banking and credit was promulgated, providing a more precise definition of acceptable banking activities, and specifying methods of monitoring and regulation. This law established a very clear distinction between commercial banks, which could collect deposits and which could carry out credit operations, and Specialized Financial Companies (SFC), which were governed by specific texts and which contributed to the financing of particular sectors. Examples of SFCs include: National Bank of Economic Development (BNDE) for providing term finance needs for the Moroccan industrial projects, the Caisse Nationale du Crédit Agricole (CNCA), and the Crédit Immobilier et Hôtelier (CIH).

The Creation of Universal Banks

138. In 1993 another series of banking laws was initiated based on international good practice to create a new concept of "universal bank". Under the terms of these laws, commercial banks provide the entire gamut of banking products and services. This new concept brought about the elimination of specialized institutions, including SFIs as well as specialized commercial banks.

139. As in other countries across the Continent, other financial sector reforms were also put into action, such as: the elimination of directed-credit programs, the liberalization of interest rates, and the launching of an interbank money market.

140. In 2006, a new banking law was announced by Bank Al Maghrib. The law was written in an effort to reinforce the Central Bank's authority over the financial system, to increase its effectiveness, and to ensure its independence

vis a vis the Government. To do so, the Central Bank was forced to sell its stock options in all banks in which it was still shareholder, including, in particular, the CIH. In this way, the Central Bank would no longer be in a position of moral hazard as both the supervisor and the beneficiary. The aim was to create an impartial regulatory control, which did not maintain any commercial connections with the banks under its supervision.

Difficulties Faced by SFCs

141. In competition with well-functioning commercial banks, the newly registered SFCs had to comply with tightened prudential rules, and faced serious management difficulties. The removal of directed credit programs resulted in a sharp increase in loan allocations by commercial banks, an increase in interest rates, and a shortage of resources in the money market. In this context, the BNDE and the CNCA had to limit their commitments due to lack of resources. Also, given the large number of non-performing loans in their portfolios, in 2002, the two organizations began a process of reorganization and restructuring.

The Case of the BNDE

142. A strategic audit was carried out on the BNDE in 1993 by the World Bank. The conclusions of the audit asserted that given the context of increased competition, the reduction of its profits margins, and the application of new banking laws, the BNDE would not be able to maintain satisfactory medium-term profitability if it did not enlarge the scope of its services and products beyond providing term finance for investment projects. The liberalization of the Moroccan financial sector had important consequences on the BNDE: it had eliminated the medium—term rediscount window in the Central Bank for commercial banks, among other things.

143. The recommendations of this audit led the BNDE to adopt a strategy of diversification, particularly commercial-oriented activities, such as equity investments, to benefit from the privatization programs for state-owned enterprises. Additionally, the BNDE began to create a network of agencies by establishing and/or purchasing branches throughout the country. In this manner, the BNDE took control of the BMAO, Banque Marocaine pour l’Afrique et l’Orient, which also helped it increase its own equity by launching a double issue of new capital shares.

144. In 1997, the State tried to privatize BNDE. Several banks and Moroccan businessmen were interested in the offer, however the process took too long. In 2000, the AFD sold its capital shares to the Spanish Caisses d’Epargne. However, the BNDE was seeking to find a buyer for the majority share of 34.16% owned by the state.

145. When, at the end of 2002, BNDE had still not yet secured a buyer, the situation of its finances became alarming. It was finally bought out by the Caisse de Depot et de Gestion (CDG) in 2003 and became its commercial

bank. Its network of branches, mostly consisting of former BMAO offices, was bought up by the Credit Agricole of Morocco. The CDG is still in the process of cleaning up the financial portfolio and identifying all the non-performing loans.

The Other SFCs

146. The ex-CNCA was able to stabilize itself as a bank, though its portfolio has yet to be entirely cleaned up. The situation of the CIH, however, is not yet entirely worked out. After a two billion DH restructuring plan, the State had planned to privatize the institution by selling it to the Banque Centrale Populaire (BCP). The CIH had formerly been a strategic investor in two important sectors in Morocco: the real estate sector, including programs for subsidized housing for low-income families, and tourism.

Lessons Learned

147. The evolution of Morocco's Development Banks followed the same path as those in Zone Franc countries: the financial sector reforms that were applied across the continent caused the creation of a new concept of banking, embodied in the universal bank. The emergence of this singular type of bank caused the eventual disappearance of the Development Bank and other specialized financial institutions.

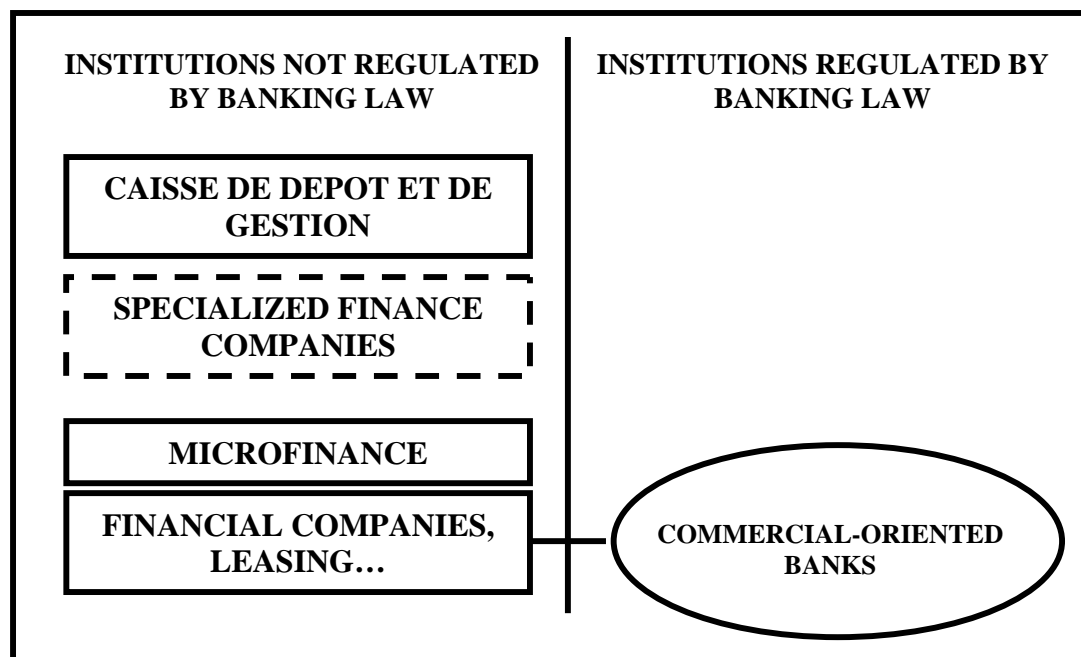
148. Morocco, like Tunisia (see below), was different from other African countries in that its banking system was already well-established at the time of this reform. Banks were already capable of performing transformation, which progressively lengthened the maturities of resources to cover term finance needs. Unlike other countries in Africa, term credit, previously provided only by SFCs, was therefore covered by the banking system once the latter disappeared.

