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Rationale, Structure and Operation of a Promotional Bank - Requirements to meet Best Practice and Excellence

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Rationale, Structure and Operation of a Promotional Bank - Requirements to meet Best Practice and Excellence

Executive Summary

Many countries all over the world have national policy-controlled financial institutions with the mission to support the achievement of economic and political goals set by the state. Belarus is no exception in this context; since 2011 the "Development Bank of the Republic of Belarus" is active in the country, growing its role in the conduct of economic policy in the country. Especially important in this process is the utilization of best international experience and practice for a successful performance of such a Promotional Bank (PB). Germany with its KfW is widely regarded as a role model around the world.

Conceptually, a PB is an institution to correct or mitigate market failures and generally to spur socio-economic developments pursued by policymakers. Such market failures can exist in different areas; common to them is that a (state) bank is used to address them, as opposed to different ministries (or different departments in one ministry) or their subordinated agencies. This increases transparency and efficiency and helps to mobilize additional commercial funds. However, the creation of a PB is not without risk; it might be misused by vested interests or lobby groups, pushed into unsustainable operations by undue political interference, crowd out commercial banks in unfair competition and thereby create also risks for the taxpayers.

Therefore, appropriate arrangements relating to PB`s structure, governance and operations need to be made. While no general model fits all, theory and experience point to some general best practice recommendations. The role of the state (i.e. the owner) should be limited to defining and supervising PB`s overall objectives, strategy, activity areas and general operational guidelines. There shouldn`t be any political interference in single or day-to-day decisions. PB`s executive board (EB) must enjoy operational autonomy under a supervisory board (SB) that is at arm`s length from the government. The SB should be designed as a system of checks and balances, which includes the selection of its members. The PB should preferably be established by a law with appropriate provisions that give a clear mandate. To comply with its mandate, a PB runs promotional schemes with advantageous conditions. An autonomous promotional potential is a prerequisite to achieve at the same time promotion, operational autonomy and sustainability. Observance of prudential behaviour and customary sound banking rules is a necessary precondition to financial sustainability. PB therefore should be subject to prudential regulation and external supervision; furthermore, this is required to create a level playing field to CBs.

The single most crucial restriction for PB`s operation is the compliance with the principle of subsidiarity (complementarity). This principle means a PB shall only be active in areas where CBs provide either no, or only unsatisfactory financing. It shall complement the offers of the commercial finance sector, and not compete with commercial financing institutes, in particular not to crowd them out. This can be applied through different mechanisms (ranging from outright bans to requests for cooperation).

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Abbreviations used in this paper

CB	Commercial Bank
EB	Executive Board
SB	Supervisory Board
MSMEs	Micro, Small and Medium-sized Enterprises
SOEs	State Owned Enterprises

1 Introduction

Many countries all over the world have national policy-controlled financial institutions with the mission to support the achievement of economic and political goals set by the state. They have different names; often they are called Development Banks (DBs). In this paper we call them Promotional Banks (PBs) since this term comes closest to their role and function.

Belarus is no exception in this context. In 2011 the "Development Bank of the Republic of Belarus" was founded. This institution is still in the process of growing its role in the conduct of economic policy in the country, and actively develops its relations with international partners. Especially important in this process is the utilization of best international experience and practice.

This paper deals with key issues that are crucial for the successful performance of PBs. It is structured as follows: In chapter 2, we provide the key rationale of a Promotional Bank, its role in the conduct of economic policy, and the costs and risks that arise when a PB is badly designed. Chapter 3 summarises the requirements of international best practice and excellence in terms of its structure and governance, as well as its operations. We conclude with some final remarks regarding target areas, subsidization and delivery mechanisms in chapter 4.

