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From financial innovation to innovation for financing: the role of development banking

The present and the future of Development Financial Institutions: a learning dialogue
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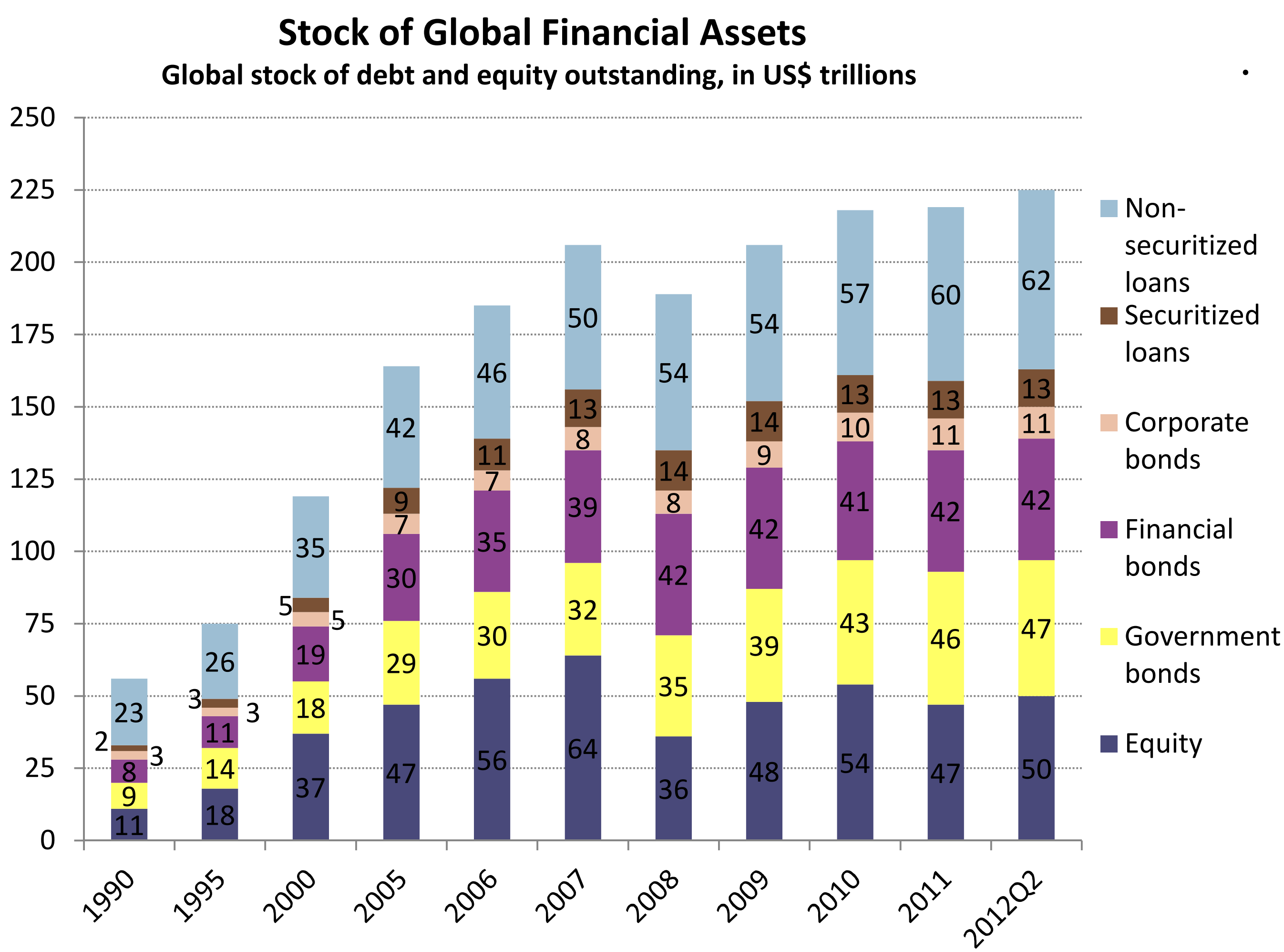
Financial innovation generated an unprecedented increase in financial depth and liquidity

•*Global financial depth* –the size of financial assets with respect to GDP- grew from around 120% in 1980 to 355% in 2007, before the global financial crisis