149. The provision of term finance by the banking system after the disappearance of SFCs did not signify that all specialized financing needs were similarly taken over by the financial sector. New institutions sprouted up to meet the needs that were not being met by the banking sector. One such sector was the microfinance sector, wherein new non-bank operators stepped in to fill the gap. Other sectors, such as subsidized housing and alternative energy, are still underdeveloped due to lack of financing possibilities, as banks are not interested and alternative credit sources for such projects have not yet been developed.

150. Thus, the disappearance of SFCs did not signify the disappearance of specialized development finance needs. While some activities were taken over by commercial banks, many were left unanswered. A telling example is that of alternative energy sources, such as solar and wind power, that have specific financing needs that are currently unmet by the financial institutions existing in Morocco today. Though Morocco has many interesting initiatives in the area of alternative energy, the necessary financing mechanisms are not in

place to support them, or more specifically, a single financial institution is needed to provide all the different types of financing schemes under one coherent and simple credit framework, that would be equally useful to local producers and private consumers.¹⁸ The lack of such an institution that would play the role of a catalyst for solar energy development is a major obstacle for getting different operators to cooperate.

Development Finance in Morocco



¹⁸ Solar energy necessitates the use of subsidized finance, mixed with bank finance, forming a package combining credit mechanisms and leasing options.
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Tunisia

151. At the end of the 1950s, Tunisia followed the trend established by other newly independent countries and began creating its own national Development Banks, in partnership, in particular, with countries from the Persian Gulf and the Kingdom of Saudi Arabia. Initially, DBs allocated loans without any specific regulation. However, the advent of liberalization policies changed this.

152. Until 1994, the principal role of the Tunisian Central Bank was to ensure the internal and external value of the dinar. However, with the adoption of the new banking law on February 7th, the Central Bank was given a new responsibility in regard to regulating the banking system's prudential ratios and accounting procedures, requiring periodic audits of commercial banks in order to monitor their compliance. Additionally, the Central Bank started to exert control over banks' subsidiaries and other entities that held these subsidiaries. The law gave it the capacity to impose an increase of share capital, to prohibit dividend distribution, and to demand new provisioning ratios. Such powers allowed it to create serious consequences for banks and their shareholders that did not comply with banking laws.

153. An amendment to the law was voted on July 10, 2001, revising banking regulation once again. The legislative act redefined the concept of a credit institution, making it much clearer. The term "bank" was specifically reserved for those institutions accepting deposits from the public, whatever the form or duration of the deposit. Credit companies, such as DBs, which took deposits were thus regarded as banks and fell under the restrictions of the banking laws. Some were absorbed by public banks; others were dissolved. Those that were created in partnership with Arab countries also gradually disappeared from the Tunisian financial infrastructure.

The Société Tunisienne de Banque (STB)

154. In 1958, STB was created as a public commercial bank. The Tunisian government quickly associated the bank with various national development projects. At that point, it specialized in the sectors of tourism, trade, industry, the market exchange intermediation, and real estate promotion. Over time, the activities of STB began to overlap with those of two other banks, the National Tourism Development Bank (BNDT) and the Economic Development Bank of Tunisia (BDET), and competition ensued.

155. In 2000, the government of Tunisia decided to reorganize its banking sector. During this process, STB absorbed its two competitors, BDET and BNBDT, in order to facilitate the creation of a more solid and wider banking entity, as well as to clean up the portfolios of the two merged banks. Today, STB still participates in various sectors of the economy, including tourism, industrial development, services, and real estate. These activities are executed by different subsidiaries directly attached to STB. STB identifies the

banking group's overall objectives, including profitability targets and internal ratios in order to help improve the financial strength of the BNDT and the BDET.

156. Today, STB is still controlled by the State which is both a direct shareholder and indirectly exerts its control by way of parastatal organizations. The State organizes and implements its development policies in part by using the specialized subsidiary companies of STB.

The Banque Nationale de l'Agriculture (BNA)

157. The Banque Nationale de l'Agriculture of Tunisia was created in 1959 as the umbrella organization for the individual and separate agricultural savings banks or "caisses" set up under colonial rule. The primary objective of the BNA was to promote agricultural activity.

158. In 1969, the Bank was renamed the National Bank of Tunisia (BNT) and began to participate in sectors outside of the agricultural industry, providing banking products and services for nearly all sectors of the economy. In parallel, a new bank specialized in agricultural was established, the National Bank of Agricultural Development (BNDA). Eventually, the BNT absorbed this bank to create a unified approach to agricultural financing and development, at which point it reverted to its original name, the BNA.

159. Today, following the example set by STB, the BNA is a purely commercial bank controlled entirely by the State. Its development-oriented activities are carried out by specialized subsidiaries, primarily in the domain of agriculture. These subsidiaries finance and implement agricultural development projects, which may subsequently be resold to private sector individuals or companies. Ranked as one of the top 50 banks in Africa, the Bank has achieved adequate profitability and sustainability.

Lessons Learned

160. The banks mentioned above lost their title of "Development Bank" when they came under the banking law in the 1990s. However, the state still remains the majority capital shareholder in both of these institutions, which has helped them maintain certain development objectives. Contrary to Morocco, the Tunisian government has no plans for privatization in the near future.

161. As was the case in other African countries, the Development Banks in North Africa disappeared during the process of economic liberalization. Also, the attenuation of certain financing needs, such as within the tourism sector, made the contribution of specialized banks less necessary. The creation of subsidiaries by state-owned banks made it possible to continue financing development, since such subsidiaries were accorded various forms of state assistance, and then eventually privatized.

162. The need for the state to have institutions involved in providing specialized financing, outside of the banking system, was illustrated by appearance of specific finance institutions, such as the Tunisian Bank of Solidarity, that were set up to meet financing needs, in this case by directly financing microfinance activities, that could not be met by the financial system.¹⁹

Conclusion

163. The evolution of Development Banks in Morocco and Tunisia followed the same course as other African countries: they were gradually phased out since special finance companies could no longer differentiate their modes of action from that of banks.

