Structure and Operation of a Promotional Bank

- Special Aspects -

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Structure

1. Distribution of profits given a mixed ownership structure
2. Accounting of budget funds (Example KfW)
3. State guarantee – Basic variants
4. Specific financial activities requested by the state
5. Regulation and Supervision – Changes and Trends (Example KfW)
6. Conclusion

Contacts

1. Distribution of profits given a mixed ownership structure

- **Principle**: A PB can`t comply with its mandate (general mission and tasks) if it behaves as a profit-maximiser. Therefore, it needs non-profit seeking capital that normally is provided only by the state. Profits earned (net after taxes if applicable, depreciation allowances and provisions) <u>should be retained and invested</u> in the enlargement and deepening of its promotional activities.
  - Example KfW (Article 10 / KfW-Law): “There will be no distribution of profits.”
- In some countries, also private capital must be raised (in cash or in-kind) to achieve the necessary minimum amount of PB´s initial capital. Normally, private capital is seeking a return. This should be handled as follows:
  - Firstly: The private capital providers should be persuaded (by the state as the dominant shareholder) that they can only earn a moderate sub-market return
  - Secondly: They should be convinced to have “their” return allocated to a separate reserve (attributable to them) and not distributed
    - Example: The German Federal Ministry for Economics and Energy has brought capital (ERP Special Fund) into the equity of KfW as a special capital reserve. This separate reserve earns a return, that is not distributed but allocated to it

Distribution of profits given a mixed ownership structure (cont'd)

- Thirdly: In case private capital owners do not forgo profit distribution, the disbursement should be bound to preconditions, as for example:
  - minimum amount of net profit or return on capital,
  - minimum requirements to solvency and liquidity figures and ratios,
  - minimum quantity and quality of promotional activities and achievements

- A similar approach and an analogous set of preconditions should be applied to potential interest payments for individual purpose-tied deposits (liabilities) of e.g. ministries or regional (state) authorities.

2. Accounting of budget funds (Example KfW)

- Budget funds earmarked to refinance specific activities/programmes:
  - Assets and liabilities held in its own name but for the account of third parties are not recognized (in the balance sheet). This applies in particular to loans extended under German Financial Cooperation to support developing countries.
  - These funds are granted and underwritten by the federal budget. They are transparently reported outside the accounting system (e.g. in the annual report).
  - Funding out of the budget for the account of KfW is recognized in the balance sheet in “Liabilities” (2014: ca. 1% of borrowed funds).

2. Accounting of budget funds (cont'd)

- Budget funds earmarked for interest rate reductions:
  - Annual subsidies (from the ERP Special Fund) in order to run ERP promotion programmes are recognized as deferred income in "Other Liabilities".
  - They are amortised in the profit and loss account under Interest Income" as the corresponding interest losses occur. Thus, they don`t affect the net income.
  - For information only: Interest rate reductions financed out of KfW`s own earnings are shown in the profit and loss account at their present value at the time the loan terms and conditions are fixed.

3. State guarantee – basic variants

- A state guarantee is an important mean to create an autonomous promotional potential for a PB (see GET Belarus PP/06/2015, p. 5). The optimal design of such instrument is a general explicit, direct and unconditional guarantee of the central state
  - Example: KfW enjoys such guarantee covering all obligations of KfW with respect to all borrowed funds (loans borrowed, debt securities issued, forward transactions fixed, options entered into, etc.) and credits to third parties expressly guaranteed by KfW itself (Article 1a, KfW - Law).
- Second and third best solutions restrain the state guarantee to certain conditions or to only a part of the funding (e.g. purpose bound for specific activities/programmes) or funding only in a certain period (i.e. the guarantee expires and must be issued newly or protracted). These variants are indeed superior to an implicit informal guarantee but they entail insecurity for lenders, reduce PB`s rating and the achievable funding advantage and widen the scope of possible undue political interference.

