LS Ipangelwa: Does the banking industry play a developmental role in Namibia?

Address by Mr LS Ipangelwa, Deputy Governor of the Bank of Namibia, to the Namibian Economic Society, held in Windhoek, 13 March 2001.

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Mr Chairman, Members of the Panel, Ladies and Gentlemen,

I'm delighted to take part in this well-directed and well-timed discussion. As a central banker I am glad to see so much attention being paid to this important topic - *"Does the Banking Industry Play a Developmental Role?*"

I compliment the Namibian Economic Society in choosing this coveted theme as a topic for discussion. Central bankers are often tipped as conservative in their approach. Let me see how I would be able to breach this barricade by indulging in fresh thinking on the subject.

Role of finance in economic development

Before we initiate a well articulated and meaningful discussion on the subject, it would, in my view be befitting to clearly understand the theoretical underpinnings underlying the role of finance in the process of growth. Views of economists on this important issue viz. the inter-relationship between finance and growth, however, diverge. While some economists feel that finance drives the wheels of economic growth, others opine that the process of economic growth itself induces financial development.

The available evidence seems to strongly suggest a bi-directional relationship between finance and development. In other words, growth drives the evolution of the financial super structure and the financial super structure, by meeting the financing requirements of the economy, facilitate the process of growth. In the latter case, it is well appreciated that if the financing requirements of the economy are not adequately met and in time, it would affect the growth process adversely. Against this backdrop, a brief digression on my part, in elaborating on the role of finance in economic development may not be out of place.

As you know, the financial institutions, of which the banking system is an integral part, play the major role of financial inter-mediation. In this regard, their traditional role consists of mobilizing resources from the sectors generating surpluses and channeling them to the sectors that need them. Thus, by meeting the investment requirements of the economy, they facilitate the process of capital formation. When domestic savings fall short of the investment requirements of the economy, the gap is closed through net capital inflow i.e.; the gap is met by way of borrowing from abroad. Banks play an important role in this sphere too by facilitating international trade and service payments.

In recent years, however, the conventional view that financial intermediaries should confine their traditional role of mobilizing resources and attracting capital inflows seems to have lost much of its ground. A global perspective on the role of banks reveals a more pro-active and positivist approach to the bank's role in facilitating the achievement of broader goals of economic development and making them a matter of reality. In the words of King and Levine, "*financial intermediaries determine which economic organizations will survive and which will perish, which entrepreneurs will control organization and which will not, which types of investment can be made and which cannot, and which new economic products can be introduced by firms and which cannot*". This statement is very much relevant to our situation here in Namibia and hence there is good reason for the public to be concerned about the role and behavior of those who are in charge of the financial sector in general and the banking industry in particular.

It is also pertinent to examine as to the precise role and responsibilities of banks in the economy in general and in the specialized function of credit extension, in particular. A pertinent issue that has often been discussed in the literature and policy circles in this regard is whether the focus on the mode of financing should be bank-based finance or market based finance. There is no precise answer to the issue as to the relative preference of one to the other. Nevertheless, a pragmatic evaluation of this issue could only be made after taking note of the state of development of the economy, and a critical assessment of the emerging credit requirements not only in terms of quantum but also in terms of their diversity and priority. It may be noted that the credit requirements of the economy are dynamic in nature and are basically a function of the way the economy expands in terms of infrastructure development, commodity specialization and productivity gains. Further, as development gains momentum, there is a need to step up the resource mobilization process as well. The structure and level of interest rates and the level of 'efficiency' (as measured in terms of the spread between the lending and deposit rates) achieved by the banking system thereof gains utmost attention of policy makers in this regard.

The role of commercial banks

Before we examine the role of the banking system in Namibia against the above backdrop let me briefly review the primary functions of commercial banks. The main traditional function of a commercial bank is that of accepting deposits and granting of loans. They accept deposits of various kinds ranging from demand to fixed deposits, and lend this money to those who are in need. That's being a broker and a dealer in money. It should also be noted that, a banker is a custodian of others surplus funds, so while earning a profit he should not forget that he is doing business with other people's money. He must always be ready to meet his liabilities at all times. In case of a banker not able to honour his commitment, he will not only suffer a shock of such a failure, but the shock will also be transmitted to the rest of the economy very quickly. The systemic risks arising from that need to be eliminated or minimized. Besides, bankers are creators of money in the sense that credit creation leads to deposit generation, which, in turn, leads to credit creation, and the process ultimately would have implications for the monetary framework.