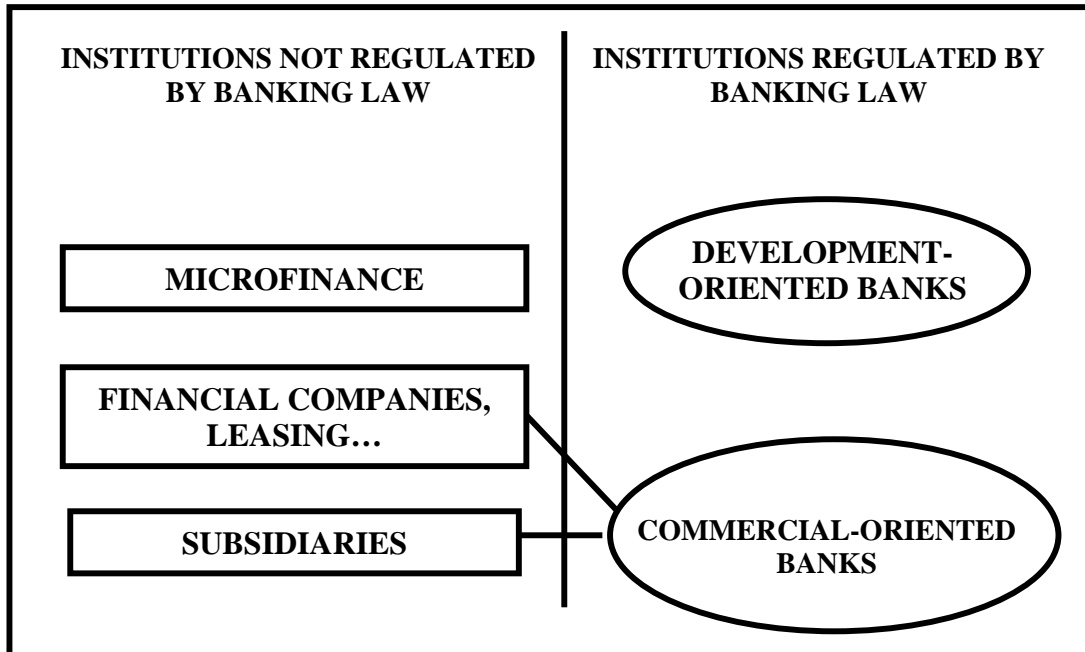
164. However, as in other countries, the disappearance of such institutions did not signify the disappearance of the specific financial needs to which they were formerly responding. Often the banking system failed to provide finance to activities and sectors that could contribute to promoting income-generating activities, housing, new energies, etc., and help alleviate national poverty.

165. Commercial banks could and did provide a partial response to the finance needs related to economic development that were formerly fulfilled by non-bank specialized finance companies. However, commercial banks will usually only choose to engage in such activity if they are publicly-owned, and thus compelled to do so by their shareholder. Economic liberalization policies promoting privatization of state enterprise makes these types of publicly-owned banks more and more exceptional. Additionally, commercial banks may be encumbered in their development-oriented activities by the banking laws.

166. Thus, replacing former Development Banks with state-owned commercial banks does not wholly answer the needs for development finance. Especially since banks can only provide financing, and cannot really play the needed role of project promoter, coordinator, partner, and catalyst, played by modern DFIs, and required for the successful implementation of development projects.

¹⁹ Contrary to the BTS, the Banque Malienne de Solidarité intends to develop a particular financial specialization through refinancing microfinance institutions, rather than directly providing microfinance services. The Banque Régionale de Solidarité in the UEMOA, has not yet announced that it would establish any particular relations with MFIs.
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Development Finance Structure
in Tunisia



7. The Zone Franc

The Institutional Landscape

167. The Zone Franc is an area that includes France, the Comoros, and 14 sub-Saharan African countries that are regrouped into two economic unions: the Western African Economic and Monetary Union (UEMOA) and the Central African Economic and Monetary Community (CEMAC). Each economic union has a Central Bank – for the UEMOA, it is the Central Bank of West African States (BCEAO), while for the CEMAC, it is the Bank of Central African States (BEAC) – a banking commission, and is charged with the organization and management of the union's monetary and economic policies. During the 1990s, the economic reforms sought to establish the banking commissions' independence vis-a-vis member-states' governments and reinforced the commissions' authority over financial institutions operating within the economic union.

168. As noted above, the liberalization reforms during the 1990s served to considerably change the financial institutional landscape of the Zone Franc. With the exception of the two regional development banks (BOAD and BDEAC), the Development Banks were forced either to transform into "universal" banks, or, otherwise, to disappear. In Mali, for example, the former Banque de Développement de Mali chose to operate as a private commercial bank, abandoning its development-oriented activities as well as its mission statement. In Gabon, on the other hand, the Banque Gabonaise de Développement chose instead to become a universal bank, preserving its development orientation and mission statement.

169. This chapter will review both the universal banks that have maintained their development objectives as well as the regional development banks still intact.

Development-Oriented Universal Banks

170. Listed as a universal bank, this category of institution is regulated by banking laws and is monitored by the Banking Commissions, but still manages to play a role in financing development within the country.

171. Within this category, there are two sub-categories:

- (i) Development-Oriented Banks providing specialized finance for specific domains, such as agriculture, rural finance, or housing finance; and

- (ii) Banks providing general development finance for many different types of development projects, which can be seen in the emergence of new “banques de solidarité,”

172. The role played by these banks in supporting national development initiatives is limited by the fact that they must follow certain bank-specific management criteria, such as risk management, portfolio diversification, and other techniques, that necessarily restrict the number of high-risk, development-oriented projects they may take on. However, their development activities are facilitated by the fact that the State has often maintained its position as majority shareholder of the bank, as well as by the presence of regional development banks that will cooperate by offering lines of credit or other financial instruments.

The Banque Nationale de Développement Agricole (Mali)²⁰

173. The Banque Nationale de Développement Agricole (BNDA) was established in 1981 as a Development Bank offering specific products and services to Mali’s agricultural and rural sectors. It was created during a time when Development Banks were widely recognized to be useful institutions for providing development finance, and additionally, when specialized institutions charged with financing specific sectors – housing, industry, agriculture – were also generally accepted. The BNDA was therefore set up to be the interface between international donors and the Malian government.

174. Originally, the bank’s role was to provide technical and/or financial services for development projects aimed at promoting agricultural and rural sectors of Mali’s economy. Its primary responsibility was to finance the cotton industry by allocating credit to its main client, the CMDT, Compagnie Maliene du Développement Textile. Following the 1990 reforms, the bank enlarged its activities and became a universal bank.

175. The BNDA benefits from financial and technical support offered by international donors. The AFD and KfW, among others, have played important roles: the AFD is a minority shareholder, and has opened several lines of credit and provided Technical Assistance packages. The KfW has recently created a package deal for BNDA to assist SMEs in Mali by opening a specific line of credit and by providing Technical Assistance.

176. The BNDA successfully established a partnership with the “Decentralized Financial System” (DFS), a network of micro banks situated throughout the rural Mali. While the BNDA has not opened direct lines of credit with the DFS, it refinances them using equity capital, and also on lends funds from international donors. The relationship between BNDA and the DFS is one of mutual benefit as the SFD have increased their resources, while the BNDA has inexpensively expanded its banking presence in the country’s rural

²⁰ A field mission was made to the bank for this study.
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zones by using the pre-existing networks, thereby eliminating the need to construct new branches.

177. In the bank's 5-year Medium-Term Strategy, it identified four major axes of its development activities: (i) continued involvement in rural finance, (ii) microfinance, through the refinancing of DFS network, (iii) SME promotion, and (iv) new financial mechanisms for individual clients, in particular with regard to housing finance. The decision to diversify its activities beyond that of financing the country's cotton industry was motivated by the government's decision to private CMDT by 2008. Certain development sectors have not yet been included in the bank's new portfolio – fishing, livestock, health, subsidized housing, and tourism.