2 Rationale of a Promotional Bank

2.1 Rediscovery of the PB-concept and renaissance of PBs

After World War II, in the 1950s and 1960s, in Africa, Asia and Europe many PBs were established. These so-called "early PBs" generally were success stories. Encouraged by these positive examples and driven by their social and economic problems, many low-income or emerging countries founded their own PB. However, many institutes of this second foundation wave performed poorly, some even failed. Therefore, in the late 1980s and the 1990s, a phase of closure, restructuring and privatization occurred.

Though these disappointing and sobering experiences were made with PBs in low-income or emerging countries, and despite the generally strong track record of the early PBs, in the 1990s the general prejudice arose that PBs as such are not capable and don`t function well. The orthodox mainstream propagated this general prejudice and recommended as sufficient financial sector policy that the state should confine itself to create an enabling environment, appropriate framework conditions and particularly an effective regulation and supervision. PBs were judged as dysfunctional in a market economy, and perhaps apart from microfinance facilities there wasn`t seen any sufficiently convincing justification for political interference in financial market processes.

But already in the 1990s, a conceptual rethinking began and the renaissance of PBs has started. It commenced in the transition countries in Central and Eastern Europe. Given these countries` huge investment needs for restructuring and modernizing their economies and the incapability or unwillingness of their commercial financial sector to provide the necessary finance, many governments established a PB to overcome or at least to alleviate these problems.

The global financial crisis of 2007/08, and the deep global recession triggered by it further spurred the PB renaissance. Many governments now rediscovered the potential of a PB as an apt instrument to counteract against recession and to strengthen fixed capital investment and growth (jobs and GDP). Starting in 2012, in Western Europe 6 PBs have been founded (see Annex). Nearly all of them are influenced by the German KfW-model.

The renaissance of the PB concept also comprises multinational financial (policy) institutes (MFIs, e.g. ADB, IBRD, EBRD, EIB, to name the most important ones). In 2014, two new MFIs were founded (Asian Infrastructure Investment Bank AIIB, New Development Bank NDB). One reason to establish AIIB and NDB was certainly the aim to mobilize additional investment funds for instance for infrastructure. A further motive might have been the widespread discontent with the dominant influence of the Bretton Wood institutions (IBRD, IMF) as revealed e.g. in the mixed experience of some Asian countries with the recommendations and strategies of IBRD and IMF in the Asian crisis (1998).

2.2 Why do we need Promotional Banks?

Conceptually, a PB is an <u>institution to correct or mitigate market failures</u> and generally to spur socio-economic developments pursued by policymakers. The main reasons of an intervention in markets are:

- Markets provide suboptimal results if competition is hampered by high concentration or high entry barriers. Then firms on the supply (or demand) side have substantial market power as for instance in a monopolistic or oligopolistic market structure. They can exploit their clients and are sluggish in investment and particularly in innovation. A PB can invigorate competition by providing suitable finance to boost investments and innovations of existing competitors or to trigger market entry of new competitors (existing firms and start-ups).

- Even if competition is workable (or perfect), markets can perform poorly because of market failures due to systematically asymmetric information and external effects with the consequence that viable and sound investment projects are not undertaken.

- Systematically asymmetric information generates a finance squeeze for opaque enterprises particularly if they can`t offer sufficient collateral. Normally MSMEs and especially start-ups or innovations are opaque for the financiers. Therefore they tend to be charged too high interest rates or they are credit-rationed and suffer from a funding gap.

- External effects can cause a gap between social and commercial (individual) rentability. In these situations, market driven investment is too small. Characteristic areas significantly hit by this type of market failure are innovations, environmental protection or energy efficiency.

- Temporary or cyclical market failure caused by pro-cyclical oscillation of commercial financiers` risk-aversion generates a too strong credit squeeze at the trough (i.e. during a recession) and an exuberant credit supply at the peak (i.e. during a boom) and thus entails unjustified deep recessions and investment bubbles also in the real economy.

