Subsidy Dependence and Financial Sustainability in Development Banks:
The Case of the Fiji Development Bank

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Abstract

The importance of financial systems in development has been widely established. The issue of subsidisation in development banking has come under public scrutiny. In the Pacific, development banks have continued to face dual pressures to perform their developmental role, as well as achieve financial sustainability. By using and applying three measurement methods - the Subsidy Dependence Index (SDI), the Net Present Cost to Society (NPCs), and the Subsidy Dependence Ratio (SDR) - to the Fiji Development Bank, this study concludes that while the level of subsidy dependence has increased, it has no demonstrative linkages to key performance indicators, and that moves to eliminate subsidy dependence would prove counter productive to policy efforts aimed at developing the traditionally weaker but critical sectors and segments of society. Given that subsidisation will remain to be an important component of good public policy, it is argued that development banks will remain to be legitimate institutions in channeling and monitoring subsidies, provided they continue to demonstrate institutional and financial efficiency.

Introduction

The importance of financial systems in development has been widely established (Stiglitz 1998). The failure of the financial sector and the weak performance of development banks to effectively deal with national and global social and economic issues have drawn global attention.

In the context, the Monterrey Consensus, 2002, called for a common re-solve to enhance the effective mobilization of financial resources so as to eradicate poverty, achieve sustained economic growth, and promote sustainable development (UN, 2002). In the same vein, Banuri and others (2002) proposed a shift of focus from access and availability-of-funds considerations to the goal and delivery processes of financing.

Historically, development banks in the Pacific (PIDBs), and in most developing countries were established as government owned creations to provide institutional mechanisms for promoting, supporting and financing medium to long term projects, generally not catered for by commercial banks. As public development finance institutions which have historically been supported by government's scarce financial resources, development banks have been a focus of public scrutiny, particularly on their ability to bring equitable development, social justice, and more importantly, their ability to demonstrate long-term financial sustainability. The issue of sub-sidisation to development banks has drawn much attention, especially as it relates to institutional performance and operational efficiency at the mi-cro level, and also its relevance (or otherwise) as a component or dimen-sion of good public policy, at the macro level.

This exploratory study examines the implications of subsidisation in development banking in the Pacific with specific reference to the Fiji De-velopment Bank (FDB). Using a two-pronged approach, we firstly meas-ure the level of subsidy dependence of the bank, using three measurement method - the Subsidy Dependence Index (SDI) developed by Yaron (1992); the Net Present Cost to Society (NPCs) developed by Schreiner (1997); and the Subsidy Dependence Ratio (SDR) developed by Khandler and Khalily (1996). Secondly, we draw important comments on the level of subsidy dependence and other related performance dimensions to high-light critical policy issues for development banks and governments.

Subsidisation and Financial Sustainability in Development Banking

Subsidization in development banking has been a much-debated agenda in development financing. Such debates have often reflected dif-fering expectations on the role of such banks. Two important roles are to promote and advance social equity, and to achieve market efficiency (premised on market principles and a strong private sector). It can be ar-gued that the original doctrine of subsidization formed an important ele-ment of the theory of development finance, culminating in the establish-ment of development finance institutions (DFIs), designed to fill a financ-ing gap created by the failure of the market to channel funds to new, long

gestation, low profit yielding, high risk projects, resulting in the neglect and exclusion of certain sectors (Diamond, 1982; UNCTAD, 2002). Current research supports the view that DFIs must aim to achieve financial sustainability in their role of financing and promoting development (Yaron, 2001; Bruck, 1999). This is based on the argument that subsidies distort efficient price and incentive structures and lead to unsustainable production and consumption patterns (Yaron, 1992; 1995 de Moor, 1997; Ledgerwood, 1999; ADB, 2000, 2001). Put differently, subsidies are no longer perceived as support to target sectors/segments but rather, as government's undertaking to underwrite financing and operating requirements of DFIs. Consequently, this perception has significantly contributed to the development and use of a methodological framework in evaluating the effectiveness of subsidy that focuses on measuring the banks ability to generate financial returns in excess of subsidies received, rather than measuring the intended benefits derived by the target sectors/segments. It is argued that if a DFI is to come into the subsidy evaluation equation, then focus should be on their institutional effectiveness and efficiency as financial intermediaries.