178. The major challenge for BNDA today is to reconcile its development-oriented activities with the constraints imposed by the banking laws of the UEMOA. Its good reputation is due in part to its ability to successfully use the region's financial markets to meet its financial needs.

Lessons Learned

179. The analysis of BNDA reveals several advantages that universal banks have in regard to financing development needs, particularly in the agricultural sector. First, a bank may in fact be better suited to meeting development finance needs than a non-bank DFI in that it has the capacity to increase financial intermediation in rural areas. Second, the fact that BNDA engages in other banking activities means that it can use these revenues to cushion the higher risk and longer term development projects that it finances. Third, the finance needs of the agricultural sector or the rural sector are not limited to term finance, but include short-term finance, working capital, and other financial products as well. This raises the question as to whether the term of credit (short, medium, or long) is the salient characteristic of development finance, or if indeed, another criterion should be used to define development finance's specificity.

180. This last point is very important as it reveals that development finance is not only limited to term finance, but rather there is a wide range of finance needs, including short-term and working capital needs, that are not being met by the private sector. Thus, though term finance is currently considered the trademark product of DFIs, it is not the only type of finance required for development-oriented activities, as shown through the finance needs for agricultural and rural sectors. A new set of criteria then is needed to define development finance.

181. Finally, it must be noted that the "mixed strategy," incorporating commercial and development banking, is largely possible due to the continued presence of the State as the majority shareholder. Its key position on the bank's board thus ensures that the bank's development objectives will be sustained over the long term.

Housing Construction Banks

182. The lack of finance for housing construction available in the Zone Franc has led several countries (Burkina Faso, Mali, Gabon, Republic of Congo...) to recently establish specific Housing Banks, based on the model of the Senegalese Banque de l'Habitat.

Box 7.1: The Complexities of Financing Subsidized Housing

There are several challenges involved in financing subsidized housing. First and most importantly, a "maître d'ouvrage" or property development investor is needed who will be able to manage the entire project and, in particular, ensure the transition from construction to sale. The role is often played by a public entity, however a private-sector actor, such as an insurance company, is equally capable of playing the role. In Senegal, the position is often given to a member of the community thanks to the law on real estate cooperatives.

Second, the funds must be mobilized to finance the construction, which can be quite difficult given the context in which construction must take place: weak or no guarantees from the building firm, delays, import costs, etc.

Third, the property development investor must have an appropriate exit strategy in order to ensure the continuity of the process from construction to the sale, which is likely to take several years. Before the sale, the investor is responsible for all costs and finances. In order to support such a position, the investor must have access to ample long-term finance.

Lastly, it is important not to confuse housing finance with long-term credit needed to purchase a residence. The latter can be provided by commercial banks with adequate medium- to long-term liquidities that are willing to cover the default risk of the borrower.

183. Once again, the main question in regard to financing housing construction is whether or not such activities are compatible with the regulations and ratios imposed by banking laws. Specifically, certain imposed ratios, such as that of medium-term resources to short-term resources, pose difficulties for banks wishing to finance housing. The problem of such banking legislation is illustrated by the fact that some housing construction banks that have the necessary liquidity to finance housing projects, such as the Banque de l'Habitat au Sénégal, have not been able to engage in such activities, and have turned instead to activities, which require short-term financing and have little to do with housing.

184. In fact, whereas long-term mortgages for the purchase of real estate are generally provided by banks, the financing for housing construction is often provided by other types of non-bank institutions.²¹ The needs for long-term resources as well as long-term risk management may be better handled by non-bank organizations, such as the French "établissement financier"²² or the British "Housing Trust." This last model, however, is poorly equipped to develop long-term relationships with, for example, insurance companies,

²¹ The Banque Tunisienne de l'Habitat is one example.

²² See, for example, the role played by the Crédit Hôtelier or the Caisse des Dépôts in the financing of housing and hotels in France.

which often have, through life insurance programs, the most stable sources of long-term capital.²³ The bond market may be used to produce stable, long-term funds by emitting specialized bonds, however this is very difficult and requires a developed market.

185. The financing of construction is therefore quite different from the financing needed for agriculture. As was presented in the previous section, despite the difficulties involved, the multiple financing needs for agricultural development projects are at least coherent with the operational model of a bank, or at least more so than with that of a traditional non-bank DFI. It seems, however, that the opposite is true for financing construction.

"Banks of Solidarity"

186. Though national Development Banks have, for the most part, disappeared, banks have not been able to entirely meet the continued needs for development finance. Thus, certain States or multinational organizations have created new banks to help meet their development needs; these are the so-called "banques de solidarité" or Solidarity Banks.

187. Tunisia developed a Bank of Solidarity which has inspired the creation of other similar banks. One of which, the Malian Bank of Solidarity, has several microfinance institutions as its equity investors. One of the bank's activities, among other things, is to refinance these organizations.

188. As indicated in its title, the Regional Bank of Solidarité (BRS) based in Niamey, has decided to expand this idea to operate on a regional level. The Group is comprised of a network of eight banks situated in each member-state of the UEMOA.

- The creation of the BRS was personal initiative of the former governor of the BCEAO, motivated by the region's severe economic difficulties and the inabilities of banks to finance development projects. The BRS was capitalized by the BCEAO and the BOAD.
- Though the BRS Group was only recently established,²⁴ it represents an important and innovative approach to development finance in that:
 - 1) First, the Group's banks provide all types of financing, and are not limited to medium and long term credit. As seen in the case of BNDA, the development finance may require instruments beyond term finance in order to meet the specific risks associated with the development project and which other financial actors cannot or will not participate in.

²³ Depending on whether it is a bank or a DFI that is involved in the Project, an insurance company can play various roles, from temporary property development investor to the executive agency to financier only as when it is a bank.

²⁴ All 8 of these banks were established during 2005.

- 2) Second, development finance is not limited to financing productive enterprise, such as SMEs or artisans, which was the primary focus of the old Development Banks. Rather, development finance must also include providing finance to the civil society and the social economy, which lies somewhere between the public and private sectors, including: associations, NGOs, mutual funds for health insurance, etc. The BRS was established in such a way as to permit the financing of such activities alongside other traditional development finance activities, which allows the BRS to take account not only of economic development objectives, but to incorporate human and social development objectives as well.

Lessons Learned

189. The fact that States and institutions within the Zone Franc are creating new banks with development-oriented objectives is very indicative of the finance deficiencies still present in the region today. The creation of such banks reveals the governments' efforts to find new solutions for financing sectors that were, in the past, the privileged sphere of activity for the national Development Banks.

***La Banque Ouest-Africaine de Développement*²⁵**

190. The two Development Banks within the Zone Frank that survived the reforms in the 1990s were the two regional development banks: the Banque Ouest-Africaine de Développement (BOAD) and the Banque de Développement des Etats de l'Afrique Centrale (BDEAC). They have maintained their original operational organization as well as their original development finance objectives.

