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The role of a Public Development Bank: Can a bank be both profitable and efficient while taking an active social role?

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1. Introduction: Characteristics of Development Banking

We are often asked by our development bank clients around the world – how we do know if what we are doing is in fact development lending rather than commercial lending?

This is not a straightforward question.

Public Development Banks (PDBs) are established with a mandate to be more than just financial institutions. They are designed so that certain social and economic objectives drive their operations. They are to pursue positive externalities in balance with profit, rather than the latter alone.

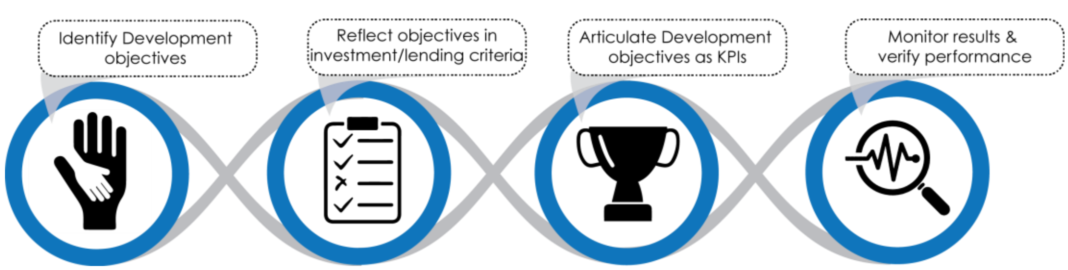
Ultimately, they are vehicles for promoting national or regional economic development.

Since development banks exist to meet a public policy need, they are designed to deliver to their shareholders (usually government or governments of multiple countries) a return on investment in both financial and socio-economic development terms. In other words, they must seek to generate a financial return as well as a "development dividend". Whether a PDB is providing long-term financing to, or facilitating the financing of, projects that generate a development impact, it is critical the bank remain viably and sustainably managed, respecting its nature as a financial institution.

Putting 'development' into development banking

Many PDBs have development mandates already stated in their articles of incorporation, while others have their development objectives mandated through their governing authority's relevant development strategies and plans. The most successful development banks we have worked with have strong internal processes that embed development considerations into credit decisions and undertake performance monitoring on a transaction and portfolio level. These banks will intentionally seek development impact as part of their lending or investment criteria. Macro-level development criteria are then incorporated at the institutional level through the PDB's policies. Coherence between these two levels is achieved by ensuring the inclusion of development objectives in the key themes of a bank's key performance indicators (KPIs). An effective bank will monitor its results as it extends loans or makes investments, and it will verify its performance in achieving these objectives. This is summarized in Figure 1.

Figure 1: Ingredients for Successful Development Banking



Operating in Market Gaps

Even though our clients are based all over the world and face vastly different political and socio-economic challenges, they are all motivated to fill defined market gaps and to be additional. Irrespective of the political and socio-economic context, market gaps arise for two reasons:

1. Private sector financial institutions' *unwillingness* to accept certain risks that they deem too high or that have relatively high transactions costs.
2. Private sector financial institutions' *inability* to accept certain risks or to fund certain tenors because of their own internal limitations.

Hence, a PDB seeks to operate within market gaps. Its intention should be to mobilize other financial institutions and investors to catalyze the supply of finance, while addressing unmet financing needs in the real economy.

Market gaps are not static and nor should they be; they change over time and require regular review and testing. Ideally, a PDB's time in any one market gap would be temporary, as it would enter the gap and achieve something that would not have occurred without it (i.e., strengthening the bankability of those on the demand side, and demonstrating to other financial suppliers the viability and profitability of entering the market).

Related to this is the concept of 'additionality'. PDBs seek to not only fill market gaps, but to be additional. This means that because of PDB involvement in the financing of a project or transaction, the project got financed. In other words, the PDB did not crowd out private sector sources of finance and, if not for the PDB's involvement, the project would not have been financed.

Info Box 1: Supply-side constraints

Generally, a lack of financial services being provided by private sector sources causes market gaps to occur on the supply side. Common examples of market gaps relate to:

- ✓ long-term infrastructure projects, due to the availability of long-term liquidity;
- ✓ strategically important companies, such as major exporters, because credit gaps and funding gaps exist in foreign currencies;
- ✓ under-served sectors, such as small and medium-sized enterprises (SMEs) or rural activities in geographically isolated areas; and,
- ✓ new green technologies with a less understood risk profile.

PDBs often enter market segments where commercial banks are not prepared to lend. In these circumstances the PDB can help develop and deepen financial markets by proving to the local financial sector the viability of new financial instruments or new sectors/clients.