What of financial sustainability? Consistent with the Brundtland definition, institutional sustainability is achieved when social benefits exceed total costs and when there is a functional working network to other local institutions (Snow, 1999). This is consistent with McGill's view (1994) that links institutional development with the institution's relationship to its external environment in terms of feedback, which is central to achieving its corporate purpose of effectively serving the community. For development banks, as development finance institutions, financial sustainability must go beyond the bottom line of financial viability and cost efficiency to embrace the ability to generate net social benefits and improve the welfare of society (Ostrom, et al, 1993); and the ability to gain comparative cost advantages achieved through established functional networking and partnerships with local (formal and non formal) development institutions that possess time, space and circumstantial information and knowledge about the target market (Snow, 1999).

The Fiji Development Bank

The Fiji Development Bank (FDB) was established in 1967, when it took over the assets and liabilities of its predecessor, the Agricultural and Industrial Loans Board (AILB), established in 1951. Under its charter, the FDB is required to assist and encourage the development of natural resources and enterprises in Fiji with special regard to the rural and agricul-

tural sectors. Within this legal framework, the FDB has defined its corporate mission to provide finance for projects that contribute to the development of the Fiji economy, and to the improvement in the quality of life of the people. Consistent with its corporate mission the FDB:

i.   gives special assistance to the indigenous community to enhance their participation in commerce and industry;
ii. offers a range of products and services matching the increasing diversification of the banking and financing industries; and
iii. provides constructive business development and management advice and training to clients.
iv. in pursuing its corporate mission and objectives, the bank will seek to remain profitable and self-sustaining.

As a development finance institution, the FDB has over the years focused on supporting the rural and agricultural sectors. Apart from its normal loans to the general public, the FDB, with the support of government and donors, also provides concessionary loans under various schemes to help those who may not have access to credit, and also to address the special needs of those that may have been adversely affected by natural disasters and civil unrest. Such concessionary schemes include:

i.   Commercial Loans to Fijians Scheme (CLFS), to promote participation of the indigenous people in business;
ii. Small Business Scheme (SBS), to assist those who do not qualify under the CLFS and/or are unable to obtain credit from other financial institutions;
iii. Small Business Equity Scheme (SBES), to cater for those interested in establishing small businesses but unable to meet the bank's equity requirement of 20 percent;
iv. The Seed Capital Revolving Fund (SCARF), to support indigenous communities interested in establishing businesses in eco-tourism, fishing and forestry;
v.   The New Zealand Small Loans Scheme, to provide soft loans for the establishment of income generating activities by women and in the rural area; and
vi. The Economic Rehabilitation Package (ERP), to provide emergency assistance to those adversely affected by disaster or civil unrests.

Recently the FDB has undergone major changes in the way it conducts its business. In 1997 the bank moved into other more commercially oriented activities to provide fresh sources of income to support its development functions. Other reasons for the diversification include: to match the increasing complexity of the economy and the consequent diverse

needs of its customers, and to lessen dependence on government financial support. In 2004 the bank implemented a major restructuring programme splitting its lending operations into two separate entities: the Agriculture and Development Finance, to carry out traditional developmental activities, and the Corporate Business Service, to focus on corporate customer needs and normal commercial banking functions. The FDB aims to move into other commercial banking activities like funds management, merchant banking and the businesses of foreign exchange and term deposits. This, however, depends on whether the Reserve Bank of Fiji grants it a full banking license. Recently the bank has also implemented a major review of its fees and charges structure to make it more commercial yet competitive to other credit suppliers.

Subsidy Dependence: Measurement Methods

In measuring the magnitude of subsidy dependence for the FDB, this study uses three measurement methods: the Subsidy Dependence Index (SDI), developed by Yaron (1992), the Net Present Cost to Society (NPCs) measure, developed by Schreiner (1997), and the Subsidy Dependence Ratio (SDR), developed by Khandker and Khalily (1996).