- Market results reflect the status quo of socio-economic frame conditions as e.g. income and wealth distribution, effective access to education, availability and quality of infrastructure. Unsatisfactory frame conditions lead to poor outcomes that policy wants to correct. For instance, a strongly skewed (unequal) income distribution can prompt a too small housebuilding activity or an inadequate educational level because not enough households or people can afford the necessary expenses. By offering targeted financing schemes a PB can mitigate such deficits.

- Moreover, by commissioning a PB instead of a nonfinancial institution to design and implement such economic policy activities (programmes) that use grants (subsidies), loans or guarantees as instruments, major gains in terms of social and individual efficiency of these activities can be realized. Such activities can aim to boost infrastructure investment, increase export efforts, strengthen innovation or advance investments in strategic projects e.g. restructuring and modernizing of state owned enterprises (SOEs).

The main reasons for the expected gains are:

- A PB with economic and banking competence is more capable of identifying suboptimal processes and results of markets. It is more familiar with deficits and problems of commercial financing offers and the financing needs and habits of the target beneficiaries. Therefore, the programmes are more adequately designed and more precisely targeted. For instance, if the utilized promotional instruments do fit in the normal (commercial) financing procedures of the beneficiaries, information and transaction costs can be saved. All this helps to optimize the promotional scheme and minimize subsidies used. Moreover, a PB working as a second-tier institution uses CBs as partners for project selection, risk assessment and especially risk shouldering. This reduces waste or misallocation of capital, ensures a level playing field and gives the chance to mobilize additional commercial funds.

- General experience demonstrates that implementing different promotional activities by different ministries (or different departments in one ministry) or their subordinated agencies substantially suffers from rivalry between the “owners” of the schemes. A lack of coordination (due to costs and unwillingness) tends to cause defective transparency, higher than necessary subsidization and non-exploited synergies. Bundling the promotional activities in a PB makes it easier to avoid or to reduce these negative consequences.

2.3 Costs and risks of badly designed PBs

The major costs and risks connected with a badly specified and designed PB are:

- Misuse by policy (vested interests, lobby groups).
- Unsustainable operations, especially neglect of prudential and sound banking rules due to professional incompetence, poor governance, or undue political interference.
- Disregard of the subsidiarity principle (no competition with CBs, see 3.2) that should be binding for all activities of PB. By competing with the commercial financing sector a PB can severely inhibit its development to the detriment of the real economy. Notably it can crowd out CBs.
- A badly governed PB with intransparent structures and activities bears the risk to be used as a shadow budget that can hardly be monitored or controlled by the representatives of taxpayers.

These dangers can be contained or avoided by appropriate arrangements relating to PB`s structure, governance and operation. Various provisions to this end have been applied in different countries. There is no universal model for a well-performing PB. Theory and experience however give strong hints to crucial requirements that minimize effectively these costs and risks and altogether have proven conducive to best practice and excellent performance.

3 Requirements of best practice and excellence

3.1 Structure and Governance

Normally, the state represented by central government is the only or the dominant owner of a national PB. Despite this strong position of policy, its influence has to be limited to defining and supervising PB`s overall objectives, strategy, activity areas and general operational guidelines. There shouldn`t be any political interference in single or day-to-day decisions. PB`s executive board (EB) must enjoy operational autonomy under a supervisory board (SB) that is at arm`s length from the government.

To limit political influence, a PB should preferably be established by a law with appropriate provisions that give the institute a clear mandate.

This mandate should comprise, among others:

- PB`s general mission and central tasks,
- eligible types of instruments,
- eligible possible (broadly defined) target sectors,
- PB`s positioning towards the commercial financing sector,
- the rights and responsibilities of PB`s owners and of its SB and EB,
- the membership of the SB
- core principles of governance.

To effectively ensure the limitation of political influence, structural arrangements are necessary - also preferably stipulated in the founding law. The SB should be designed as a system of checks and balances. Besides the (precisely-defined) representatives of capital owners (government) it should be made up of members with voting rights representing no-owner stakeholders. These stakeholders could comprise representatively selected members of the Parliament (mirroring its composition), the central bank, representatives of business communities (industry, commerce, MSMEs, start-ups), the banking association, possibly also independent experts.