It's therefore important that, a banker should always and at all times bear in mind that, he is a guardian of a very important mechanism. A mechanism, which not only bears relevance for monetary policy but also paves the way for future economic growth and development and any disruption or deviation in this regard, could create economic or financial chaos.

Do Namibian commercial banks play a developmental role?

The traditional functions of Commercial Banking in Namibia have undergone rapid transformation since independence. The total assets of commercial banks currently operating in the system increased from N$1.9 bn in 1990 to about N$10 bn in 2000 with branches now numbering about 101 and the total number of employees reaching close to 3000.

Commercial banks real credit to the private sector grew at an average rate of about 10 per cent between 1990 and 2000. In nominal terms, the total commercial bank credit as a percentage of GDP currently stands at about 45 per cent. This is quite high compared with the norm of 13 per cent in sub-Saharan African countries. Except for South Africa and Mauritius, the ratio of credit to GDP in Namibia is the highest among the SADC countries. Although substantial credit is still allocated to individuals, there has been of late, a favorable shift in the allocation of credit to the manufacturing, real estate and construction in the last 10 years. Credit extended to the productive sectors of the economy has not been that encouraging. This is the area that needs our immediate attention and where we need to work together to find our way through in exploring an ideal solution for resolving the issue.

As with real credit to the private sector, the total deposits, on an average, witnessed a higher growth rate since independence of about 13 per cent as compared with about 3.7 per cent (on an average) for the period 1980-89. If the rate of growth of deposits is an indicator of the ability of commercial banks to mobilize deposits, the performance of commercial banks in Namibia has been quite commendable. However, it is worthy to note here that there has been a considerable shift in the structure of deposits particularly since 1995 with a noticeable slide in the growth rate of time deposits. This would tend to suggest, that despite the high growth in the overall deposits level, the commercial banks are no longer able to mobilize substantial long-term deposits particularly in the wake of competition brought about by the introduction of unit trust and other products of non-bank financial institutions.

As you all know the most important indicator of the soundness of the banking system is the bank's operating efficiency. Research conducted by the research department of the Bank of Namibia shows that commercial banks in Namibia are characterized by high gross margins, high return on assets, high cost-asset ratios and moderately high equity capitalization ratios. With a gross margin of about

9.0 per cent, a return on asset of 3.5 per cent and return on equity of 54.2 per cent, commercial banks in Namibia outperform their counterparts in Lesotho, Botswana, Swaziland and South Africa. It has been argued that the cost of delivering services is also quite high in Namibia. On a comparative note, this could only be true when weighed against the situation in Botswana. It is, however, encouraging to note that cost ratios are lower in Namibia than in Swaziland, Lesotho and to a large extent, South Africa.

Emerging economic paradigm - need for transformation of banking

From the point of view of the central bank and based on a review of banks' performance reflected through major indicators, one could conclude that Namibia enjoys a robust and stable banking system. Having taken stock of the bank's ability to perform in the emerging economic scenario, may I reiterate the point that this is the most appropriate time for us to reflect on some of the major issues as a matter of introspection and with a view to reaping optimal benefits from our strengths?

As you are aware, credit extension is very important for rapid economic development particularly in a bank-based economy like ours. The volume of credit as well as its allocation to key sectors of the economy can help to stimulate productive activities. Although our statistics show that the ratio of private sector credit to GDP is quite high in Namibia, more still needs to be done especially in the area of long term loans. There is a strong need to direct credit to the previously disadvantaged people who because of the accident of history may not possess the specified collateral required by banks.