Our highest performing PDBs will regularly undertake market gap analysis. Building on this, they will develop a clear strategy and road map detailing how they: will enter the market gap; will operate within the gap; and when they will exit it. This strategy would then be linked to specific performance expectations around development outcomes and impacts. A PDB should regularly update this exercise and integrate the results of this update, in conjunction with "development lessons learned" through its activities, in an updated strategic framework.

Even with a mandate to generate a development impact, the deemed social value of a financially non-viable project does not justify involvement by the PDB. In cases of "national interest," where costs exceed direct benefits, the government should turn to the national budget for funding. We have found ourselves reminding our PDB clients that they are only one of a variety of instruments available to the government. Thus, it is important for the PDB to be strategic and to remain connected. High performing PDBs continually dialogue and engage with stakeholders from various spheres of society, such as government, the private sector, civil society groups and organizations, international donors and counterpart banks etc.

Info Box 2: Demand-side constraints

PDBs can also have an approach to address non-financial gaps and stimulate demand. For example, SMEs may need business advisory support, as well as capital, to grow. A PDB that offers training and advisory services to strengthen and build SME capacity could help improve the creditworthiness of the SME and make it more eligible for commercial bank financing. Other ways we have seen our clients respond to demand-side deficiencies include:

- ✓ partnering with local business support services to offer technical assistance;
- ✓ establishing entrepreneurship programs and incubation centers;
- ✓ facilitating knowledge sharing workshops and seminars; and,
- ✓ investing in technologies such as mobile money that enable disconnected or rural entrepreneurs to access financial services.

2. Defining Development Impact

Playing a social role

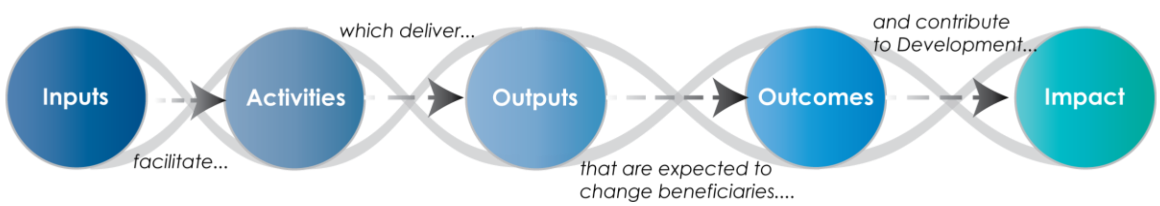
A healthy PDB is one that finds a financially sustainable way to effectively balance the needs of all stakeholders - shareholders (governments), clients, private sector intermediaries and taxpayers - while achieving its development objectives. Yet, the social role played among different PDBs will vary and for a given PDB may change over time. The following figure summarizes some of the key areas where PDBs can track and measure their impact.

Figure 2: Areas PDBs can track and measure their impact

Understanding development in a logical framework

Even though many of our clients are accustomed to pursuing social–economic objectives and playing a social role in their economies, they often struggle with defining the 'development' aspect of their development banking operations. For a PDB to know whether it is successful it needs to define what 'development' looks like in terms of its inputs and outputs, as well as the outcomes and impacts expected from these. This is known as a 'Results Chain'. A Results Chain is a conceptual framework demonstrating that inputs (provided by a PDB) are translated into specific activities (and products) which are intended to result in changes to stakeholders' conditions and cumulatively over time will have an effect on the economy at large. Figure 3. illustrates a generic Results Chain.

Figure 3: A Results Chain



A "Theory of Change" completes the results chain by presenting a full narrative, or 'theory,' describing how a sequence of events are expected to lead to desired outcomes and specific developmental impacts. It establishes the logical framework connecting what a PDB does, why it does it, and how it contributes to defined development outcomes. It builds on a results chain to describe specifically how a PDB's operations are intended to fulfill the development agenda of its shareholders. To the extent that a PDB's development mandate is captured in its strategic planning activities, the Theory of Change should align with the PDB's strategic plan and serve to reinforce the bank's vision. Often, a PDB's definition of 'impact' will echo its vision statement while 'development outcomes' will tend to be reflected in the bank's strategic objectives.

Furthermore, a key element of successful development banking is maintaining cost-efficiency amid long-term activities and ambitions for a development impact. PDBs incur various costs while carrying out their mandates. Finding the optimal balance between the cost of inputs and return from outputs is essential. Developing a Theory of Change will position a PDB to better understand where it sits in this balance, as it forces the bank to identify and articulate exactly what it is putting in and what it should be getting out.

Hence, a Theory of Change can help an organization establish and communicate its development impact both internally and externally to key stakeholders. It fulfils many organizational needs. Repeatedly, our clients will ask the question "are we doing the right thing?" when designing new products or programs. Developing a Theory of Change can be a crucial conceptual tool in determining this. Integrated within a broader Monitoring and Evaluation framework, it will:

- Establish what should be measured and reported;
- Communicate to stakeholders the rationale for chosen activities and how these activities lead to development outcomes; and,

- Prevent unrealistic expectations of impact directly attributable to the PDB's interventions.

