

# IN-COUNTRY DFIs: PROFITABILITY UNDER STATE OWNERSHIP

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## Abstract

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The credit landscape in commercial private finance is fast evolving as available funds continue to chase for enhanced returns, for optimised risk acceptance. On the other hand, developing countries, and economies in transition continue to grapple with factors such as public debt, widening fiscal gaps often exacerbated by persistent budget deficits. As a result, governments prioritise provisioning of critical public goods, which then leaves a gap in the financing of less urgent, yet developmentally important investments. This gap is often left to state-owned Development Finance Institutions, or DFIs to fill (UNCTAD, 2019), yet success for these institutions has been generally dismissed (Xu, Ren, & Wu, 2019). This paper appraises the continuing importance of DFIs and analyses factors that drive their sustainability, with the state ownership dynamic in mind. A secondary research approach is taken, predominantly applying the document analysis method, i.e., extant literature from reputable sources on the subjects of state-owned enterprises, development finance, profitability of financial institutions, and firm financial structure. The paper concludes that DFIs are still relevant, and that the type and cost of carefully blended capital available to them is a fundamental determinant of effectiveness in the context of the two-pronged objectives SOEs are known to have. A practical framework by which this can be achieved is proposed.

**Keywords:** Development Finance, State-Owned Enterprise, Stakeholder Theory, Public Choice Theory, Firm Ownership, Firm Finance Structure

**Authors' individual contribution:** The Author is responsible for all the contributions to the paper according to CRediT (Contributor Roles Taxonomy) standards.

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## 1. INTRODUCTION

Governments worldwide, particularly those of developing countries and economies in transition are facing ever-increasing competition for resources, amid widening fiscal deficits (UN, 2020). This compels a less-than-ideal prioritisation of available resources towards critical, and often politically important public goods. On the other hand, commercial private finance continues to be availed on a rapidly changing credit risk landscape and often prioritises returns for given risk appetite. This leaves a gap often addressed by what is normally termed "patient capital", typically, and appropriately so, provided through state, or majority state-owned

Development Finance Institutions, or DFIs (UNCTAD, 2019). Unfortunately, these institutions have a chequered history and their success rate is considered dismal (Xu et al., 2019). This paper, therefore, appraises the continuing importance of DFIs and analyses factors that drive their sustainability, with the state ownership dynamic in mind.

Development finance, as an alternative source of investment funds, is a concept gaining widening attention, although a universal definition of the concept itself has not been adopted. Dickinson (2007) views development finance as those inflows that occur between public aid and private investments. This sort of finance is usually provided

by government-backed institutions, although limited cases of varied and mixed ownership exist (Schreiner & Yaron, 2001). Such institutions are commonly referred to as in-country Development Finance Institutions or DFIs. Calice (2013) defines a DFI as 'an institution which is majority-owned by the government and that has an explicit legal mandate to foster economic and social development in a country, sector or target market, mainly by providing investment finance' (p. 3). Consistently with this definition, DFI's often carry a dual or two-pronged mandate infusing commercial outcomes with social development impact (Gyimah & Agyema, 2019). This duality can be seen as an important filler of the gap between private sector finance and national budget allocations. This paper explores the possibilities of making profits while pursuing sub-commercial investments.

In the context of developing countries, a wide range of development needs continue to impose a widening gap between private sector financing interests and public sector budgetary possibilities, thus emphasising the basic importance of in-country state-owned DFIs, or National Development Banks as they are also known. On the other hand, state-owned enterprises, or SOEs are widely known to be riddled with blurred objectives often in conflict with the basic principles of sustainability (Liljebloom, Maury, & Hörhammer, 2019), yet in the context of DFIs sustainable operations remain the most promising answer to the ever-reducing government support. This scenario calls for a strong balance between remaining profitable while attaining the non-commercial development objectives of the state, the shareholder, and this is the focus of this paper.