191. The BOAD has operated within the UEMOA since 1973. It is a publicly-owned institution, which receives support from international donors, created to promote "balanced development of the Member States" and "economic integration of West Africa." The eight member-states of the UEMOA along with the BCEAO are the principle shareholders, holding 96% of the capital. The remaining shareholders include African Development Bank (ADB), the European Investment Bank (EIB), the Republic of France, Deutsche Entwicklungsgesellschaft (DEG) and the Kingdom of Belgium. The BOAD, supervised by the BCEAO, is audited by an independent company.

192. The BOAD contributes to regional and national development projects by providing lines of credit that are allocated to the national governments and/or the principle banks involved. It also provides medium and long-term loans to companies as well as venture capital. In this way, the BOAD finances development projects in various sectors: infrastructure, agriculture, energy, telecommunications, etc. Within the framework of the IMF's Heavily Indebted

²⁵ A field mission was made to this institution.
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Poor Countries Initiative (HIPC),²⁶ the BOAD may sign accords providing debt relief for countries that are part of the initiative, resulting in the partial cancellation of these countries' outstanding debt.

193. The BOAD's resources come from financial markets as well as lines of credit supplied by international donors at concessionary rates in the name of development aid. Recently, China has granted BOAD more than 100 billion FCFA to finance the UEMOA's Regional Economic Program. China has proposed to reinforce its provision of Technical Assistance to UEMOA countries, particularly in the field of agriculture.

Lessons Learned

194. For the UEMOA, a region in which national Development Banks are no longer in operation, the BOAD has a unique role to play. Its approach to development finance has largely remained that of a traditional Development Bank: collecting resources from donors and on-lending them to finance projects, companies, or financial institutions which will then themselves on-lend the funds to development projects; providing loans and venture capital to the sectors of infrastructure, housing, SMEs, etc.

195. As a supranational institution within a region that is rapidly integrating, the BOAD could play a greater role in financing development projects within the UEMOA, such as:

- The BOAD is well positioned to be the institution that introduces and develops the process of *transformation* in the region's principle banks. Instead of directly granting medium to long-term loans to the region's banks, which can reduce the banks' efforts to develop their own term resources, the BOAD could create refinancing mechanisms which oblige banks to progressively increase their long-term maturities for medium to long-term commitments. This type of intervention, both in liquidity and in risk management, would help, for example, banks specialized in financing housing construction become sustainable over the long run.
- Concerning infrastructure development, the BOAD is also well positioned to provide financing on a regional, national, or (especially) local level in the form of a simplified BOT (Buy Own Transfer) operation, which enjoins both the private sector and markets to provide financing. An example to follow could be the DBSA, which has used BOTs to set up urban infrastructure on a local level in South Africa.
- As regards to SME loans, the BOAD could provide greater additionality if it were to concentrate more on helping manage SME-related risks rather than providing liquidity, which is already abundant in the UEMOA. One way to do so would be to support existing guarantee

²⁶ Five out of the eight member status have signed such accords.
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funds, or introduce new mutual guarantee funds, which would provide banks with alternative forms of collateral in the case of a customer's default, facilitating lending to SMEs and artisans. The BOAD is well-suited in that it must be a regional initiative that must be launched by a reputable financial institution with close connections to the region's Central Bank.

196. Given the significant development needs for the UEMOA, the BOAD is a unique tool that is well-placed to play a key role in the future. However, to do so, its underlying concept and design must be reconsidered in light of the region's changed economic and financial environment, and the evolutions in development finance across Africa must be taken into account. By applying a sector-oriented, as opposed to a project-oriented, policy and by using its financial intervention as a catalyst for development finance, as opposed to a direct contributor, the BOAD could be more effective in providing economic agents within UEMOA financial solutions for development issues.

The Banque de Développement des Etats de l'Afrique Centrale

197. Established in 1975 by the six member-states of the CEMAC, the Banque de Développement des Etats de l'Afrique Centrale (BDEAC) promotes the region's common goals of economic and social development. Its activities include project promotion, through the identification and financing of feasibility projects, as well as project financing, by mobilizing and providing financial resources.

198. Operational since 1977, the BDEAC faced serious financial problems in the 1990s following liberalization reforms. Its activities were subsequently suspended during a long period of reorganization. These events caused the member-states' stakes in the equity capital to be reduced from 72% to 51%. Today the six member-states are still major stakeholders, though, following the BOAD's example, other actors, such as the Banque des Etats de l'Afrique Centrale (BEAC), the ADB, and French Republic are also shareholders.

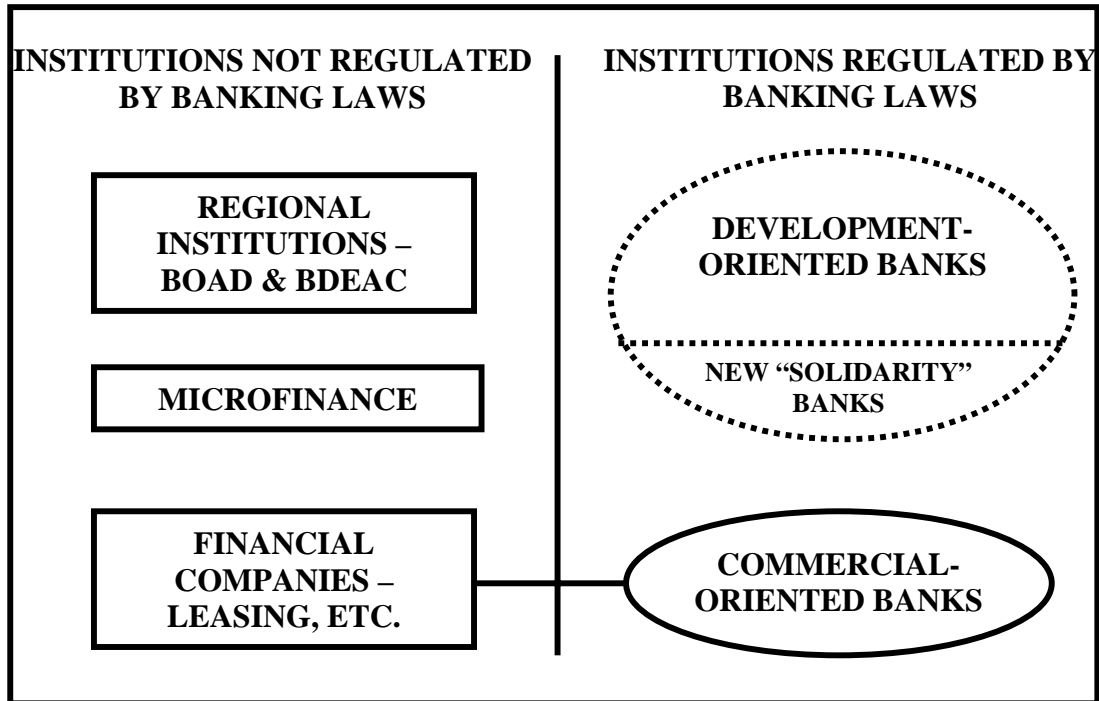
199. Since its revival in 2003, the regional Development Bank of Central Africa has engaged in the same types of activities as its counterpart in Western Africa. The BDEAC refinances loans of financial institutions within the CEMAC and provides loans for large national and regional development projects. The bank has planned to increase its activities over 2002-2007. One of its principle objectives is to become the CEMAC's premier institution in the provision of term finance, while, at the same time, ensuring its own long-term sustainability.