3. State Guarantee - basic variants (cont'd)

- The contingent liabilities of the state created by its guarantee in favour of PB should be reported comprehensively and transparently in the context of the state's debt (ceiling). Given these circumstances and in particular if the state is not heavily indebted, it is not absolutely mandatory to include PB respectively the actual guaranteed debt in the state sector (to add it to the state debt or contingent liabilities).
  - Example: According to the rules of the European System of Accounts, a PB and it`s liabilities are not subsumed under the state sector if:
    1) the institute is classed as monetary financial institution (MFI) by ECB,
    2) it channels funds between third parties via it`s balance sheet,
    3) it has autonomy and discretion in the exercise of it`s principal functions, and
    4) it places itself at risk by acquiring financial assets and incurring liabilities on its own account.
- Pursuant these rules, KfW is not classified in the state sector regardless of the general explicit unconditional state guarantee. However, specific transactions assigned to KfW by the state (whose risks are fully covered by a specific guarantee) are allocated to the state sector, respectively included in the state debt.

4. Specific activities of PB requested by the state

- The state (government) as dominant owner has the right to commission PB not only with broadly defined promotional tasks within its mandate, but also to assign to PB precisely defined special tasks. However, government must shoulder the risks caused by the execution of the task and those costs that can`t be earned by PB. Moreover, PB`s board must have adopted explicitly the special task.

- Example KfW: The legal basis to assign special tasks to KfW is set in Article 2(4) KfW-law. The requirements of such assignment are: It must occur on a case-by-case basis. A state interest must be given. An assignment letter of the government is necessary containing a description of the task, reporting requirement and a risk-covering state guarantee. There has been a wide range of special tasks. They can comprise capital market functions, financing activities or the execution of specific services.

4. Specific activities of PB requested by the state (cont'd)

Examples of special tasks executed by KfW:

- Privatisation of Deutsche Telekom and Deutsche Post: KfW acquired shares from the firms` owner – the Federal Government – since 1997 and placed some of them in the market.
- "KfW Special Programme": The scheme was designed to ward off a credit squeeze in the crisis 2008/09. It started at the end of 2008 and ceased as planned at the end of 2010. It offered mid-term loans for investment and working capital to SME and large firms (on-lending) as well as project financing (on-lent or directly).
- Financial Support Measures for Greece: The first rescue package for Greece in 2010 included coordinated bilateral loans of the Euro area member states of altogether up to EUR 80 billion. KfW was commissioned by the German government to provide and handle Germany`s portion - a loan of up to around EUR 22 billion collateralized by a state guarantee.

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4. Specific activities of PB requested by the state (cont'd)

- Refinancing of Export Loans covered by Federal Guarantees: KfW offers banks the refinancing of long term export loans granted to buyers of German goods that have their place of residence outside EU. The loans to be refinanced must be secured by an export credit guarantee and a securitisation guarantee. The programme terminates 31 December 2020.
- EU Global loans: KfW extends global loans to partner banks in EU countries enabling them to extend loans to SMEs for fixed capital investment and to municipalities for environmental and climate protection.
- Financial Reunification: Special Tasks after 1989
  - Outstanding financial claims and bank account credit balances were transferred to West-Germany in the reunification process. They are managed by KfW.
  - Outstanding financial claims out of foreign trade relations of former East-Germany against other countries are handled and unwound by KfW.
  - Currency Compensation Equalization Fund. Established in connection of the German monetary union and administered by KfW.

5. Regulation and Supervision – Changes and Trends (Example KfW)

- In order to ensure compliance with prudential and sound banking rules, PB shall be subject to prudential regulation and external supervision in an appropriate manner that takes into account its particular mandate and business model.
- Triggered by the global financial and economic crisis (2008/09-…) a process of streamlining and strengthening of supervisory structures also of PBs arose in many countries (e.g. France, Italy, Germany, EU - concerning EIB). In this context, in 2013 also the KfW-Law was amended.
- KfW: Regulation and supervision <u>before</u> amendment:
  - not subject to EU Banking Regulations and German Banking Act (GBA). Main reasons: activities limited to promotional tasks, no need to protect retail depositors, ban to conduct current account business and financial commission business, no banking licence – thus, all GBA-provisions of revocation and expiry of authorisation can`t be applied.
  - subject to legal supervision by Ministry of Finance (in consultation with the Ministry of Economy and Energy). Supervisory authority has the power to adopt all measures necessary to have KfW in conformity with laws, by-laws and other regulations.
  - Though KfW was not subject to GBA, it voluntarily applied components of the GBA (e.g. solvency regulation, minimum requirements for risk management).