	1990	1995	2000	2005	2006	2007	2008	2009	2010	2011	2012Q2
Non-securitized loans	23	26	35	42	46	50	54	54	57	60	62
Securitized loans	2	3	5	9	11	13	14	14	13	13	13
Corporate bonds	3	3	5	7	7	8	8	9	10	11	11
Financial bonds	8	11	19	30	35	39	42	42	41	42	42
Government bonds	9	14	18	29	30	32	35	39	43	46	47
Equity	11	18	37	47	56	64	36	48	54	47	50

Source: McKinsey, 2013

But this growth in financial depth was not tied to greater or improved real sector activity

Growth in Global Financial Depth
(1990-2007, in percentage points)

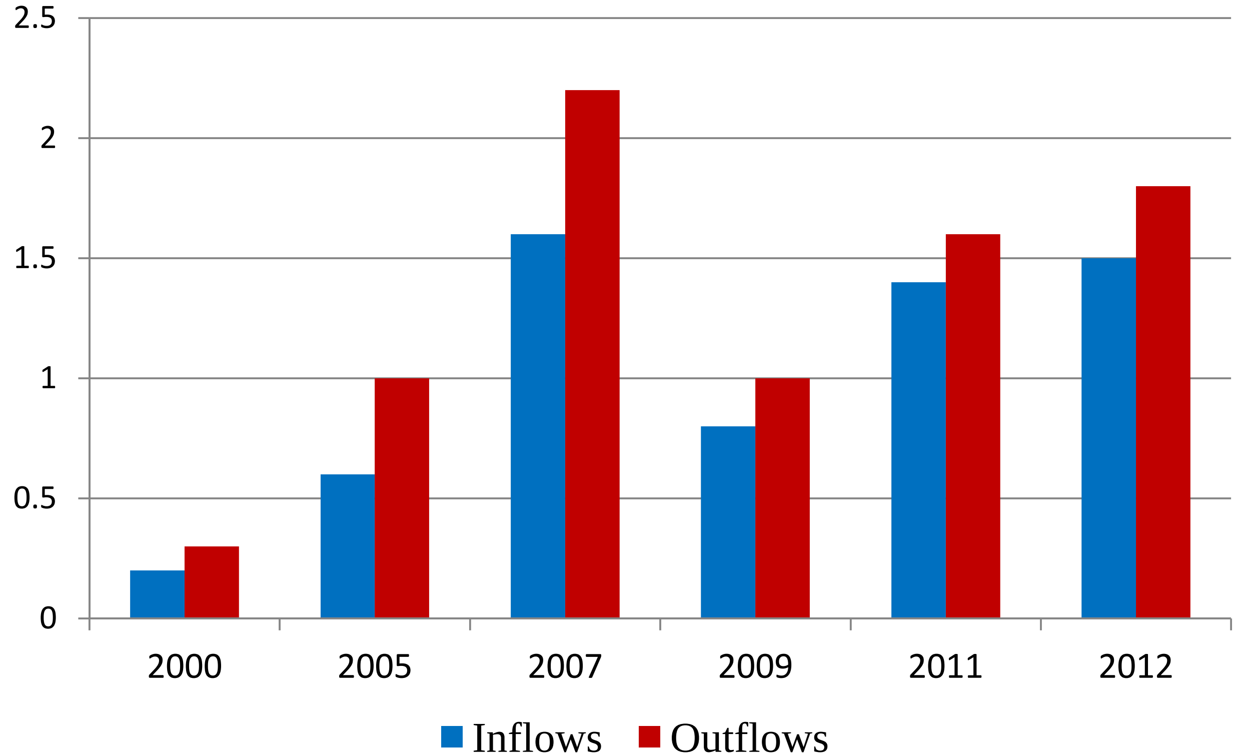
	90-2007
Total Financial depth	92
Equity	58.6
Government bonds	12.9
Financial sector bonds	29.6
Corporate bonds	-0.3
Securitized loans	13.0
Non-securitized loans	-21.9

Financial deepening was not a result of more *financing for the real sector* (firms and households)

Moreover greater financial depth has not increased the availability of funding for developing economies

➢Developing economies are net providers of 'finance' to the developed world

Emerging market economies financial inflows and outflows 2000-2012
($ trillion, 2011 constant exchange rates)



Source: ECLAC On the basis of McKinsey, 2013

Channeling resources towards the productive sectors and developmental objectives requires approaching financial innovation from a new perspective

- Financial innovation should be conceptualized as a public good in a broader sense that differs from the traditional definition based on non-rivalry and non-excludability.