Yet, in surveying members of the Association of Development Financing Institutions in the Asia and Pacific (ADFIAP), we found that only 22% of Development Banks use a logical framework and only 11% use a Results Chain when defining their impact, even though 78% reported on Development Impact and 100% document how their programs (both lending and non-lending) are intended to contribute to economic and social development. Info Box 3 provides further key findings from the survey of ADFIAP members relating to how they measure their development results.

Measuring Development Impact

Defining development in development banking is one challenge; measuring it is another. While a Theory of Change establishes a conceptual link between the 'what', 'why', and 'how' of a PDB's operations, our clients have experienced its full value when it is posited in a full framework for monitoring and evaluation (M&E). A well-articulated framework, with accompanying tools and procedures for capturing relevant and accurate data, will guide a development bank in its decision-making, as it balances financial returns with development impact. Designed well, it will add value to the operational effectiveness of the bank — supporting operational processes and decision-making. Hence, defining development, understanding the costs and qualitative and quantitative returns of it, and establishing a coherent framework to capture this information is a priority for our PDB clients that are in pursuit of international best practice.

Info Box 3: Indicators and M&E practices among ADFIAP members surveyed in 2016

Of Development Impact Indicators selected by PDBs:

- 88% are linked to specific Government policies/determined by Government
- 63% are linked to specific products/programs
- 38% are influenced by donors/financiers
- 25% are standard macro-economic indicators
- 25% are influenced by best practice.

Of the PDBs surveyed:

- 30% measured anticipated results only
- 70% measured actual results
- 80% commission impact evaluations
- 29% publicize the results

An M&E framework provides a foundation for measuring the extent to which a PDB is successfully impacting development. Such a framework establishes: (a) the extent to which a PDB's activities support the achievement of the development outcomes stated in its Theory of Change; (b) the indicators that are required to demonstrate its performance; and (c) the required data, data collection methodologies and roles and responsibilities for collecting, analyzing and reporting, which feeds into the analysis required to address these key evaluation questions.

PDBs that adhere to world-class practices will define strategic themes (relevance and efficiency) and strategic perspectives (clients and beneficiaries, finances, internal process, and organizational learning and growth) in their creation and implementation of monitoring and evaluation mechanisms. Central to this is the selection of appropriate performance indicators and measuring performance against these indicators on an ex-ante and ex-post basis. Reporting on an ex-post basis helps a bank understand what has worked and what has not, so it can incorporate these "lessons learned" into future business and strategic planning activities. It also allows the bank to verify whether the results of its activities meet the expected outcomes and impacts defined in its Theory of Change. Finally, an M&E framework assists PDBs in overcoming the challenge of 'attribution.' This refers to the difficulty of determining whether the results observed in target beneficiaries or on the national level can be truly attributed to the activities and interventions of the PDB.

Case Study: A PDB with a successful M&E framework

A sound M&E framework need not be overly complicated. CABEI has excelled in creating and implementing a coherent system for measuring its development impact. Five simple features of its system give rise to its strength and effectiveness:

1. Its system is grounded in its **vision and mission** and reinforces its strategic planning activities. It uses the Balanced Scorecard tool to convert the elements set out in its Institutional Strategy into a group of performance measurements (perspectives);
2. **Performance indicators** are established in accordance with the characteristics of the action they are measuring. As such, it constitutes a concrete qualitative or quantitative expression of what is expected to be achieved for a specific established goal;
3. Indicators are relevant to their expected Results Chain (i.e., **Theory of Change)** and include input (physical, human and financial resources used in carrying out the actions), output (quantifiable services produced and/or provided by the interventions), effect (progress in achieving the objectives of the actions), and outcome (derived from results and achievements on a group of clients);
4. Each indicator is **evaluated quarterly and bi-annual** to determine its progress level in relation to its annual goals; and,
5. An **annual report** reflecting the behavior of all indicators against goals is prepared and considered in the following year's business planning cycle.

The principle of internal control is entrenched in well-performing commercial banks through the segregation of duties and through having an independent department of internal audit to evaluate the overall internal control system. Some of our clients have established a dedicated M&E unit, and thus approach performance assessment, particularly in terms of Development Impact, on a level of analytical rigour akin to portfolio management from a financial perspective. This unit not only ensures that tools, processes and procedures are integrated within the PDB's day to day operations and performance assessment processes, but they are also responsible for evaluating ex-post the bank's 'development return' and making recommendations for improvements to the bank's practices for 'development management'. Undertaking periodic evaluation activities and reporting on an annual basis on a range of indicators, the M&E unit of a PDB will observe trends in performance over time and validate the extent to which the PDB is delivering on its intended development results.