The basic operating model of a financial institution entails sourcing funds for the purposes of lending and investing for a return, wherein sustainability is additionally supported by re-investing internally generated profits for more returns (Duraj, Imeraj, & Moci, 2013). Invariably, what it costs for a financial institution to raise and retain capital determines what it levies and expects on its lending and from its investments respectively. While free markets, within the context of a regulatory environment (which varies from one territory to the next), determines actively the margins a commercial banking financial institution may achieve, the same may not necessarily hold for in-country DFIs, particularly in developing countries. Generally, a DFI with adequate financial backing from its government may enjoy a low cost of capital, and afford to support a greater deal of pro-development projects (often sub-commercial). However, the ever-decreasing allocations to DFIs from national budgets impose two limitations, the first being inadequacy of capital, the other being increased cost of capital both which lead to impaired ability of a DFI to support sub-commercial, yet pro-development projects. Whilst some DFIs are able to raise capital from the market place, such capital is often on terms that impose the need for operating on full commercial terms, which in itself becomes a problem for the state as an equally important development impact objective gets overlooked. Extant literature does not comprehensively address this conundrum, nor does it offer a guiding framework that DFIs could adopt in order to remain

both sustainable and relevant, and this is the quest for this paper.

The rest of this paper is structured as follows: Section 2 reviews relevant literature, Section 3 outlines the methodology adopted, Section 4 discusses the main findings and Section 5 is the conclusion. References are outlined at the end.

## 2. LITERATURE REVIEW

The origins of in-country DFIs is without a clear trace but generally associated with the period of the industrial revolution (UN, 2005). Although their specific mandate and functions may differ from one jurisdiction to the next, the following are proposed by Pragash (2016) as generic objectives of in-country DFIs:

- Lay foundations for industrialization;
- Meet developmental capital needs;
- Need for industrial and market stimulation and promotion;
- Help small and medium sectors.

A review of missions and objectives of the following DFIs, among others, reflect some resounding congruency; Development Bank of Namibia<sup>1</sup>, Industrial and Commercial Development Corporation (Kenya)<sup>2</sup>, Development Bank of Southern Africa<sup>3</sup>, Development Bank of Rwanda<sup>4</sup>, Bank of Industry (Nigeria)<sup>5</sup>, Development Bank of Gabon<sup>6</sup> and the Banco de Desenvolvimento de Angola<sup>7</sup>.

Key themes enshrined within the missions, mandates, and objectives of these, and many other similar enterprises are:

- Resource/capital mobilisation;
- Contribution to economic, social and industrial development;
- Modernising and supporting local entrepreneurship;
- Achieving developmental impact through the provision of long-term pro-development finance.

These themes can be seen as falling within a rather universal objective of in-country DFIs espoused by UN (2005); 'Filling gaps in the financial sector development'.

From the above, it can then be deduced that in-country DFIs exist to bridge the gaps between public sector funding and commercial private sector finance through capital support towards the socio-economic development agenda.

A distinct feature of DFIs that needs to be emphasised is the ownership by the state; the fact that DFIs are by their nature SOEs places them within a special group of enterprises operating in a unique set up, often characterised by conflicting stakeholder demands and excessive political interest (Aharoni, 2000; Mbo & Adjasi, 2017). From an organisational theory perspective, two theories, among others need to be looked at in order to project more the implications of an enterprise being owned by the state, these being the stakeholder theory and the public choice theory.

<sup>1</sup> <https://www.dbn.com.na/corporate-profile/vision-mission-values>

<sup>2</sup> <https://www.icdc.co.ke/>

<sup>3</sup> <https://www.dbsa.org/EN/About-Us/Pages/About-Us.aspx>

<sup>4</sup> <https://www.brd.rw/brd/brd-profile/>

<sup>5</sup> <https://www.boi.ng/about-us/>

<sup>6</sup> [www.bgd-gabon.com](http://www.bgd-gabon.com)

