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State Financial Institutions

Can They Be Relied on to Kick-Start Lending?

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This is the 12th in a series of policy briefs on the crisis—assessing the policy responses, shedding light on financial reforms currently under debate, and providing insights for emerging-market policy makers.

The need to kick-start lending to the real sector in response to the global financial crisis is leading many countries to expand the role of state-owned financial institutions. The effectiveness of the support by these institutions depends in large part on the nature of the shock, on their ability to leverage private commercial banks to scale up their impact, and on the existence of a sound institutional framework. While it is too early to evaluate their effectiveness, past experience with the use of such institutions is sobering. Whether countries will heed the lessons of this experience remains to be seen.

Commercial banks in several countries have been severely affected by the global financial crisis and are seeking to raise new capital and shrink their balance sheets. Internationally active banks are reducing their cross-border exposure and retreating to core markets as part of this deleveraging process and in response to increased risk aversion. At the same time there has been a severe contraction of aggregate demand as households and companies attempt to cut back on spending and investment. All these factors have combined to slow the growth—and even reduce the level—of bank lending in many economies.

In response to the perceived credit crunch, authorities in many countries have taken measures to kick-start lending, including through the use of state financial institutions. Governments in both developed and emerging economies have used their state financial institutions to support lending in specific sectors, such as for trade finance and for small and medium-size enterprise loans (box 1). While some governments have not provided additional funding explicitly for this purpose, others have committed such resources and have even used state financial institutions to recapitalize or provide liquidity to troubled banking institutions (for example, Brazil, Germany, and the Russian Federation).

A sad history

While state ownership of banks has been reduced over the past 20 years, state financial institutions remain important in many parts of the world (table 1). OECD countries had the lowest public participation in bank ownership in 2005, while low-income countries have recently been the most active in reducing the role of state-owned banks in the financial sector (Barth, Caprio, and Levine 2000).

Box 1 Some crisis-related policy responses using state financial institutions

- **Brazil.** The government authorized state-owned banks to take equity stakes in private banks and to buy loan portfolios from financial institutions that have liquidity problems or are owed money by companies in financial difficulties.
- **Canada.** Besides committing Can$350 million in capital to both Export Development Canada and the Business Development Bank of Canada, the government is increasing their authorized capital and associated borrowing limits.
- **Chile.** The government doubled the Tier 1 capital of state-owned Banco Estado so as to increase lending to vulnerable sectors.
- **China.** The government instructed state-owned banks to increase lending to specific sectors to stimulate growth.
- **Finland.** To increase lending to small and medium-size enterprises, the government raised the ceiling on state-owned Finnvera's commitments for domestic and export financing. In addition, it allowed new countercyclical loans and guarantees and raised the compensation paid by the state to Finnvera for losses arising from their issuance.
- **Germany.** The government instructed KfW to increase its lending by up to €15 billion in 2009. It also requested KfW to provide an additional €3 billion to its infrastructure programs and required the bank to lend to larger companies to bridge short-term liquidity shortfalls. KfW and state governments have also provided funding to recapitalize weak regional state banks (*Landesbanken*).
- **Republic of Korea.** The government provided capital injections to state-owned banks, such as Korea Development Bank, the Industrial Bank of Korea, and the Export-Import Bank of Korea, to enable them to roll over existing loans and provide new loans to small and medium-size enterprises.
- **Mexico.** State-owned development banks extended guarantees on commercial paper and credit instruments issued by specialized nonbank credit institutions (*sofoles*). They have also acted as a lender of last resort for large companies and participated in programs to support fragile sectors. They have funded the new exposures using a guarantee fund created by the government and in some cases (such as Bancomext) through capital support.
- **Russian Federation.** The government injected US$5 billion of capital into state-owned development bank Vnesheconombank (VEB) to assist with the failures of several smaller banks. The government also allocated 175 billion rubles (Rub) from the National Wealth Fund to VEB for investment in Russian financial instruments with the aim of diversifying the fund's investments. In addition to Rub 960 billion in subordinated loans to the largest state-controlled banks, the government is to inject another Rub 400 billion of state funds into two of these banks in exchange for an increase in their lending to Russian companies.

Source: World Bank analysis.

Empirical evidence from several authors shows that many state financial institutions around the world have been characterized by political interference, lack of transparency, low accountability to stakeholders, inadequate prudential regulation and supervision, and lack of managerial skills and proper incentives. These weaknesses have typically resulted in credit misallocation, high losses, and persistent needs for recapitalization—and have spurred the drive toward bank privatization in recent decades.

Table 1 State financial institutions' share of banking assets, 2005

Region or country group	Share of total assets (%)[a]
East Asia and Pacific	27
Europe and Central Asia	15
Latin America and the Caribbean	23
Middle East and North Africa	46
South Asia	20
Sub-Saharan Africa	20
OECD countries	6
Non-OECD high-income countries	7

Source: Fitch Ratings; World Bank Regulation and Supervision Database.
a. Based on majority ownership.

While the literature makes no distinction between state development banks and state commercial banks, it suggests that state financial institutions have adversely affected economic growth (box 2). La Porta, Lopez-de-Silanes, and Shleifer (2002) find that government ownership of banks is associated with slower subsequent financial development, lower economic growth, and lower productivity growth. Beck and Levine (2002) fail to find any positive effect of government ownership of banks on growth. Caprio and Martinez Peria (2002) show that government ownership of banks is associated with a higher likelihood of banking crises.

