Can Capital Markets be a solution for long term lending for our banks

In my last recent columns I have focused in motivating and encouraging business enterprises, Real estates developers, Local governments, Central government (mainly through privatization and implementing legislative actions) to use the local capital market to raise long term capital (or finance) through equity and debt asset classes for the purpose of financing their growth and development, improving the welfare of our people, and achieving financial and economic empowerment through ownership of companies and projects in key sectors of our economy.

Recently, we have heard voices from our local commercial and community based banks (those privately owned, those publicly owned and those owned by the government) that capital inadequacy or lack of long term funding sources has been one of the key reasons that hinders their lending capacity to key productive sectors of our economy such as real estate development, agriculture sector, or any projects that requires long term financing. These recent voices echo and cement further to what has been they key embedded structural challenge on the role of commercial banks in financing long term development projects.

As it is, commercial banks are such a dominant element in our present financial system, and therefore there has been a natural tendency and debate to assume that commercial banks must carry the major responsibility for delivering even the long term financing to projects and sectors that requires long term financing; in reality commercial banks by their nature and business model are either relatively poorly equipped to take such role or do not necessarily have not capacity to do that.

And, the central, even though not the only explanation, is that commercial banks typically have high level of dependence on mobilising deposit (usually short term) from those in the public and corporate organizations who have surplus funds for on-lending to those in need of financing, being the government, business enterprises or individuals. Since most of these deposits are normally left with banks for only a short-term period, there can be an argument that banks may need to make a significant maturity transformation for them to be able to lend long. This, and other explanations confirm that the difficulties that banks face in transforming substantial proportions of their available funds into longer term lending are structural and deep-seated. I understand that this will not be a relatively easy task and the risk that banks potentially perceive in making the maturity transformation will vary over time as will the actual proportion of such transformation that banks will regard as prudent and acceptable.

So, commercial banks structurally, by their nature and business model are meant to solve the short (and to some extent medium) term financing challenges in the economy. Long-term development projects are usually left to be financed by development banks, private equity funds or long term public funds that come out of issuing securities (shares or bonds) to the public investors (retail and institutions) followed by listing those securities into the stock market to enable easy and efficient exit and liquidity creation.

I understand that there is no simple one dimensional solution that will timely facilitate engaging commercial banks with significantly financing long term development projects and/or in such sectors that requires long term capital but the extent of deposit-loan maturity mismatch and capital inadequacy voices has been, looking for financing options that will enable banks to lend long to some of these sectors and projects would be one the preferred approaches. We have heard banks, for example those with government ownership going into the government seeking for recapitalization, others have gone to their shareholders (normally a handful, for privately owned banks) for recapitalization through rights issuances, others (especially international banks operating in our local market) have gone to their parent company seeking for recapitalization and others have gone into International development financing institutions seeking long term debt financing for on lending to long term projects.

Having observed this trend, sometimes engaged in these debates and given my understanding of the extent to which the local capital market can offer or unleash its potential, I am propelled to say something.

About 30% of commercial banks in Kenya are listed into the local stock market. These banks do regularly use the capital market for taping in new capital whenever requires arises – they use rights issuances, they use corporate bonds (which is accepted by central banks as tier II capital) and enable them to lend long term. Over 30% of banks in Ghana are listed into the local Exchange. More than 70% of commercial banks in Nigeria are listed in the local exchange and benefits through various capital raising options that are provided listed companies. Over 80% of commercial banks in Sri-Lanka are listed into the local stock market, and so the list goes. In the opposite, our market is predominantly a private banking system where private banks are allowed to operate in freedom albeit in the context of a regulatory structure and as a result we have 52 banks and only 4 -- less than 10% are listed in our local market.

As is, banks, like other business enterprises or public institutions may use the stock market for capital raising. They can increase their equity investors base, allowing these banks accessible to capital in case of future expansions and growth from a pool of wider and diversified group of investors – through this availability of future funds will be enhanced, as a rights issue may be used to secure further equity if the need arises; the stock market makes it easier & less costly to obtain other forms of finance i.e. corporate bonds (which qualifies as Tier II or Supplementary Capital for banks); capital raising, listing and using the stock market provides for an efficient & effective basis for the valuation of the bank's investment; it also enables implementation of share incentive schemes that may result in a significant improvement of the motivation of its staff and management -- listing into the stock market makes such a scheme more attractive to employees, there is also an enhanced status brought about by a listing favorably affect relations with banks, suppliers, customers and the Government, improve in corporate governance there are tax incentives for being listed to the company and to investors in the company and other many benefits.

I believe, if our banks may consider to opt for this approach, it will enable and compliment other efforts that will enable commercial banks to raise efficient and better priced capital using assets classes that will enhance their engagement in long term lending agenda as other mechanisms and solution for addressing long term development finance challenges in our economy are being sought for.