- In a broader sense public goods refers to those goods and services that:

  - Are provided through non-market production because there is no effective market for these.
    - ✓ This may occur due to asymmetries, absence of knowledge or uncertainty.
    - ✓ As a result public goods/services tend to be under provided or simply not provided at all.
    - ✓ Should be widely available because they have significant positive externalities.

- Likewise financial inclusion should also be considered as a public good

  - Just as in the case of health and education, financial inclusion is increasingly conceived as a public good in the "sense that exclusion is neither desirable nor justified."

Within this framework *Financial Innovation* means channeling finance to different agents, investments and productive needs

Innovation for Financing

↓

Innovation in products, processes and institutionality

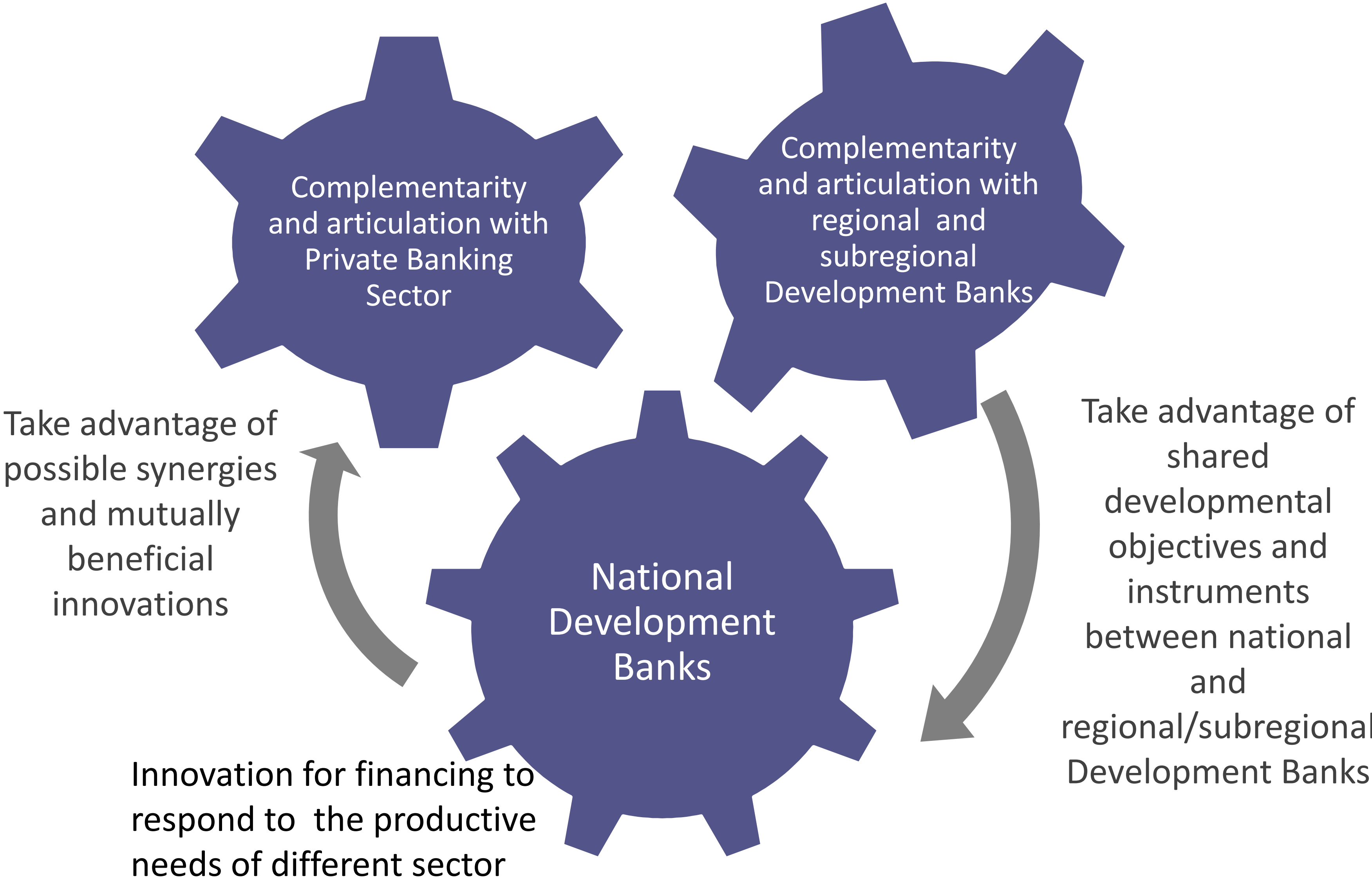
↓

Promote inclusiveness for firms and households

Generate adequate instruments to manage different risk across heterogeneous agents and sectors of the economy