<sup>7</sup> <http://bda.ao/pt-pt/Sobre-o-BDA/Missão-Visão-e-Valores>

*State ownership and the stakeholder view* – an interesting theory by Freeman (1994) suggests that an organisation's existence needs to be fully aligned to the aspirations of its stakeholders for the achievement of organisational excellence. This theory is in itself potentially problematic when taken in the light of SOEs for the reason that this type of enterprise faces a myriad of stakeholder interests arising from the heterogeneous nature of SOE stakeholders (Donaldson & Preston, 1995; Heath & Norman, 2004). Whilst the theory tends to presuppose that an indiscriminate chase of stakeholder interests is a cornerstone of organisational excellence, and by extension sustainability (Jones & Wicks, 1999) it overlooks the negative impact of pursuing conflicting interests (Donaldson & Preston, 1995; Post, Preston, & Sachs, 2002). This remains a puzzle that DFIs face, and with an impact of materially undermining sustainability.

*State ownership and the public choice perspective* – the public choice theorists view politicians as self-serving individuals often making decisions on the basis of personal interests (Niskanen, 1971). Supporting this view is Shaw (2008) who blames the lack of incentives as well as ignorance on the part of the public to monitor actions by politicians, who then act in concert to manipulate public systems to their personal advantage (Hill, 1999). Whilst subscribing to the basic tenets of this theory, Mbo an Adjasi (2017) introduce a concept of positive public choice, under which politicians may pressurise SOEs to pursue interests of wider stakeholder groups rather than their own, which unfortunately coincides with the negative implications of the stakeholder theory connotations to undermine sustainability in SOEs.

Ultimately, the state-owned DFIs face diverse stakeholder groups, each with conflicting yet legitimate expectations supported by the shareholder, who also commands political influence. Invariably, this scenario weakens DFI credit strength, and as a result makes it very difficult such institutions to raise funds from the market place, at least without some form of government backing. On the other hand, the ever-dwindling state support threatens sustainability, and consequently the very existence of the DFIs despite their widely acknowledged relevance and importance (Pragash, 2016). This puzzle calls for a funding and investment framework that can streamline the need for state support, yet achieving the development impact that DFIs exist for.

The body of literature dealing with the subject of profitability in financial institutions is large but often skewed towards deposit-taking banks, leaving a gap from the DFIs perspective. A number of researchers in this field have dissected factors affecting the profitability of financial institutions into two broad categories, that is, external and internal factors (Kamran, Yaseen, Ashraf, & Haroon, 2016; Staikouras & Wood, 2004; Rachdi, 2013; Duraj & Moci, 2015; Revell, 1979).

Management quality, portfolio mix, loan concentration, and the extent of customer deposits with an institution's liability book are the most commonly cited determinants of profitability (Kamran et al., 2016; Zimmerman, 1996). On the other hand, trends in local Gross Domestic Product (GDP), inflation, capital availability, regulatory, and

other economic pressures are commonly cited as those external factors with a bearing on the profitability of financial institutions (Revell, 1979; Perry, 1992).

Clearly, DFIs are not immune from most of these factors, and unfortunately for them, the stakeholder and public choice perspectives, as discussed above, place an additional and unique burden arising from state ownership.

According to Duraj and Moci (2015), management's quality determines the strength of institutional policies, commercial decisions, objectives, choices, and actions all of which translate into operational results. In extending this view, Zimmerman (1996) stresses the role of quality management in dealing with portfolio concentration-related risks and their impact on institutional performance. Pragmatically, it can be argued that it is management quality that determines how well a financial institution deals with internal determinants of performance, typically through the implementation of the right policies and timely decisions that reflect commercial acumen.