Case Study: Less successful M&E practices

Job creation is a common development objective set by national governments for their PDBs. As such, number of jobs supported by PDB investments is a popular metric for assessing the development impact. However, many PDBs only reporting *ex-ante* the expected number of jobs its investments will support without a verification system to monitor whether any jobs were created. Thus, their claims of development impact reflect the potential jobs created through their efforts rather than their true impact. Furthermore, since it can be challenging to collect data and attribute ‘impact’ level results to institutions’ activities it can be tempting for a PDB to focus too heavily on measuring job creation, which is comparatively easy to determine, at the expense of other useful indicators of demonstrating development impact.

Case Study: Risking Reputation

Working with clients to strengthen their M&E practices or build a development impact framework, we have encountered the full spectrum of best to worst practices. One example of poor practice is worth highlighting as it is not uncommon and it poses significant reputational risk. This practice is to publically report on the ‘anticipated impact’ of funding/investment in a project based on forecasts, as though they were certain. Later, when these forecasts are not met, the PDB risks considerable reputational damage. Worse yet, we have seen PDBs profile the new projects in their annual report and publicize the future impact of their investments, only to have the project turn into a non-performing loan within a year.

3. Remaining Profitable

Measuring true profitability at a development bank

The concept of profitability in a PDB should be more straightforward than social or economic impact, but it is not.

First of all, financial sustainability is a term that is used by PDBs, but it may mean different things. Some PDBs might seek a return on capital equal to the government’s long-term bond rates, while others might be satisfied with a break-even position.

Second, how PDBs measure profitability may differ. Some PDBs, although unregulated, follow international or national rules that apply to commercial banks on provisioning for expected and unexpected losses, while others choose to have more forbearance with NPLs and, therefore, may not reflect the economic reality of repayment in the provisions. As a consequence, actual profitability could be overstated. Best-in-class PDBs take a sober view of the NPLs to determine the main reasons for the non-performance: Quality of credit underwriting? Political interference? Borrower perception that the PDB is “government”.

Third, there is a common view that subsidies are used by PDBs to address market gaps. But, the concept of a subsidy can mean two things: a) lending at rates that are below your costs plus risks; and, b) lending at rates below those available from other private financial players in the market. Point a) will lead to an erosion of capital, but subsidies defined as being below the market can have a useful role.

However, it is not axiomatic that development banking involves subsidies. In the past, our clients have been surprised to learn that a PDB which is not offering concessional prices may well be fulfilling its development impact objectives. Indeed, there are examples, world-wide, where PDB's interest rates are higher than commercial banks and yet these banks may still be additional and generate positive externalities. This apparent misconception comes back to the importance of identifying the market gap and analyzing what the real needs are. Here, the PDB's use of interest rates that reflect the underlying risks, even if they are higher than the commercial banks, may be important not only for securing the PDB's financial sustainability, but because a central element of a PDB's *raison d'etre* is to crowd in the private sector. If a company/sector flourishes, there will be a signaling effect to the private sector of a potential new market segment. The PDB would thus: 1) support the development of a viable early stage company or nascent sector; and, 2) encourage the growth of the local financial sector.

Finally, PDBs need to focus on Economic Capital and Strategic Planning for long term financial resiliency. This includes stress testing multi-variate scenarios to their credit and market risk exposures (for example, imagining a 15-20% devaluation along with a sharp drop with commodity prices and ensuring sufficient capital is set aside for such risk events). Doing this will help a PDB ensure it has sufficient strength and wherewithal to support its clients when they need it most. This relies on the periodic capture, measurement, monitoring and reporting of credit and market risks, and the management of these against acceptable thresholds determined by a Board of Directors. Thus, it turns a "Risk Appetite" statement into a management process that determines which economic or political developments might be escalating and emerging risks, not currently captured by ratings. Moreover, it contributes to a new view of portfolios, improved underwriting analysis, and institutional cultural changes.

4. Conclusion

Can a PDB be both profitable and play a social role? The answer is categorically – yes. In order to do so, a PDB must set itself up to pursue each objective with excellence and both in balance. In seeking a development impact, it important for a PDB to establish and integrate a coherent M&E framework which articulates a Theory of Change, specifies development indicators, and includes reporting tools and processes into its performance management. Meanwhile, the PDB needs to operate as a true financial institution that makes decisions to ensure its financial sustainability. In doing this, it must adhere to best practices in risk management, capital allocation and credit / lending procedures.

Not only can a PDB do both, it must do both. It requires navigating between its day-to-day operational demands and higher-level strategic thinking about its context and operating environment, including what tools it should use, what it should offer, and with whom it should partner. The objectives of profitability and social impact are not in conflict, but do require strong leadership, clarity of focus, solid analytical frameworks and unflinching discipline to monitor and evaluate both financial and development objectives.