As a logical step forward towards transforming the banking system, there seems to be a greater need for a review of our lending procedures, practices and credit assessment mechanisms with a view to ensuring supply of credit to the genuine clients and particularly to the hitherto neglected sectors. Available evidence shows that most of the credit extended by commercial banks is mainly used to finance properties and other personal items. There are also reports by loan applicants that banks do not carry out proper investigation on project viability particularly when this has to do with projects falling outside the purview of their traditional areas of financing. The application of venture capital gains relevance in this context. There is therefore, a need for both the commercial banks and the policy makers to explore ways of evolving appropriate assessment mechanisms and credit evaluation techniques with view to extending credit to all viable projects.

These steps would result in deploying the high level of financial savings in the economy and reaping the best possible advantage in terms of gearing the economy towards the optimal growth path.

Mobilization of resources

Let me now turn to mobilization of resources for the purpose of funding. This is another area that needs our urgent attention and calls for the extension of banking services to population group-wise as well as spatially. An increase in the number of bank offices can mean channeling of a greater fraction of the nations savings into investment through the mediation of the banking system, which in turn, may lead to initiation of increasing number of investment projects.

Available figures show that in the sub-region, apart from South Africa, Namibia posts a low ratio of population per bank branch. This in itself would indicate that banking services are available to a greater percentage of the population. This paradoxical situation mainly stems from the lop-sided distribution of the available branches. As you know, Windhoek alone accounts for close to 25 per cent of the total number of bank branches and 4 out of the 13 regions account for about 67 per cent of total branches. The two regions with the largest population viz., Ohangwena and Omusati, however, are sparsely banked. This is a situation that deserves attention by commercial banks, as spread of banking is imperative for greater deposit mobilization in years ahead. There will, of course, be appropriate support from the authorities in this regard.

Banks have made substantial efforts at reducing the spread between the lending and deposit rates particularly in the past two years but again in this regard the efforts so far are inadequate. The spread between the lending and the deposit rates fell from 8.96 to 7.48 per cent between 1998 and 2000. However, what is worth noting, is that the level of spread seems to be still high as compared to an average level of around 3 to 4 per cent observed in the case of many developing countries.

Narrowing of spreads is reflective of the efficient management of the bank through minimization of operational costs. The smaller the spread, the greater could be the stimulation for loan demands for industrial development. It will also be easier to provide the necessary stimulus to the process of deposit mobilization, particularly from those areas/regions which though endowed with surpluses/savings but have no investment/saving outlets. Thus, savings could be appreciably boosted by exploring ways of garnering hitherto untapped saving potential across the various regions in Namibia.

Commercial banks in Namibia have been able to meet the credit requirements in the economy, particularly, the short-term financing requirements. However, it is worth noting that the situation regarding mobilization and allocation of resources for meeting the medium and long-term financing requirements of the economy has not been that encouraging.

While realizing the fact that commercial banks in Namibia are efficient, the fact remains that, financing gap still exist in the economy. An effort to meet this financing gap requires the creation of appropriate institutional structures. Else such financing gaps continue to exist, hampering the growth process. This is reflected in high unemployment rate and disappointing performance of the manufacturing and services sectors that are in dire need of long-term capital. A review of the contemporary global experience with the banking systems also suggests the need for resolution of such financing gaps in economic development on an urgent footing.

Regulatory environment

The underlying problem in this context arises from the fact that the commercial banking system normally operates under certain regulatory framework. The regulatory framework requires that banks should pursue prudent lending activities. This in most cases has meant adherence to strict lending norms as per regulatory requirements. Further, the short-term nature of the liabilities of commercial banks dictates that the term structure of their loans should be tailored to suit their balance sheets. It is very important that banks should pursue a policy of maintaining a most appropriate asset-liability structure. In other words, there should be a consistency between the asset structure and liability structure in terms of maturity and yield structure. These requirements very often constrain banks in fulfilling the medium and long-term requirements of financing or in extending loans to deserving sections of the society even-though their requirements are genuine.

The widening of the financing gaps: options open and the way out

It needs no emphasis that all identified viable projects need be encouraged and financed. For the reasons outlined above and based on a host of other considerations, the encouragement of the growth of other financial intermediaries outside the banking system is imperative. A case in hand is the plan to establish a development bank. Later, we deal with the need for creation of other financial institutions.