External factors, however, can exert themselves as beyond management control, and thus making internal hindrances to profitability almost impossible to manage with certainty. For instance, whilst management may anticipate inflation and build some aspect of it in their planning assumptions (Perry, 1992), levels beyond anticipation may exert pressures on internal cost structures (Revell, 1979), and beyond what can reasonably be passed on to customers owing to regulations and market intricacies. A slump in economic activity such as what resulted from COVID-19 usually translates into reduced spending activity, demand for credit, diminished disposable income, job losses all with a significant and negative impact on portfolio quality of financial institutions (Sturm & Sauter, 2010; Khamis & Iossifov, 2009), and all these factors combine to contribute to an upsurge in Non-Performing Loans (NPLs) and actualised credit losses. High economic stress levels, on the other hand, lead to constrictions of the capital markets, wherein lending may become stringent or capital simply becomes unavailable (Khamis & Iossifov, 2009). Although excessive inflationary pressures tend to lead to ease on interest rates, depressed credit qualities of borrowers may make access to capital a difficult and costly undertaking.

The case of state-owned DFIs has additional considerations; though expected to make profits, they are not profit-centric, and may be expected to carry low to zero profit investments, the non-commercial aspects of their operations directly constrain their ability to freely raise adequate capital from the market place, their risk profile, as influenced by their usual low portfolio quality exposes them to the high cost of capital and finally, the government as the sole owner has different and often unclear expectations compared to private investors holding ownership to commercial financial institutions.

Thus, within the context of what drives profitability in financial institutions, a refocus of the discussion to the specific case of state-owned DFIs projects three key factors: 1) the two-pronged objectives; 2) the availability and cost of capital; 3)

the implications of state ownership, all of which will have a direct bearing on financial performance.

*The two-pronged objectives:* Economic and social objectives potentially clash when pursued by the same enterprise. Social objectives, in the context of DFIs, are usually accepted to have no commercial return (Calice, 2013), and are a very broad, and potentially vague concept which extends to include job creation, provision of rural infrastructure, supporting education and construction of social facilities and amenities. Whilst it ordinarily costs money to chase such objectives, associated activities often do not attract cost-reflective fees, charges, or levies. Economic objectives on the other hand directly address the issue of sustainability, that is, under such objectives, DFIs are expected to earn a return on their investments enough to 1) fund internal operations and, 2) plough back retained earnings into additional investments.

Typically, a DFI would sustain social objectives on two basic principles: getting subventions or other forms of concessionary funding from state and/or donors (Schreiner & Yaron, 2001), and cross subsidising them with profits from commercial operations that are carried out in pursuit of the economic objectives. This scenario presents an interesting challenge: if DFIs fail on their economic objectives, they will neither attract market capital nor create any from internal operations, thus depend on concessionary funding, which is becoming scarce in recent times. Conversely, if DFIs do not obtain concessionary funding or state-backed commercial funding lines, they will lean more towards commercial investments for a return, thus fail on their social objective.

*The availability and cost of capital:* Credit quality, determined by the strength of a borrower's balance sheet, portfolio quality, management quality, investment return prospects, among other factors, are key determinants of the ability for a non-banking financial institution to raise optimal finance from the market place. Whilst these factors may not entirely inhibit a DFI from raising some form of capital, they actively determine the terms on which such capital is provided, especially tenure and cost. High cost, short tenure funds typically force DFIs to concentrate on commercial investments, with which there is scope to adopt a structuring regime that allows for adequate margins. By their nature, pro-development projects, which are mostly sub-commercial are funded from low cost-long tenure funds, and a DFI's failure to raise these will have a direct bearing on its ability to invest in such projects, hence induce a failure to attain social objectives.

*The implications of state ownership:* Privately owned commercial financial institutions, unlike DFIs, have clearly articulated profit-orientated objectives, attained through purely commercial investments, save for limited Corporate Social Investment (CSI) activities. A commercial financial institution that plunges into persistent losses will become unsustainable and shut down. A commercially viable and profit-making financial institution will build up a strong credit strength, and attract capital to venture into more commercial investments. All these factors, guided mainly by the profit motive make decision making processes within privately owned firms a defined process.