To comply with its mandate, a PB runs promotional schemes with advantageous conditions or provides favourable financing to priority projects, hereby observing sound banking and sustainability. The combination of promotional financing and sustainability is in the medium or long-term only possible if PB has recourse to budget resources or if it has an autonomous promotional potential enabling it to simultaneously offer attractive (below-market) conditions, cover costs and risks and earning a moderate profit (for capital adequacy needs). Since recourse to budget resources opens the door for undue political pressure and thus jeopardizes financial solvency, an autonomous promotional potential is prerequisite to achieve at the same time promotion, operational autonomy and sustainability.

Such potential can be generated by

- an adequate capital endowment,
- financial privileges (tax exemptions),
- a general explicit state guarantee for PB`s funding
- the prohibition of any disbursements (dividends, profits etc.).

Appropriate provisions should be stipulated in PB`s founding law. The actual utilization of the state guarantee should be counted towards the state`s ceiling for contingent liabilities.

With regard to independent decision making and financial sustainability, further conditions referring to PB`s board should be realized:

- the members of the EB are appointed by the SB,
- all decisions concerning the level below the EB are the right and responsibility of the EB alone,
- EB members must have an excellent banking competence,
- Board members should have the same responsibilities and obligations as directors of corporations under company law, i.e. in particular they should be hold accountable to the SB for the profit & loss account. as well as for PB`s promotional achievements.

The government must have the right to commission a PB with broadly defined promotional tasks, if these tasks are covered by PB`s mandate as laid down in its founding documents. In addition, in order to observe and respect PB`s operational autonomy, the design of concrete implementation strategies must be the responsibility of the PB alone. Eventually, PB`s SB has to decide ultimately whether the commissioning is accepted and the implementation strategy is adopted.

In case the government assigns to PB on a case-by-case basis a precisely defined specific task or even single financings, two basic prerequisites must be fulfilled:

- The government has to cover all cost and risks caused and connected with the specific task.
- The SB must explicitly adopt the mandate.

Observance of prudential behaviour and customary sound banking rules is a necessary precondition to financial sustainability. PB therefore should be subject to prudential regulation and external supervision; furthermore, this is required to create a level playing field to CBs. A conflict of interest and a channel for opaque political influence however might arise if the external supervisor is not sufficiently independent from the government.

3.2 Operation

The single most crucial restriction for PB`s operation is the compliance with the principle of subsidiarity (complementarity). This principle means a PB shall only be active in areas where CBs provide either no, or only unsatisfactory financing. It shall complement the offers of the commercial finance sector, and not compete with commercial financing institutes, in particular not to crowd them out.

First of all, competition with commercial financing institutes can be limited by barring PB completely from activities deemed to be served satisfactorily by the commercial sector. Examples of banned activities are short-term loans (to firms or consumers), working capital or trade finance, private equity. Moreover PB might not be permitted to fund itself by taking deposits or to engage in the financial commission business (trading with securities on account of others).

Besides the complete prohibition of activity areas further and different methods can be applied to ensure subsidiarity depending on the characteristics of activities and promotional products.

- The most apt method to achieve subsidiarity is on-lending. Thereby, a PB functions as a second-tier bank and channels it`s financial products via CBs to the beneficiaries. In case of wholesale on-lending, a PB grants global loans to CBs that transform the global loans in many retail credits to the final borrowers. In case of retail on-lending, each individual loan is channelled via the intermediary CB to the beneficiary. In both cases the CBs have to respect contractually agreed conditions and obligations. In addition they select the ultimate borrowers, assess its` creditworthiness and have to assume the credit risk fully or partly.