The development bank

There are currently two main options available to the authorities in re-organizing developmental financial institutions in Namibia. The first option is to create a development bank and make the Development Fund of Namibia (DFN) part of it and leave out Namibia Development Corporation (NDC) to remain as the government-implementing agency for industrial and other development projects.

The second option is to create a development bank by consolidating or converting the NDC and the DFN into one strong, well capitalized, and well structured development financial institution to be called a “Development Bank” or “Industrial Development Bank”, the name does not matter.

In my view, the first option is sub-optimal. It is an expensive and unaffordable option for the size of our economy and given the limited resources at our disposal.

The second option is much more realistic and optimal in my view. It means consolidation of available expertise under one roof. Consolidations of funding streams and resources. It also means savings on bureaucracy.

The consolidation of these two institutions into a viable development bank will help to channel resources to well-targeted developmental priorities and supply the missing link between bank finance and long-term capital requirements. It is in this regard, that one views the on-going attempt at establishing a development bank as a step in the right direction.

My view on the development bank

I believe that, the institution should be developmental oriented but run on business principle where possible. As a leading agency of the Government it should trigger medium and long-term projects for developmental purposes. It should be charged with the responsibility of channeling scarce capital into selected industries, prohibit/minimize risk taking through issuance of guarantees, for medium term and long-term loans. Its structure should ensure that resources flow widely and efficiently to promising sectors that are capable of creating additional employment and value addition to the economy.

Such an institution shall be owned by the public sector in the majority. This is important to enable the institution to raise funding at low costs and have credibility with other Developmental agencies at the regional and international arena such as African Development Bank, Southern African Development Bank, IDC, etc. Other institutions of super national nature or institutions owned by foreign Governments could be invited to participate as minority shareholders. Private sector agencies could also be encouraged to work together with this Institution by way of subscription to preferential shares and debentures of the institution. What is important here again, is that, the institution should be well capitalized, because without sufficient resources, it will never be able to perform its assigned responsibilities as per expectations.

Yet unfinished agenda: the role of other financial institutions

Commercial banks alone will not solve the deficit in demand for long-term credit nor the development bank could meet the overall financing requirements. Financing needs being diverse and specific in nature, there is a need for other types of institutions like venture capital, private debt equities, etc.

Venture capital can play a major role in providing equity capital to finance high-risk investments e.g. grape projects, ostrich and many others. Advantage of venture capital allows investors to share more fully in the rewards to a successful venture and also helps firms in avoiding cash-flow problems associated with debt financing. This is one of the options that need to be looked into by the policy makers. In this light, a tax system that recognizes, the authorities should consider the effort of venture capitalist. The same could be applicable to leasing and factoring companies.

Private Debt securities market can also enhance the availability of long-term capital. A well-established private debt securities market can improve the capacity of domestic capital markets to accommodate large and more complex funding arrangements and diversify the process of financing away from the banking sector. Private bond market would allow companies to obtain long-term fixed rate financing at a much lower cost relative to bank credit. This will be quite a challenging task to all of us.

Conclusion

The Namibia financial sector is still under-developed. It is still dominated by the commercial banking institutions. Though there are a few specialized financial institutions, a well-designed financial super-structure is yet to evolve.

On your question as to whether commercial banks do play a developmental role, my answer would be: Yes, commercial banks have played, are playing and would play a much greater and much more proactive role in economic development. In this context, what needs to be addressed now is as to how to improve their contributing to economic development further, given the fact that their contribution to GDP is still below their potential. Some of the thoughts outlined by me earlier deserve attention in this regard and provoke further thinking on the subject. Yes, they need to do more. Yes, they need to be innovative in order to increase their participation in economic development.

Yes, there still exists a wide financing gap. But that gap cannot just be filled by commercial banks alone. Commercial banks may not have sufficient resources to provide long-term loans for investment purposes because of the structure of their balance sheets as explained by me earlier. Other players do need to play their role as well, including the authorities. The challenge is for all of us to come up with workable but lasting solution.

I thank you for your rapt attention.