In-country DFIs are state-owned, and that comes with implications. SOEs are known to be modelled around political cycles (Aharoni, 2000), often faced with ambiguous two-pronged objectives (Shirley, 1998). Whilst the quality of management in financial institutions is emphasised as a key determinant of profitability (Kamran et al., 2016), the quality of managers in SOEs is compromised by appointments made on the basis of political affiliations (Mwaura, 2007). Credit quality is a contentious issue in state-owned DFIs; sub-optimal investment decisions are made, often imposed by compelling social grounds that overlook sustainability and viability, foreclosures and recoveries are difficult to achieve in a politically exposed environment and given social objectives (Andrews, 2005), ability to attract and retain top quality management is impaired (Bolton, 1995) and generally a portfolio in a typical DFI normally yields low returns, despite carrying a high risk. All these issues combine to discourage appetite from the commercial private credit market place. These issues render capital availability to DFIs a factor-driven mainly by state interventions, while capital from the credit markets may continue to tickle in at high cost and unsustainably short tenures. In such a scenario, the ability to strike a balance between the two facets of state-owned DFIs becomes critical.

### 3. RESEARCH METHODOLOGY

The author adopts a secondary research approach, predominantly applying document analysis as a primary method. Such an approach to research is of great use when the researcher seeks to produce comprehensive descriptions arising from a single phenomenon (Stake, 1995), and such is the case in the current study. In using this method, the researcher reviewed corporate information (missions and objectives) of certain relevant DFIs and extensively reviewed extant appropriate literature on the subject. This has the advantage of helping to uncover deep meaning and reveal critical insights to the research problem at hand (Merriam, 1988).

A mixed-method approach, applying both qualitative and quantitative approaches has been considered for adoption by the current study but discounted. With such an approach, the researcher would have obtained quantitative, primary data typically from financial statements and records of a number of DFIs, and possibly augment such data with interviews and surveys conducted with officials of the same DFIs. However, given the lack of a unifying framework for capital and investment management for DFIs, the approach would not have yielded the broader objective of this study, i.e., to evaluate the continuing importance of DFIs and analyse factors that drive their sustainability, with the state ownership dynamic in mind. A mixed-method will, however, be appropriate post this current study, as it will benefit from its findings.