The SDI method measures subsidy dependence by aggregating all subsidies *(S)* received and comparing it to the total loan revenues, being the product of the bank's on-lending interest rate *(i)* and the average loan portfolio *(LP)*. This is mathematically expressed as:

SDI= S/LP x i,   ----- (1),   where SDI is the index of subsidy independence; S is the aggregate of all subsidies received; LP is the average loan portfolio; and i is the weighted average on-lending rate paid on the loan portfolio.

The amount of annual subsidy received is defined as:

S = m x E + A x (m-c)+ (RG+DX–P) -------- (2), where S is the annual subsidy received; m is the social opportunity cost; E is average equity; A is average public debt, c is the rate paid for public debt; RG is revenue grant; DX for discounts on expenses, and P for accounting profit. This equation can be decomposed into two terms. First, (m x E) representing the opportunity cost of equity grants received viz; direct grants (DG) and paid in capital (PC) and second, [(A x (m-c)+RG+DX)-P], being the sum of three profit grants (PG) viz, discount on public debt, revenue grants and discount on expenses, adjusted by accounting profit (P) being the amount of profit available to compensate for opportunity costs while still showing a profit.

The Net Present Cost to Society (NPCs) measures the subsidy dependence in dollar value terms by comparing the cost flows of resources between society and a DFI. To calculate the NPCs, the equation used is:

$$NPCs = (I - d^T_T) \; x \; Eo + S^T_{t-1}(d^{t-0.5}_t - d^T_T) \; x \; FF_t - d^T_T \; x \; S^T_{t-1} \; TP_t, \; .... \; (3),$$
where d is social opportunity cost, *FF* is fresh funds and *TP* is true profit (accounting profit less profit grants viz, discount on public debt, direct revenue grants, and discount on expenses).

The SDR method is similar to the SDI except that it compares total subsidy with aggregate revenues from loans and investment. Subsidy dependence under this method is measured using the following equation:

$$SDR = S/(LP \; x \; i) + (I \; x \; j), \quad ...... \; (4),$$
where *SDR* is the subsidy dependence ratio; *S* is total subsidy; *LP* is average loan portfolio; *i* is the bank on-lending rate; *I* is average investment and *j* is the yield on investment.

Both the SDI and SDR attempt to inform the central question about the social cost of supporting and maintaining a DFI and hence the progress made to generate revenues to cover subsidies by giving an index of subsidy independence. An index of zero (0) shows that a DFI is able to generate sufficient revenues to cover subsidies. The NPCs, on the other hand, measures (in net dollar value terms) the social cost of maintaining a DFI. A negative NPCs figure shows that a DFI is able to generate sufficient cash flows to cover subsidies. Central to the use of these measurement methods is the question of social cost which Yaron and Schreiner (2001) define as the return its public funds could get in their best other use. This study uses the 'Ten Percent in Real Terms' as a proxy for the true social cost, which has been extensively used by the World Bank (Belli, 1996; Katz and Welch, 1993; Kittinger, 1982). Applying this method to the case study, where inflation over the 1996-2004 periods has averaged 3.23 percent for Fiji, the respective estimated social opportunity cost used in computing the SDI, NPCs and SDR is 13.23 percent (ADB, 2004). Tables of results and findings below are based on data drawn from various annual reports of the FDB.

Results and Findings

Tables 1, 2 and 3 show the *subsidy dependence index* (SDI), the *net present cost to society* (NPCs), and *subsidy dependence ratio* (SDR).

Table 1: Subsidy Dependence Index (SDI) for FDB, 1996-2004 (F$000's)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Types of Subsidies									
Subsidy on Equity, E*m	9333	9622	9677	9705	9746	10114	10493	10675	10840
Discount on Public Debt, A*(m-c)	14364	15031	14762	15074	14857	14185	13118	13007	14871
Revenue Grant, (RG)	4235	3686	3489	3347	3286	3347	3719	3559	3210
Accounting Profit, P	302	522	316	105	515	301	697	2042	453
Total subsidy, S	27630	27817	27612	28021	27374	27346	26633	25199	28468
Yield on Lending	0.12	0.12	0.12	0.12	0.12	0.11	0.12	0.13	0.12
SDI	0.77	0.77	0.75	0.75	0.76	0.80	0.81	0.81	1.02
Subsidy (% of Av. Assets)	8.2%	8.4%	7.8%	7.8%	7.9%	8.4%	8.8%	9.1%	10.5%
Subsidy (% of Av. Equity)	39%	38%	38%	38%	37%	36%	34%	31%	34.7%
Loan Revenue (% of Total Rev)	97%	98%	98%	97%	97%	96%	96%	95%	84.9%