- When a PB wants to promote a smaller number of bigger projects or firms, direct lending might be more suitable. Also in this case, a PB should obey subsidiarity and cooperate with commercial financial institutes. A wide range of pertinent cooperation variants is available as for instance co-financing (pari passu, subordinated), syndication, risk sharing. The commercial partners should provide to the overall financing their specific strengths e.g. short term loans, working capital finance or equity. They should have a substantial role in risk assessment and particularly should have to shoulder at least part of the risks.

The different variants of on-lending and complementary direct lending are not constrained to deliver loans; they can also be used in providing equity finance. The involvement of CBs in the appraisal of creditworthiness, in the assessment of risks and particularly in risk shouldering is also another protection against political influence.

PB`s concrete promotional and financial objectives have to be defined and set by its SB. Profit maximization must not be an objective since it is in the first place the cause of the market failures that policy wants to mitigate. A moderate minimum profit rate (hurdle rate) should be among the financial objectives, which altogether should give incentives to minimize costs, to manage risks prudentially, to earn a profit necessary for capital growth and durable solvency.

In addition, market discipline exerted by ratings in the context of PB`s funding via debt issuances is beneficial to sound banking performance. PB should also be rated on a stand-alone basis. High standards of disclosure, reporting and evaluation add control-pressure by stakeholders and the general public and intensify market discipline. An appropriate continuous monitoring is necessary for internal supervision and for controlling the achievement of set objectives. Regularly, in not too large time intervals, PB´s activities and programmes should be evaluated externally[1].

4 Final remarks on target areas, subsidization and delivery mechanisms

The negative consequences of market failure caused by asymmetric information and externalities can strongly affect micro, small and medium-sized enterprises (MSMEs) and most significantly start-ups and innovative companies. Their access to (long-term) finance for investment is severely inhibited and many viable investment projects can`t be realized. On the other hand, the investments of these enterprises in particular of innovative start-ups and innovative existing firms have a highly positive impact on the economy`s competitive strength and a high potential to create growth and jobs. Therefore, financial promotion of MSMEs, start-ups and innovations should have a top priority.

A further target area for financial promotion should be energy efficiency, because here the pertinent propensity to invest is too low given strong external effects and a too short time horizon of commercial economic agents. Moreover CBs don`t offer enough suitable (long term) finance as their risk aversion is high. Thus either low investment propensity, or lack of finance, or both hinder strongly viable investments in energy efficiency. This applies to the housing sector, industry and the energy infrastructure area.

In order to boost standard (non-innovative) investments of MSMES, in many cases an on-lending loan programme with favourable conditions based only on PB`s autonomous promotional potential (mainly it`s funding advantage in comparison to CBs) has proven to be sufficiently attractive. In order to stimulate innovative start-ups or innovations of existing SMEs, additionally the injection of budget resources might be compulsory. Very high risk innovation projects (e.g. seed finance investments) need equity finance that should be granted directly (not via on-lending), but in close cooperation (in particular risk partnership) with commercial equity investors.

The tapping of budget funds is also required in a credit scheme to fund energy efficiency investments adequately. For the housing area an on-lending scheme may be satisfactory. For larger industry or infrastructure projects usually direct lending in close cooperation (especially burden sharing) with

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[1] See our Policy Paper 03/2015 „"How to make it better – Evaluation and Monitoring of Promotional Activities" for more details.

commercial banks and possibly equity financiers is necessary. The same delivery procedure would have to be applied when a PB had the task to support restructuring and modernization of state owned enterprises (SOEs).

Annex

Table 1

Recently established Promotional Banks in Europe

Banque Publique d`Investissement (bpifrance)	2012
British Business Bank (BBB)	2014
Development Bank of the Republic of Belarus	2011
Instituicao Financeira de Desenvolvimento (IFD)	2014
Institution for Growth (IfG)	2014
Strategic Banking Corporation of Ireland (SBCI)	2014
UK Green Investment Bank	2012
Vnesheconombank (Russia)	founded 1922, restructured and converted into a Promotional Bank in 2002 - 2007
Dutch Investment Bank (DBB)	establishment is under discussion

Source: Own research

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