### 4. RESULTS AND DISCUSSION

#### 4.1. A sustainable framework to fund DFIs

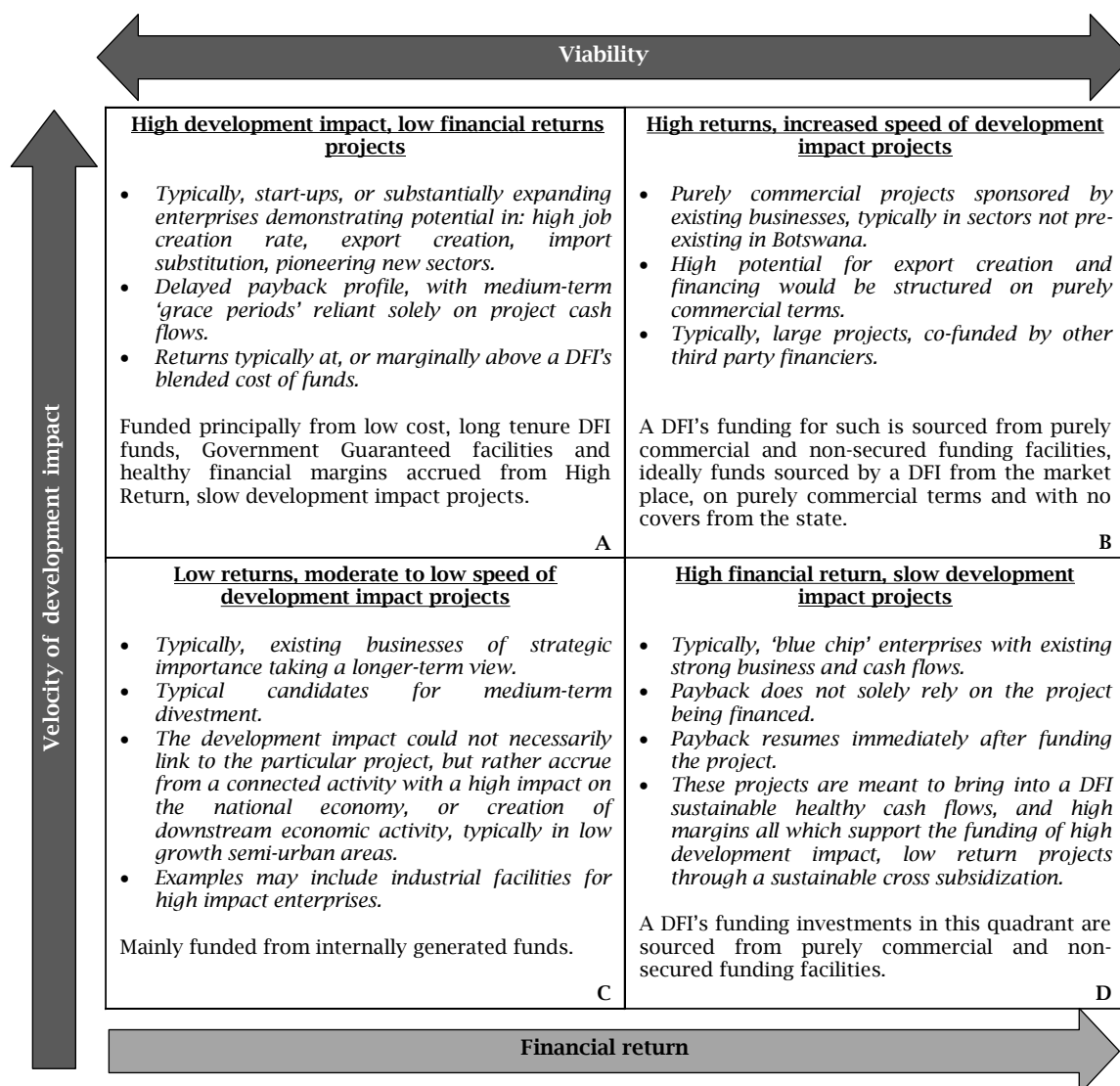
State funding and support (through guarantees and other forms of covers) will remain critical for DFIs to pursue their social objectives to an extent of the

noticeable impact. However, demands on national budgets are growing possibly at rates that surpass their accumulation. This implores DFIs to actively seek alternative funding from the market place, and aggressively pursue commercial operations from which returns can partially cross-subsidise pro-development investments.

The state supports should not substitute funds from the credit markets, and vice versa. Similarly, attainment of social objectives should not necessarily undermine sustainability, but at the

same time, a pursuit for commercial investments by DFIs should not eliminate the developmental role that DFIs are set up to achieve. Rather, state funding and support should be complemented by funds from the credit markets, and profits from commercial investments should support low return investments, in the long run. Most importantly, state intervention should gradually involve less of funds flow, but take other forms of support. Figure 1 below presents a framework on how this needs to be achieved.

Figure 1. A proposed framework for DFI sustainable funding



#### 4.2. The model explanation

In understanding the model presented in Figure 1, certain fundamentals need to be appreciated: 1) DFIs have an obligation to do developmental projects, 2) DFIs need to undertake commercial projects, which can attract commercial capital, and 3) The type, structure, and cost of capital available to DFIs have a direct bearing on the type, structure, and returns of investments undertaken.

In the model proposed above, there are four quadrants detailing an investment mix that a successful DFI should ideally target, successful in

the sense of making decent commercial returns whilst still undertaking developmental projects with the desirable social impact. Thus, the model does not in itself depart from the two-pronged nature of the objectives of DFIs but rather focuses on sustainability.