Table 2: Net Present Cost to Society (NPCs), FDB (1996-2004)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
NPCs (one year) ($F000's)	25245	24825	25404	26782	25177	25121	24438	23078	26144
NPCs (one year)/Av.Assets	8%	8%	7%	7%	7%	8%	8%	8%	9.6%

Table 3: Subsidy Dependence Ratio (SDR), FDB (1996-2004)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total subsidy, S ($F000's)	27630	27817	27612	28021	27374	27346	26633	25199	28468
Loan Revenue ($F000's)	36059	36262	36784	37507	35920	33982	32929	31238	28037
Investment Income ($F000's)	172	191	180	973	227	426	466	828	470
Total Revenue ($F000's)	36997	37002	37619	38578	36946	35234	34150	32851	33021
Yield on Lending	0.12	0.12	0.12	0.12	0.12	0.11	0.12	0.13	0.13
SDR	0.76	0.76	0.75	0.73	0.76	0.79	0.80	0.79	1.00

Analysis

As clearly shown in Table 1, subsidies have continued to feature prominently in the operations of FDB. While the level of subsidy in FDB has declined by 8.8 percent from $F27,629,766 in 1996 to $F25,199,380 in 2003, total subsidy in 2004 rose to $F28,467,553, or by almost 13 percent. Comparing total subsidy to average assets and average equity shows

that FDB subsidy levels averaged 9 percent and 36 percent respectively. An analysis of the structural composition of subsidies shows that equity subsidies and discounts on public debt are the major components of subsidies and that such subsides to FDB are in the form of interest subsidies and grants to promote particular sectors and segments of society. In terms of indices, ratios and NPCs calculated, the level of subsidy dependence for FDB has increased from a SDI of 0.77 in 1996 to 1.02 in 2004 and a SDR of 0.76 to 1.00 for the same period. The one year NPCs show that the net cost to society of supporting and maintaining the bank has increased from $F25,495,571 in 1996 to $F26,143,803 in 2004, which, if expressed in terms of average assets, stood at 7.6 percent and 9.7 percent for the two years respectively.

An analysis of the operating performance of FDB reveals important insights into the strengths and weaknesses of FDB as an effective intermediary of development finance. As shown in Table 4, the FDB has faced major setbacks.

Table 4: FDB Performance Highlights (1996-2004)

|	1996	1997	1998	1999	2000	2001	2002	2003	2004
Lending									
Growth in Portfolio	1.6	2.2	0.7	1.8	-5.86	1.41	-8.83	-3.68	-0.46
Loan Arrears	9.93	10.11	10.00	7.65	6.51	7.29	6.84	6.66	7.42
Lending market share	22.9	22.70	25.10	24.40	20.60	22.00	20.40	18.20	16.21
Financial									
Net profit (FD$000s)	302	522	316	106	517	302	696	2042	453
Growth in Earning Assets	0.07	0.03	0.02	0.02	-0.03	-0.04	-0.06	-0.09	-0.07
Net Profit/ Av. Equity	0.42	0.72	0.43	0.14	0.7	0.39	0.88	2.53	0.55
Interest Spread	2.36	2.08	1.82	1.96	2.08	2.01	2.51	3.97	3.73
Earnings Spread	3.06	2.7	2.46	2.61	2.7	2.84	3.3	4.61	6.13
Debt/Equity	3.23	2.78	3.39	3.56	3.3	2.99	2.43	2.12	1.99
Operating Efficiency									
Total Income/Av Earning Assets	11.13	11.25	10.32	10.39	10.25	10.19	10.42	10.88	11.73

Source: Data from FDB Annual Reports

Resulting from the declining share of the lending market (loans and advances), from 22.9 percent in 1996 to 16.21 percent in 2004, the bank recorded negative growths in its loans portfolio from the years 2000 to 2004. Further, the bank also experienced contraction in its average earning assets as shown by the negative growth rates recorded for the same period. Such negative growth rates have had a disguising effect on the seeming improvements in operating efficiency (earning assets turnover) recorded, when gross loan earnings and hence profitability have actually declined. On account of interest and earnings spreads, FDB has recorded

strong performance.