5. Regulation and Supervision – Changes and Trends (Example KfW) (cont'd)

KfW: Regulation and supervision after the amendment:

- Ministry of Finance (in consultation with the Ministry of Economy and Energy) issued a specific KfW-regulation stipulating that:
  - selected key provisions of GBA will be analogously applicable to KfW
  - technical supervision of compliance with these provisions will be exercised by the German Federal Supervisory Authority (BaFin) in cooperation with the Deutsche Bundesbank.
- Already in summer 2014, the corporate governance rules of GBA (suitability of directors, expertise required of members of Supervisory Board, structure of SB-committees) were implemented by KfW.
  - there are exemptions concerning special tasks assigned to KfW
  - the specific KfW-regulation provides that the particular function of KfW as a PB shall be taken in consideration into BaFin`s supervision
  - large parts of the specific regulation will enter into force on 1 January 2016 (selected provisions before this date).

5. Regulation and Supervision – Changes and Trends (Example KfW) (cont'd)

What did the specific KfW-regulation <u>not</u> alter?

- Also in the future, KfW will not be a "normal" bank. It is classified as a public sector entity, it is <u>not</u> subject to GBA and EU Banking Regulations, their provisions will only applied by analogy.
- Application of liquidity ratios and maintenance of recovery and resolution plans are excluded as they are not relevant for the state-guaranteed KfW.
- The legal supervision is unchanged. It will continue to be conducted by the Federal Ministry of Finance (in cooperation with the Ministry of Economy and Energy).
- The amended regulation and supervisory regime has no bearing on KfW`s tasks and functions set in its law.

Remark: The new regime will cause significant additional transaction costs

6. Conclusion

- Net profits should be retained and reinvested in promotional activities. If the ownership structure makes it necessary to distribute part of the net profit, then a set of appropriate preconditions should be fulfilled before.
- Accounting should show transparently the use and volume of budget funds and subsidies. Funds hold or channelled for the account of third parties should be reported comprehensively.
- A state guarantee should be designed and handled in such manner that the promotional potential created by it is maximized and that the autonomy and discretion of PB will not be reduced. Reporting on the use of the state guarantee should be transparent and comprehensive. In the EU, according to the rules of Eurostat even a general explicit unconditional state guarantee will not automatically have the consequence that a PB is subsumed under the state sector and its debt is qualified as state debt.
- The government should have the right to assign on a case-by-case basis special tasks to a PB. However, a set of prerequisites must be satisfied.
- Regulation and supervision: It is necessary that rules of prudential and sound banking, as well as key norms of the national banking law are applied to a PB, hereby however considering its particular functions and business model. The supervision should be exercised by an independent external body - generally by the national banking supervisory authority.

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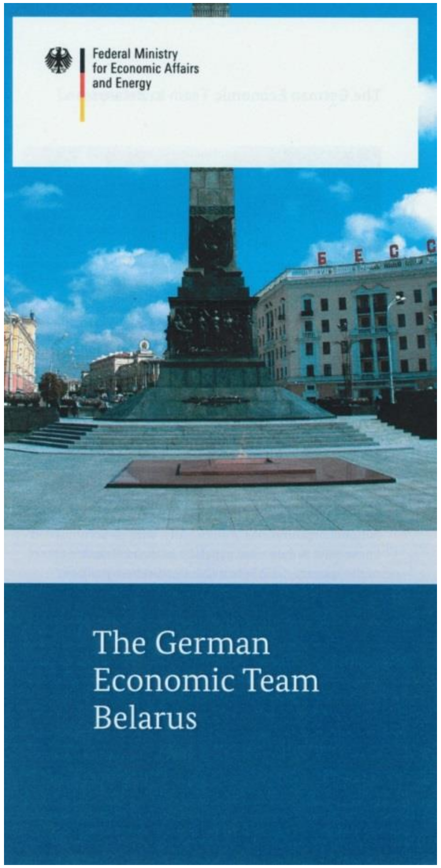

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