Key findings

The Maturity Lengthening Role of National Development Banks.

International Review of Finance, 1-28

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This overview is published in the framework of the third edition of the Finance in Common Summit in Abidjan "Green and Just transition for a sustainable recovery".

We analyze why national development banks (NDBs) may provide longer-term loans to firms than private commercial banks (PCBs). If NDB bonds have higher collateral value than PCB bonds, then NDBs may lend longer-term than PCBs. NDBs may enjoy higher recapitalization willingness and capacity by the state and hence greater collateral value than PCBs. Moreover, NDBs may have advantages over state-owned commercial banks if NDB bonds enjoy higher market liquidity. However, NDBs may suffer from poor monitoring quality owing to undue political intervention, thus undermining collateral value. Our study implies that NDBs are not substitutes for but complements to PCBs.

Objectives and research questions

The availability of long-term finance has a positive and significant impact on long-run growth. Despite its significance, long-term finance is in short supply, especially in developing countries. One way to overcome the scarcity of long-term finance is to establish national development banks (NDBs). Though empirical studies (Hu et al., 2022) demonstrate that NDBs on average lend longer than commercial banks, few has explored why NDBs are able to provide the long-term finance. Our paper is the first applied theoretical paper that explains why NDBs lend longer than commercial banks.

Methods

Our baseline model starts with a banking system with PCBs only. We analyze the determinants of the optimal maturity of bank lending to firms when this lending creates liquidity risks for banks, and interbank payments may be settled by paying with liquid assets or by lending to each other through bank bonds or, equivalently, by making interbank loans. We analyze why commercial banks may be reluctant to provide long-term finance. Then we introduce an NDB to the banking system where the NDB finances its lending to firms by issuing bonds to be purchased by commercial banks. We explore under what conditions the NDB can lend longer than commercial banks.

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Results

Our main proposition is that a banking system with both NDBs and PCBs could provide longer-term lending to firms compared with a banking system with PCBs only, if NDB bonds have higher collateral value (i.e., the maximum amount that banks may obtain by issuing bonds) than bonds issued by PCBs. One reason NDB bonds may enjoy greater collateral value is that NDBs are owned by the government, which may have a higher recapitalization willingness and capacity than private bank owners in case of defaults. Another advantage may be that NDBs finance themselves through bond issuance rather than deposit-creation and -taking, which implies that the trading volume of NDB bonds is higher than that of any other commercial bank, thus enhancing the market liquidity of NDB bonds. This enables NDBs to have an advantage over state-owned commercial banks. However, if NDBs have a lower level of monitoring skills and quality than PCBs because of undue political intervention, their advantages over PCBs would be reduced in terms of their maturity-lengthening role.

Recommendations

To unleash the potential of NDBs for providing the long-term finance, we have drawn the following policy implications:

- **First, NDBs should be well capitalized to unleash their potential for scaling up the provision of long-term finance**. This policy recommendation is particularly relevant given the trend that NDBs are undergoing a renaissance worldwide. Even if NDBs have comparative advantages in providing long-term finance, their contribution to filling the financing gap would be substantially undercut if they are undercapitalized. Hence, the maturity-lengthening role of NDBs is more relevant for countries that have governments with stronger credibility, finances, and net worth than for countries with governments plagued by credibility concerns, over-indebtedness, and excessive fiscal deficits. For countries whose governments are in a relatively weak financial position, their NDBs should try to seek on-lending from multilateral development banks or NDBs from countries with a strong financial foothold.
- **Second, NDBs need to be well governed to unleash their potential for providing long-term finance**. State ownership is a double-edged sword. Although governments should play a steering role in setting the corporate strategy of NDBs to ensure they proactively fulfill public policy objectives, governments should not unduly intervene into the microlevel loan approval or appraisal procedure of NDBs. Otherwise, undue government intervention would undermine the quality of assets, hence undercutting their ability of providing long-term finance. Therefore, governments should try to build the firewalls to guard NDBs against undue political influence and should ensure that NDBs enjoy a sufficient degree of professional autonomy to better implement their development-oriented mandates.
- **Finally, the maturity-lengthening role of NDBs is enhanced by the higher market liquidity of NDB bonds if NDBs are larger in terms of their relative bond issuance size in the banking system**. Ensuring the higher market liquidity of NDB bonds is an important argument in favor of NDBs that follow a business model centered on financing themselves through bond issuance rather than trying to mimic commercial banks that are in the retail payment system and are deposit creators and takers.

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