Relating total subsidy to key performance indicators viz; interest income and loan portfolio, loan revenue and accounting profit suggest that level of subsidy to FDB bears no significant relationship to either lending or financial performance (see Figure 1).

Figure 1: Subsidies vs Performance Indicators
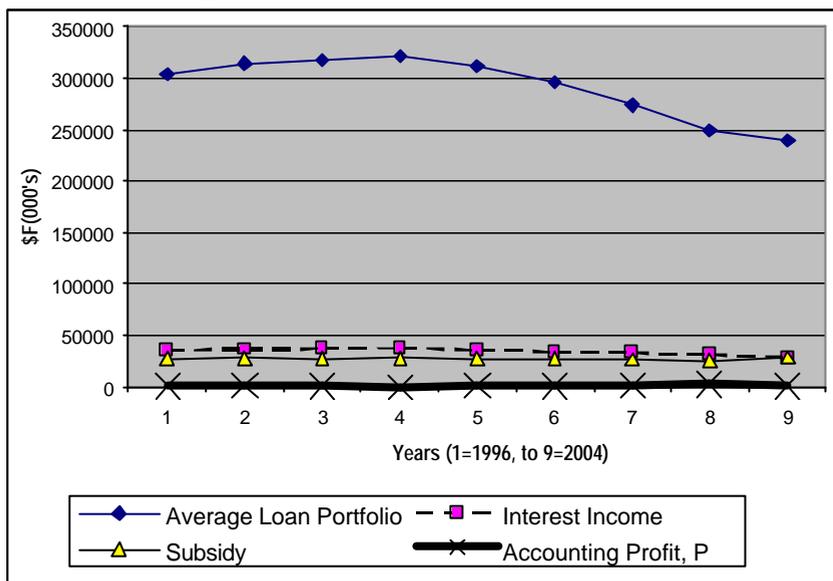
Source: calculations from FDB Annual Reports

Subsidies to the FDB have clearly featured into specific lending products, aimed at promoting identified sectors and segments of society, namely agricultural loans, the Commercial Loans to Fijians Scheme, the Economic Rehabilitation Package Scheme, and the Small Business scheme (FDB Annual Reports, 1996-2004).

Translating the computed SDI indices and SDR ratios into the required changes in lending rates, if FDB were to be subsidy independent, assuming that loans portfolio remained constant, the bank would need to increase its lending rates as shown in Table 5. The net effect of policy attempts to eliminate subsidy dependence, as demonstrated by the implied change in yield (SDI free yield), would be that FDB lending rate would have needed to be higher – for 2004, from the bank's current rate of 12

percent (against the weighted average commercial lending rate of 13.5 percent) to 24 percent. The move to increase lending rate would have been at odds with declining weighted average lending rate, which in 2004 stood at 7.39 percent (RBF, 2004). In other words, the doubling of lending rate to 24 percent would have led further exclusion of certain sectors and segments of society from bank loans.

Table 5: Subsidy Free Rates

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Yield on Lending	0.12	0.12	0.12	0.12	0.12	0.11	0.12	0.13	0.12
SDI	0.76	0.77	0.75	0.75	0.76	0.80	0.81	0.81	1.02
SDI Free Yield	0.21	0.20	0.20	0.20	0.20	0.21	0.22	0.23	0.24
SDR	0.76	0.76	0.75	0.73	0.76	0.80	0.80	0.79	1.00
SDR Free Yield	0.21	0.20	0.20	0.20	0.20	0.21	0.22	0.23	0.24

Discussion

It has been demonstrated that over the years, subsidization continued to feature prominently in the activities of the FDB. To the extent that subsidization addresses equity and social justice issues, by ensuring effective participation of those who cannot afford access to credit through market institutions, such policies on the part of government, donors and multilateral financial institutions will remain to be an essential element of good public policy and governance for sustainable development. The issue of eliminating subsidy dependence and attain financial sustainability, as suggested by numerous studies and implicit in the World Bank and the ADB approaches, would prove counter productive to policy efforts aimed at developing the traditionally weaker but critical sectors and segments of society. Put differently, the transformation of DFIs into commercial financial institutions would result in the further exclusion of certain sectors and segments of the community, and in turn, in the widening gap between the rich and the poor.