200. In 2005, the BDEAC's commitments reached 20.3 billion FCFA which covered the financial needs of seven projects, two feasibility studies, and the acquisition of a holding. The BDEAC continues to diversify its sources of financing: the EIB has just granted the institution a credit limit of 15 million euros.

Lessons Learned

201. Given the similarities between the macro-economic, political, and regulatory frameworks of both unions within the Zone Franc, as well as the similarities between the Development Banks themselves, the lessons learned in regard to BOAD are equally applicable to the BDEAC.

DEVELOPMENT FINANCE INSTITUTIONS IN THE ZONE FRANC



8. The Way Forward: Components of an Action Plan

202. The preceding analyses and observations show that Africa is confronted with a true challenge in regard to development finance. Each country must continue following policies that promote financial deepening, policies which have revitalized financial sectors that faced many difficulties in the past. However, because the overall situation has radically changed in the years since the first financial sector reforms were launched, today it is clear that countries must reformulate and implement comprehensive national development agendas based on the situation as it stands today. This means that countries must take account of current economic and social difficulties faced by citizens, keeping in mind the current capacity of existing financial infrastructure.²⁷

203. The formulation of national development policies would be facilitated by an international initiative headed by states and specialized development assistance agencies to create a framework in regard to development finance. This set of initiatives would constitute an Action Plan that would support development finance in Africa, bringing together various institutional and conceptual components to facilitate a coherent national policy.

204. Today, international support is necessary to help respond to four sets of development needs. Steps to do so are described below:

1. An internationally recognized definition concerning the specificity of development finance, relative to financing for other aspects of the economy, is needed. This will help governments implement best practices and better articulate their own conceptual frameworks for development finance.
2. Capacity-building measures, similar to those designed for banks in the 1990s, are needed to reinforce and increase DFI and regional DB capacities.
3. Mechanisms are needed to link banks to DFIs, particularly to help the former increase their capacity to provide term finance through transformation.
4. Best practice is also needed for development-oriented commercial banks engaged in financing "difficult" economic sectors, in order to ensure sustainable financing practices.

²⁷ A comprehensive Action Plan would indeed include other components than those mentioned here. See, for example, the proposals made by the World Economic Forum (World Economic Forum, 2006).

205. These four proposals will be examined in greater detail below.

Establishing the Specificity of Development Finance

206. Before the reforms of the 1990s, the specificity of development was that it originated from external sources and on-lent to development projects. In general, mobilizing domestic resources was overlooked since such resources were considered to have limited importance in economic growth, based on the theory of monetary and financial neutrality. In the 1990s, the financial sector reforms changed this approach by supporting that there was but one single category of financing, based on one single mechanism (the market) that could encourage more national savings to increase investment. The primary consequence of this new approach was to say that development finance in itself did not exist separately from market-based finance system used by the entire economy.

207. However, today the perspective has again changed. Development finance is recognized as being an exception to the rule, distinct from market-based finance, even if it is accepted that eventually development finance must evolve toward market-based mechanisms in the future. The new approach thus positions development finance as a well-defined, legitimate exception to the rule.

The Market-Based Approach

208. The financial sector reforms of the 1990s primarily attempted to establish an approach to finance based on market mechanisms. Essentially, this meant reinforcing financial markets (buying and selling stocks) and other institutions, such as banks, which use markets (supply and demand for credit). This mechanism was viewed as the most rational approach and best adapted to efficiently allocate available financial resources in a development economy. According to economic theory, market mechanisms function “naturally” without the need for external intervention; it optimizes economies by allowing them to reach equilibrium as supply adjusts to meet demand and vice versa, through the mechanism of price variation. In the case of the financial sector, the price is indicated through the interest rate. This approach differs from the former approach in which government intervention (or human decision) determined the allocation of resources. Thus, the adoption of a market-based approach eliminated the basic *raison d'être* of Development Banks and other institutions which had been created explicitly to allocate credit and other financial resources.

209. Passing from interventionism to market-based mechanisms made it possible to restructure the financial sectors. The reforms went faster and were carried out more completely in African countries since they were also liberalizing their entire economies through privatization and tariff reduction programs.

210. The advantages of the market-based approach in financial sectors were first disputed towards the end of the 1990s with the early success stories in rural microfinance. The economic utility of microfinance projects indeed posed a problem for the market-based approach: banks had not been able to open up branches because potential returns were insufficient to cover the costs. How then had these subsidized MFIs been successful? The answer was that the market mechanism does have certain exceptions: in situations in which external circumstances impede the optimal equilibrating of supply and demand, public intervention can be justified.

The concept of "market failure"

211. The term "market failure" is used to describe a situation in which the market mechanism for a good or a service fails to function properly, resulting in an equilibrium that does not reflect the true value or price of the good or service. Box 8.1 lists various cases in which market failures can occur.

Box 8.1: Types of Market Failures²⁸

Collective goods: There are certain goods that are considered as "useful" to the community as a whole. However, supply and demand for the good may remain weak, causing the market price to remain high. At the current level of demand, economies of scale are not possible, and the price of the good remains high. The high price keeps demand low. If, however, the price of the good could be lowered, demand would greatly increase, allowing the market equilibrium to be reestablished. Typical examples of this type of market failure are the environment or low-income housing in Africa.

Externalities: Some goods and services have consequences (externalities) which generate costs, collective costs, that are not taken into account in the price. In this case, the market price for the good or service does not reflect its true cost and is thus undervalued. A commonly cited example is that of environmental pollution created as a bi-product of industrial production: the price of the good produced does not taken into account the costs of the environmental damage generated during the production process. In order to correct this type of market failure, funds, such as the Global Environmental Facility (GEF), which subsidize environmental protection measures for the public and private sectors, have been created.

Access Barriers: If market entry is difficult, actors who are already in the market have a strong advantage, or quasi-monopoly. The market price of the good or service reflects the producers' position of force thanks to limited competition, as opposed to the true value.

Information Asymmetries: Similarly, if actors do not have the same (symmetrical) information to negotiate a price, market failures may exist. Negotiating the price of credit is a good example, in that the price of credit, or interest rate, may not accurately reflect the risk of the project to be financed since information is asymmetrical – only the credit applicant has complete information about his or her project.

Moral Hazard: Market actors are sometimes willing to finance high-risk projects because, in case of default, an external structure has been set up to cover their

²⁸ Economists discuss the advantages and inconveniences of the market failure approach as a way of justifying state intervention in developing countries in Cowen and Crampton, 2006. 26/06/2006 (Vers. 3.1)

losses. This type of situation is called moral hazard, since the decision-making actor does not bear the consequences of his or her own decision. This market failure often appears when Guarantee Funds, which can facilitate lending to SMEs, are set up.

