Key findings

Effective Development Banking: Loans or Guarantees?

Eduardo Fernández-Arias
(visiting research fellow at INSE, Peking University)
Jiajun Xu (INSE, Peking University)

PEKING UNIVERSITY
Institute of New Structural Economics

This overview is published in the framework of the International Research Initiative on Public Development Banks working groups and released on the occasion of the 14th AFD International Research Conference on Development

THE VISIBLE HAND:
Development
Banks
in Transition

National Development Banks (NDBs) are often unclear about which financial instrument to use and tend to offer casuistic justifications for their choices. This research assesses the pros and cons of National Development Banks using loans, versus loan guarantees, and offers analytical guidelines to help them decide how to assign financial instruments to credit support programs to maximize development effectiveness. There is a role for each instrument.

Objectives and research questions

The paper's analysis makes it explicit that the role of National Development Banks (NDBs) is to support credit for investments with high social returns, meaning investments that would increase aggregate wealth, which the market fails to finance. This generally requires the use of below-market financial terms, and therefore needs to be backed by fiscal resources. The authors propose a sound metric to evaluate performance in terms of the social return of the additional investments a NDB attains given the fiscal resources at its disposal, and use this framework to evaluate the use of alternative financial instruments.

In short, when are loans or loan guarantees most suitable?

Methods

This analysis considers some of the typical market failures addressed by NDB programs, both in the supply of credit (rationing of low-collateral firms and risk aversion limiting financing of innovative and long-term investments) and in the demand for credit (the case of investments with positive spillovers to other firms). The paper first develops stylized models of second-tier lending, with no financial frictions, to derive insights about when and why either a soft funding loan or free partial credit guarantees to loans made by intermediary private banks are preferable. In turn, the authors discuss friction costs and how to extend the analysis to first-tier interventions.

Eduardo Fernández-Arias (visiting research fellow at INSE, Peking University), Jiajun Xu (INSE, Peking University)

Results

The analytical evaluation yields a rule of thumb, in which the suitability of financial instruments depends on the type of market failure they are trying to address.

Loan guarantees are generally preferable to loans to address credit supply failures. In the case of low-collateral restrictions, because loan guarantees are selective instruments activated only as needed, while funding loans are blunt, distorting the cost of capital and spending fiscal resources in every loan. In the case of risk-averse lenders, loan guarantees are a more efficient incentive mechanism because they actually reduce risk by selectively enhancing repayment when it is low.

In contrast, credit demand failures due to spillovers call for soft loans to boost private investment profitability head-on.

The study also brings the analytical framework to bear on the case in which second-tier lending becomes onerous because profit-seeking intermediary banks cannot be disciplined, and first-tier direct operations are manageable. For example, concerns with moral hazard associated with second-tier loan guarantees may favor the use of direct loan guarantee certificates to borrowers. Given the NDBs' superior capacity to bear risks, direct lending may be the best way to finance risky projects (rather than indirect loan guarantees). This is especially the case when direct loans can be made contingent on investment returns so that NDBs receive a share of the gains of high returns.

Recommendations

This research suggests three steps for a sound financial design process, and as a benchmark to test National Development Bank practice:

- ➔ **Identify the market failure justifying each program**
- ➔ **Design a suitable financial instrument based on the rule of thumb**
- ➔ **If direct implementation is preferable, apply the analytical framework to refine conclusions**

The research program "Realizing the Potential of PDBs for Achieving Sustainable Development Goals" is initiated by INSE and financed by AFD, Ford Foundation and IDFC.

Access the research paper
EFFECTIVE DEVELOPMENT BANKING: LOANS OR GUARANTEES?