Provide financing for new developmental objectives and priorities, i.e. infrastructure, international trade, green economy

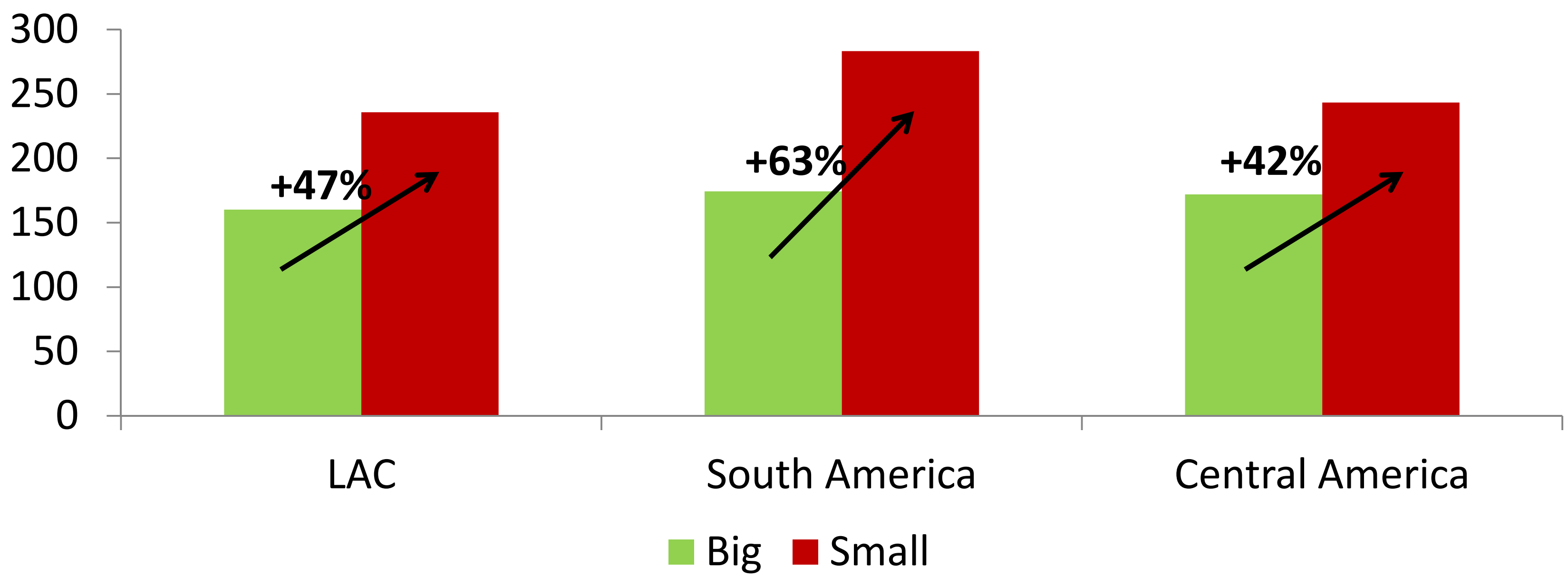
Development Banks have an important role to play in generating *innovation for financing* both directly and through their articulation with other banks



In the context of Latin America and the Caribbean the adoption of **innovation for financing** poses significant challenges

- It requires developing a range of instruments to address a diversity of risks inherent to economies characterized by productive heterogeneity.

- This is exemplified by the high value of collateral (% of the value of a loan) that SMEs in the region face to access funding



In Latin America and the Caribbean there is a need of financial innovation to address traditional and new challenges