If possible violations of an agreement signed between actors cannot be detected and sanctioned without increased expenditure, the actors run an important risk, which is not reflected in the price that they negotiate together.

212. Market failures are used to justify (temporary) public intervention, either by the State or by an international donor, to correct the suboptimum allocation of resources. However, the use of the concept of market failure in no way implies a return to a system of public interventionism, rather it promotes a spot-treatment for specific market distortions.

Market Failures in Financial Services

213. The concept of "market failure" can be applied to the way in which financial services themselves are exchanged through supply and demand. In Africa, despite market-based reforms, financial sectors still do not yet function like real markets. In this regard, certain market failures in the financial sector are common to all developing countries, while others are specific to Africa. The latter are discussed below:

- Information asymmetry is very prevalent due to communication difficulties and the obstacles to collecting information.
- The opening of branches in rural areas entails costs that cannot be reflected in the price of credit
- Transaction costs are very high due to (i) administrative costs, which are necessary but expensive, related to compliance; (ii) legal costs related to non-performing loan recovery.

Compounded Market Failures in Africa

214. Development finance is particularly difficult in Africa because there are both market failures related to specific economic sectors, as well as market failures related to financial services. This sort of "compounded" market failure is particularly difficult to overcome.

215. The combination of the two market failures generates a set of specific and complex risks that do not exist for the standard financing, and which are not easily covered by standard risk-covering mechanisms.

216. This is the case, for example, in Morocco, where renewable energy projects and, in particular, solar energy projects have difficulty finding financing for two reasons. First of all, the solar collector market remains underdeveloped because of certain market failures, such as asymmetric information (consumers are not aware of the benefits or even existence of

solar energy alternatives). Secondly, the credit market related to the acquisition of solar collectors by the households is also affected by market failures.

The Specificity of Development Finance

217. We would like to approach the question of development finance from the perspective of helping correct market failures, both sectoral and financial. According to this approach, development finance is not defined by the category of financial institution which provides it; rather, the term development finance applies to finance made available in situations where standard financing mechanisms are not sufficient to meet the complex risks generated by market failures. Development finance thus requires particular financial engineering. By this logic, one can go as far as saying that the nature of the institution which accords development finance is not important; what counts is that it has the capacity to engineer finance mechanisms in order to properly take into account the risks generated by market failures.

218. As the example in Box 8.2 shows, engineering development finance solutions involves a proper appraisal of a projects' needs (in terms of liquidity and risk), and the distribution of risks between the various actors and systems that will intervene in the operation.

Box 8.2 Financial Engineering for Thermal Solar Energy

In order to be able to finance an extensive campaign to equip households with thermal solar collectors, an appraisal of the risks created by the market failure must be carried out which takes into account the following risk factors: (i) for households, lease agreements with option to buy must cover the repossession of the material in case of nonpayment (difficulty in implementing debt recovery contracts); (ii) for rent collection, a collection agreement must be signed with another company which provides an indispensable product or service, such as the electricity company (creation of governance and rules); (iii) for the feasibility of the entire venture, the monthly rent for the thermal solar collector to be paid by households must be fixed at a level similar to that of energy bills previously paid by the household.

The Development Finance Matrix

219. If development finance is approached from this angle, a matrix can be designed which crosses existing market failures within an economy with the various actors capable of providing development finance. This matrix will thus provide a holistic approach to the question of development finance, wherein all possible sources of finance are sought out for a given field of development.

220. Below is an example of how this matrix could be used to help finance a common market failure – low-income housing. In this example, five different actors could participate: development-oriented banks could provide financing for low-income housing in rural areas, for example; commercial banks could

provide credit for buyers; regional development banks and financial markets could help establish mortgage markets and bond securitization.

	Rural Areas	Low-income housing	Infrastructure	Environment	Social Economy	...
Commercial Banks		XXX				
Development-oriented banks		YYY				
Regional DBs		ZZZ				
DFIs		AAA				
Foundations						
Financial Markets		BBB				
...						

Conclusion:

221. Far from being perceived as a return to state interventionism of the past, this approach to development finance allows for punctual public intervention in a particular domain to correct the existing market failure, mostly by leading the way for the private sector to step in afterwards.

222. Development finance must also be viewed as financial engineering, which aims to decrease risk exposure by distributing risks to various institutions and actors of the operation.

223. Viewed in this way, development finance may well constitute a new domain in and of itself, deserving the official attention of States as well as international donors.

Legitimizing and Reinforcing DFIs

224. Today, it seems that the priority for financial sectors is not only financial deepening, which was one of the important objectives of the 1990 reforms, but also financial widening, which would seek to incorporate non-bank institutions and organizations that have been largely ignored since the 1990s, but which play important roles in providing development finance.

225. Among the non-bank development finance institutions, certain categories – foundations, markets, microfinance institutions – already receive attention from the international donor community and others, who are ready to support and reinforce their programs. However, DFIs, the successors of DBs, still seem somewhat forgotten, even though they have been responsible for establishing new approaches and mechanisms for meeting national financial needs, which have not been met by banks. Modern DFIs, primarily Development Corporations, have clearly differentiated their modes of action from that of banks: whereas both types of institutions may provide term finance, DFIs have additional roles to play both *ex-ante* (financing of feasibility studies, partnership brokering, and project promotion) and *ex-post*

(providing services once the project has already been launched, such as Technical Assistance.)²⁹

226. The role of national DFIs in African countries could be reinforced if good practice could be identified for governance, management, and operations and used to create a standard legal framework for DFIs, similar to that created for banks. Also, it seems DFIs could benefit from a standard mission statement concerning their development objectives. This process of standardization – uniform statute, uniform legal structure – would help reinforce their legitimacy and serve to streamline their operations, as they would have the benefit of knowing other similar organizations' successes and mistakes. Just as with banks, this type of standardized framework would not serve to replace internal management and operational rules, but supply a system of benchmarks applicable to DFIs in general.

227. Once these general benchmarks are established, a pan-African auditing commission could be launched in order to determine, among other things, (i) the recapitalization needs of each DFI; and (ii) an appropriate resource allocation policy for each DFI in relation to local banks (see below).

228. From this perspective, regional DBs should also be reconsidered and reinforced in light of recent economic evolutions across the Continent. This reflection would help determine how the role of Regional DBs could shift from that of traditional development bank to regional catalyst for development finance. This shift would encourage other actors, notably banks and multinational corporations through operations such as BOT, insurance, etc, to participate more actively in the development finance paradigm.

Coordinating Different Actors

229. The mobilization and allocation of long-term resources will be all the more important in each country if the various actors implicated in providing development finance are aware of their mutual relations and interdependence. Therefore, it would be useful to organize National Round Tables on the questions of development finance where banks, national DFIs, regional DBs, microfinance organizations, NGOs, and foundations could all participate. The proceedings of such Round Tables would help Governments formulate their national policies concerning development finance and identify willing actors and useful mechanisms.