**Quadrant A:** This accommodates investments with demonstrably high development impact, but low financial returns, and would ordinarily carry the tag 'development projects'. Typically, these will be infrastructure and related projects for which impact is realised with significant delays. In addition, business start-ups, particularly green fields would

fall into this category. From a financing perspective, these types of investment projects require concessionary financing terms that would include low-interest rates, a relaxed convenient regime, extended grace periods, and interest payment moratoriums. Naturally, this then requires DFIs to have proportionate sums of concessionary funds within the broader investment funds pool. In this case, concessionary support would take the form of guarantee covers, grants, and multilateral DFI funds, it is important to emphasise that guarantees do not necessarily carry cash obligations on the part of the state.

*Quadrant B:* These are high return investments, but with demonstrable ability to spur high development impact within a short to medium-term period. These would carry the tag 'commercial investments with high development impact'. By their nature, such projects would be rare and probably carry an increased profile. Typically, the project would be in the form of venture capital wherein highly potential start-ups with confirmed off-takers, or existing enterprises venturing into new business lines or markets are being pursued. Such ventures would typically demonstrate high-profit potential but at the same time carrying the following developmental merits: job creation, export creation/diversification, development of the private sector, import substitution as well as pioneering new technologies and industries, among others. These are all typical priority areas in modern-day development country agendas. Such projects would typically be funded by proceeds raised from the market place on purely commercial terms with no state covers. The proportion of these types of capital within the larger investment fund must be determined by the extent of such a project in this quadrant within the pipeline of investments.

*Quadrant C:* Low return, low development impact would typically be held for strategic reasons. Such include old equity investments that have outlived their investment horizons and payback periods, and as such otherwise ideal for divestment to the private sector, but held on to for strategic reasons. Such investments would typically not require any significant periodic capital outlays, and could be supported by minimal funds allocated from internally generated cash flows.

*Quadrant D:* These are investments with a high financial return, but unlike those in Quadrant B, the development impact is minimal. These would carry the tag 'commercial investments'. These could include highly commercially attractive investment opportunities outside the DFI's country and are normally blamed for 'externalising capital and exporting jobs', although such a view overlooks the resource mobilisation aspects of such investments wherein returns are repatriated back into the country, typically to fund or cross-subsidise Quadrant A projects.

## 5. CONCLUSION

This paper explores the two-pronged nature of DFI objectives and the possibility of making profits under state ownership. The paper appraises the importance of DFI's generic mandate and highlights a theoretical framework in the context of which the subject needs to be looked at, particularly with the state ownership dynamic in mind. It is evident that state ownership introduces some uniqueness to the type of financial institutions DFIs are, with a direct bearing on their operational models, if sustainability is to be ensured. The type and cost of capital available to a DFI emerge as a fundamental determinant of how effectively a DFI becomes, measured from the perspective of the two-pronged nature of their objectives.

DFIs should raise capital in accordance with the type of investments they have in their pipelines, and not necessarily the other way round. Three variables emerge as being crucial in the construction of investment pipelines for DFIs; the velocity of development impact, viability as well as financial returns, and perhaps unlike with commercial private finance, financial returns are not central to DFIs. Governments should continue to support DFIs in executing projects of high development impact, but of low financial returns (e.g., Infrastructure projects, labour-intensive investments, and greenfield investments). Government support could be in the form of concessionary loans or explicit guarantees (not necessarily grants). On the other hand, DFIs should be properly governed and soundly managed to attract purely commercial private finance for investments with the ability to generate good financial returns while displaying demonstrable viability. Such projects need not necessarily be of high development impact but can be a crucial source of internally generated profits, which then subsidise the funding of developmentally important projects of low returns. This paper proposes a model by which this can be achieved.

The paper lays a very crucial foundation for future research. DFIs are evolving, as are capital markets. The framework provided by this paper provides a context within which future quantitative, and more interestingly correlational studies can be conducted on this subject.

A major limitation of this study is that it has not benefited from primary data from a range of DFIs in the varying status of organisational soundness, but this will be more possible for research that adopts the framework proposed by this paper. Further, extant research has not touched on the subject of measuring development impact from the lens of capital support, and this paper lays a foundation for such.

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