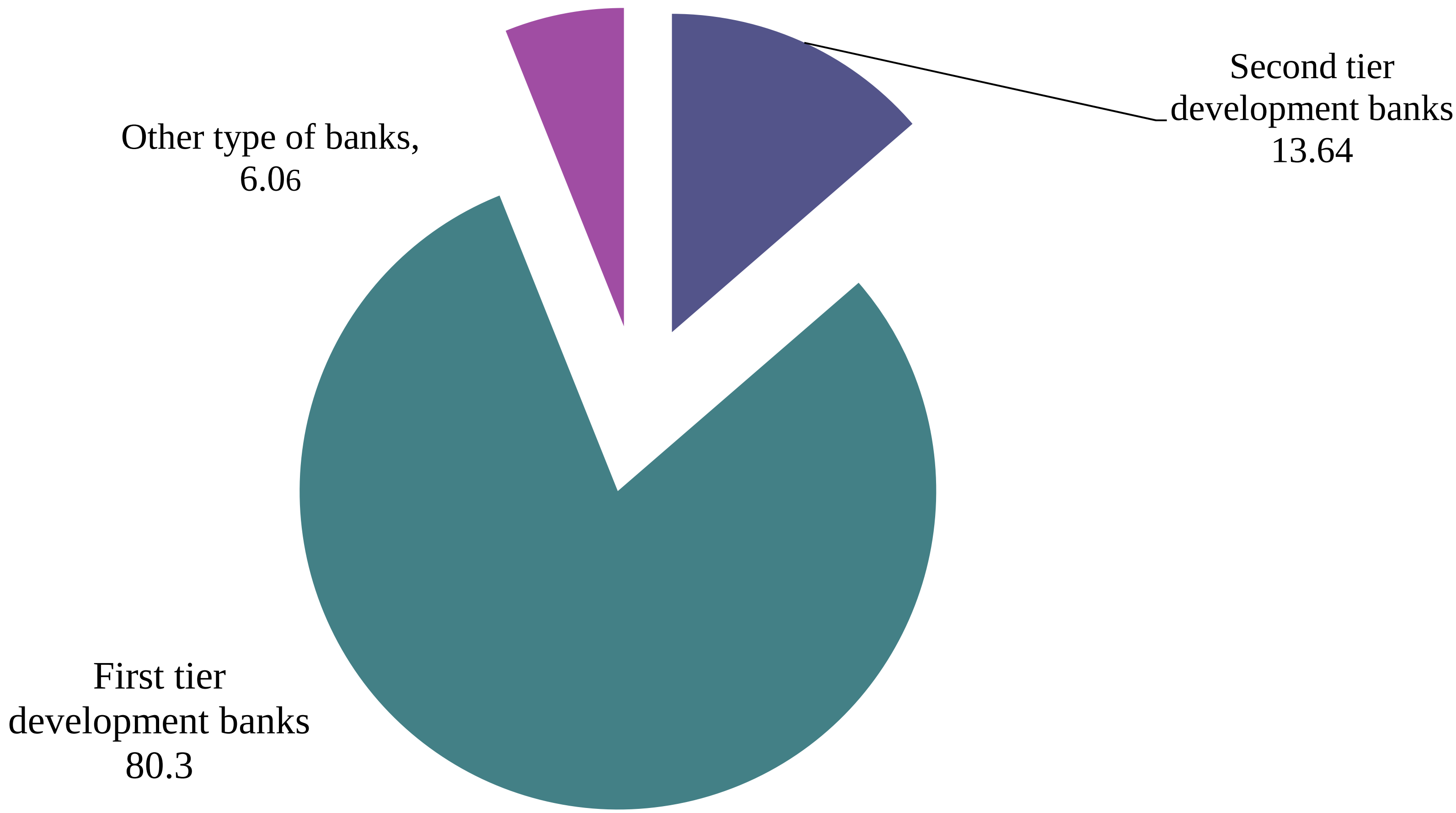
- Inclusion of Small and Mediun Enterprises.
  - Product innovation through the development of venture and seed capital.
  - Innovation in financial processes centered on improving the flexibility in the evaluation of payment capacity (arm’s length and relationship banking).
  - Expansion of the financial network.

- Close the infrastructure gap (roughly 6% of GDP)

- Create financial instruments to foster international trade.
  - Development banks in the region foster trade mainly through traditional commercial instruments (credits for pre and post financing of exports).
  - However, development banks that specialize in foreign trade include as part of their business strategy new financial instruments and a wide variety of programs for trade promotion (international factoring guarantee).

- Strengthen the complementarity between public and private financial intermediaries.
  - This requires that development banks function as first and second tier banks.
  - The majority of national development banks in the region are first tier banks (80% out of a sample of 66 banks).

Innovation financing should also focus on strengthening the complementarity between development and commercial banks



Nota: On the basis of a sample of 66 development banks.
Source : On the basis of CAF (2012), ALIDE (2012) and ECLAC (2012).