230. In addition to the dialogue between actors, the objective of National Round Tables could be to develop a Charter, like the South African financial sector has done, which identifies sector-wide objectives, inventories the fields of intervention of each actor, and identifies links between actors and domains.

²⁹ The question and problems posed by having the State as a major shareholder will not be discussed here (Yaron, 1992).

Encouraging Banks' Participation

231. In Africa, even in common-law countries, banks still remain the principal, if not unique, source of capital, and the sole institution capable of mobilizing resources. Admittedly, development finance policies which formerly encouraged banking intermediation are today promoting disintermediation, where companies seek term finance in financial markets or from other companies, rather than turning to banks for credit. So far, however, financial markets in Africa have limited capacity, so banking intermediation remains central.

232. The same is true in countries outside of Africa as well – banks continue to be the central actors in providing development finance. Even in countries where DFIs operate, banks are still the key actor in mobilizing resources and transforming liquidity. This is how it should be, since ultimately, development needs should be primarily met by resources mobilized domestically as opposed to a situation of dependence on subsidized resources from international donors.

Recalling the Strategic Importance of Transformation

233. Financial sector reforms in sub-Saharan Africa did not include incentives for banks to engage in financial transformation. Today, this can be achieved by establishing policies of close cooperation between banks and DFIs. Banks should be the first institution referred to for term finance needs; DFIs should be placed on a second-tier level, refinancing banks with medium to long-term liquidity resources, and gradually phasing out their participation as banks develop their own capacity to provide liquidity and cover the risks associated with term finance. This process of phasing out would be arranged according to each bank's capacity, but in every case, the end point would be to have banks fully autonomous in providing term liquidity, if not for risk as well.

Box 8.3: Liquidity Transformation

Banks cannot lend on the medium or long-term on the basis of its medium to long term resources only. This is because 1) these resources are weak in general, and 2) even resources that are entitled medium to long-term are in fact deposits that can be withdrawn at any time by the client. Therefore, banks must learn how to transform short-term deposits into stable resources for long-term lending. As long as banks receive long-term resources from external sources that can be on-lent to clients, it will not seek to develop its transformation capacity, which requires tying up a portion of their short-term resources for long-term appropriation. Capacity for transformation, as well as for long-term risk management, must be increased gradually. So far, financial sector reforms have not sought to increase banking capacity in this way.

234. In the Zone Franc, medium to long-term refinancing windows could be provided to banks by Regional DBs.³⁰ Banks receiving refinancing could on-

³⁰ The Central Banks in the Zone Franc have a medium-term window that functions in such as a way as to exclude SMEs in general. Central Bank intervention, which is normally limited to 26/06/2006 (Vers. 3.1)

lend to development sectors; one of the first fields that could be financed in this way renewable energy. This mechanism could replace credit limits which provide medium-term lines to banks directly, and do not require that they increase their own capacity to provide term liquidity or cover long-term risks.

235. Thus, in order to increase banking transformation capacity across the Continent, a series of pilot partnerships could be set up between international donors, DFIs, and banks. Through these partnerships, resources provided by donors to DFIs would not be used directly by DFIs, but rather on-lent to banks to refinance medium to long-term credit operations. Providing term finance to banks under these terms would help establish a gradual phasing out of DFI support, allowing banks to increase their own capacity for transformation.

236. Training programs could also be included in these partnerships. Especially in the area of information technology management for balance sheet operations, credit risks, and other aspects, training could increase banks' capacity to lend on the medium to long-term.

Creating an Information Warehouse for Development-Oriented Banks

237. Development-oriented banks, whether they are former development banks (BNDA, BACB, etc...) or recently created institutions (BTS, BMS, BRS), have a rather difficult task to fulfill in that they must make their development-related activities compatible with their long-term sustainability and profitability objectives. Additionally, they must do so within the legal banking framework and the constraints which that entails, i.e. compliance with banking laws.

238. It could be useful to undertake a detailed inventory to create an information warehouse on good practices for development-oriented banks. In particular, case studies could consider the ways in which banks manage to both comply with certain banking regulations (provisioning, risk management, etc.) and be able to take the risks that are necessarily associated with development projects. Such studies may lead to arguments for easing some of the constraints imposed by current banking legislation.

239. The objectives of such a warehouse would be to first establish a set of best practices on the subject. Banks wishing to engage in development finance (refinancing a microfinance network, for example) could then refer to best practices to understand the potential problems, specifically in regard to likely problems with banking laws, and how they may be resolved. Secondly, the warehouse would accumulate information on obstacles faced by these banks, and thus could serve as a platform for launching studies considering the types of modifications that could be made to banking laws to facilitate the participation of banks in development finance across the Continent.

240. Within development-oriented banks, it would be useful to examine in greater detail the model forwarded by the Banque Régionale de Solidarité, particularly in regard to the way in which it finances the social economy. Comparative studies regarding whether this type of model could be used in other regions in Africa could be undertaken.

Conclusion

241. The formulation and the implementation of national development finance policy in each African country seems inevitable and necessary considering the number of financing needs that are still unmet, particularly in sectors which are imperative for promoting the country's future economic growth and poverty reduction.

242. The formulation and the implementation of national development finance policy in each African country seems inevitable and necessary considering the number of financing needs that are still unmet, particularly in sectors which are imperative for promoting the country's future economic growth and poverty reduction. To form a coherent and effective national development plan, countries must take account of current economic and social difficulties as well as the current capacity of existing financial infrastructure.

243. Development finance must first be recognized by the international community as being a legitimate form of economic intervention and placed on the political agenda, which was not done during the 1990 financial sector reforms. Legitimacy for development finance will be reinforced by accepting the idea that the government may (temporarily) intervene in sectors that are normally regulated by free markets, in order to correct certain perversions or market failures, to facilitate eventual private sector, market-based participation.

244. Second, it is necessary to recognize all of the potential actors that can provide development finance as such and to view them as legitimate participants in achieving development objectives. In particular, Regional Development Banks in the Zone Franc, and national DFIs for other African countries deserve to be reinforced and, if necessary, recapitalized in order to play the role needed of them. Relations within and between these institutions and other actors providing development finance would greatly benefit from being formally organized through periodic meetings.

245. Third, development finance will only be provided on a sustainable basis if national banking structures increase their capacity to provide term finance. In order to do so, banks need to increase their capacity to perform transformation of short-term resources. This process must be strongly encouraged and supported throughout Africa, notably by initiating partnerships between national and regional DFIs, donors, and universal banks.

246. Lastly, it will be useful to collect a representative sampling of experiences of development-oriented banks with regard to financing development initiatives, from which best practice can be identified. This will be particularly helpful for banks to understand how to manage the high risk levels associated with development finance and, at the same time, ensure sustainability and adequate profit margins. Also, recommendations could be made concerning modifications to the legal framework governing these types of banks that could help facilitate banks' participation in development finance.

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