To the extent that subsidization falls within the policy framework of the state, within the context of the social cost of public funds or subsidy to society, the need for official oversight is of critical importance to ensure continuing efficiency and viability of development banks as implementing institutions. They must also demonstrate efficiency and social responsibility and be committed to achieve financial sustainability that goes

beyond financial self-sufficiency. This would require their success in establishing partnerships and networks with other local institutions in the common drive to generate a socially desirable, economically viable, and environmentally sustainable development. At the macro level, the FDB must play an active role in the selection and design of subsidy programs and also in the design of appropriate systems of program evaluation. At the micro/institutional level, the FDB must demonstrate a sustained ability to effectively deal with identified structural, policy, and operational issues, especially those relating to organisational structure, management (accounting) information system, and lending systems and procedures. The restructuring program now pursued by the FDB to clearly delineate its purely commercial from development lending activities will certainly allow more transparent and accurate recording of the full costs of servicing the weaker sectors/segments of the community and in particular the cost of channelling subsidies (FDB, 2004; Fiji Times, 2003).

The use of the three measurement methods in the study to measure the level of subsidy dependence in the FDB has provided valuable insights in understanding the relationship between subsidy and key performance indicators. As already mentioned, there appears to be no demonstrative positive linkages between levels of subsidy dependence and operating/financial performance of the bank. By using the social cost of capital, the three methods have delved into the important question about the social cost to society of public funds used to support and maintain development banks. Further, by attempting to net off profit grants from accounting profit to determine true profits, the three methods attempt to overcome the identified limitation of conventional accounting; - the distortionary effect of revenue subsidies on accounting profits.

These comments notwithstanding, the three measurement methods have conceptual limitations. First, the use of interest income as in the SDI and NPCs, or aggregate loan and investment income as in the SDR, omits equally important and relevant income generated from off balance sheet products and services of DFIs. Second, given that financial sustainability, being a macro economic concept, is more than the bottom line of self-financing or financial viability, and that it embraces DFI's ability to generate net social benefits, to use DFI revenues only would be inappropriate as a measure of financial sustainability. Further, the implied definition of subsidy in the three methods as governments undertaking to underwrite financing and operating requirements of DFIs has led to the use of a methodological framework in evaluating the performance of the concerned DFIs that focuses on the ability to generate financial returns in excess of subsidies received, rather than the intended benefits derived by the

target sectors. The identified conceptual limitations of the three meas-urement methods used in this study strongly point to the need to redefine subsidization and financial sustainability in ways that are consistent with the doctrine of development finance and the goal of total value creation in society (Woller, 2002; UNCTAD, 2002)

Conclusion

By measuring the level of subsidy dependence and hence the social cost to society of funds used to support development banks, this study clearly shows the lack of positive demonstrative linkages between levels of subsidy dependence and performance. Yet it can be argued that sub-sidization in development banking will remain to be an important dimen-sion of good public policy, because of their key role by design to correct market failures, which has resulted in the neglect and exclusion of certain sectors and segments of the community. Put differently, policy attempts to eliminate subsidy dependence through upward adjustments on lending rates will most likely lead to further financial and social exclusion. As key public development institutions, with a wealth of skill and experience in development financing, development banks in the Pacific will continue to remain legitimate financial institutions in channeling and monitoring subsidies. But the PIDBs must continue to demonstrate institutional effi-ciency and financial sustainability that go beyond financial self-sufficiency. This would require them to establish working partnerships and networks with local institutions in promoting equitable and sustain-able development. The conceptual limitations of the measurement meth-ods used in this study to measure subsidy dependence suggest the need for further research to develop an appropriate method to measure finan-cial sustainability in the PIDBs; one that is premised on a definition of subsidy that is consistent with the doctrine of development finance and the goal of total value creation in society.

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