Dinc (2005) provides evidence that state financial institutions increase their lending during an election year and that in emerging markets they finance the government to a greater

Box 2 Classifying state financial institutions

State financial institutions can be classified as deposit takers or non-deposit takers and as development institutions with a public policy mandate or commercial institutions without one. Following Scott (2007), this brief uses *state commercial bank* to refer to a deposit-taking institution that seeks to maximize profit (or value) and has no mandate to pursue public policy objectives (see table). Such banks exist in many countries and are often the legacy of central planning. The brief uses *state development bank* to refer to an institution that has an explicit public policy mandate. While some state development banks are funded mainly by deposits from the general public, others receive exclusively endowments from the government. The brief uses *development finance institution* to refer to an institution that is presumed to be financed mainly by nondeposit resources, such as loans from the state, long-term loans from multilateral institutions, and bonds issued in local and international capital markets. All three types of institutions are referred to collectively as *state financial institutions.*

While classifying a state financial institution in a single category is sometimes difficult, this brief focuses mainly on state development banks and development finance institutions with an explicit public policy mandate.

Characteristics of state financial institutions

Type of institution	Profit maximizing	Deposit taking	Public policy objective
State commercial bank	✔	✔	
State development bank		✔	✔
Development finance institution			✔

Source: Scott 2007.

degree than do private banks. In the same line Micco, Panizza, and Yañez (2007) find that state financial institutions have lower profitability and higher costs than commercial banks and that the gap widens during election years. Evidence provided by Sapienza (2004) suggests that the presence of state financial institutions in Italy has distorting effects on the allocation of financial resources. In particular, the lending behavior of these banks is affected by the electoral results of the political party with which they are affiliated: the stronger the political party is in the area in which such a bank is lending, the lower the interest rate charged by the bank.

The ability to respond

How effective can state financial institutions be in tackling a crisis-induced decline in lending? The answer depends largely on the nature of the shock and on the capacity of those institutions.

Nature of the shock

When a crisis-induced decline in lending occurs as a result of banks' behavior (supply-side effects), state financial institutions may be able to play an important role in channeling credit toward underserved sectors. But when the shock results from a severe slowdown in the demand for credit by the real sector, such measures may be counterproductive, crowding out private market players and leading to future losses. By helping to artificially boost production, they would also postpone any adjustments that may be needed in the country's economic structure after the crisis.

The supply-side effects may arise not only from banks' undercapitalization and deleveraging, but also from the procyclical behavior of banks' risk aversion independent of the nature of the shock. Commercial banks typically move to safer assets during periods of turbulence or recession and tap riskier markets during periods of sustained economic growth, which may increase the depth of economic cycles (de la Torre and Ize 2009). Because state financial institutions have less volatile risk aversion and therefore provide a more stable source of financing, they can play an important role in acting as a buffer and filling the credit gap. In sectors with marked cyclical behavior, state financial institutions should therefore be able to expand their portfolios during periods of recession and shrink them during periods of economic growth.

A separate but related issue is the relative degree of risk aversion of state financial institutions. Because state financial institutions (particularly those with a public policy mandate) serve riskier economic sectors than commercial banks, and most have reasonable return (rather than

profit maximization) targets, they can naturally be expected to have lower profitability. Under this argument, acceptance of lower returns should not necessarily be confused with higher inefficiency; instead, it is a natural consequence of riskier portfolios and higher operational costs as a result of operating in more difficult markets (Yaron 2004). Of course, even in this case state financial institutions need to develop information platforms, control systems, and pricing policies consistent with the risks they are taking.

During recessions and financial crises, including the current one, it is no easy task to identify the nature of the shock (Bernanke and Gertler 1995), particularly the roles of demand- and supply-side effects. Policy makers have tended to respond to crises by using all instruments at their disposal to ease the effects. When using state development banks for targeted credit support, however, they are well advised to act prudently.

Capacity constraints

Sheer capacity constraints and lack of management skills can limit the ability of state financial institutions to quickly accelerate their credit operations. For example, it is unrealistic to think that a development bank with a 1 percent market share could solve the problems in an economy in which overall credit is shrinking by 10 percent a year. While state financial institutions should operate with some idle capacity so as to be able to deal with periods of recession, forcing them to significantly expand their lending operations might result in poor credit allocation and lead to future losses. This is particularly likely when they are asked to engage in activities in which they have little experience—for example, acting as lender of last resort in providing liquidity to commercial banks struggling with illiquid assets.[1]

During a financial crisis, state financial institutions should look for smart lending strategies. They are unlikely to have much impact by themselves in cushioning a credit crunch. Thus a more effective approach may be to leverage the infrastructure and expertise of commercial banks. This approach could include using cofinancing arrangements and providing credit guarantees to encourage commercial banks to enter into particular lending transactions. In such cases state financial institutions may have to absorb more risk than commercial banks, for example, by taking the junior debt in syndicated loans or assuming first-loss positions in guarantees. Lines of credit, insurance products, and technical assistance may also help state financial institutions scale up their impact by leveraging the operations of private banks.

Key elements of institutional design

Policies for using state financial institutions to support credit growth will succeed to the extent that they are prudently applied and complement other measures to restore economic stability (de la Torre, Gozzi, and Schmukler 2007). As experience in Africa, Latin America, and Central and Eastern Europe shows, the institutional design of state financial institutions is also critical to their successful use (see, for example, Hanson 2004 and Sherif, Borish, and Gross 2003).

Restructuring the institutional framework of state financial institutions may be expensive and take time. Some countries consider restructuring during a crisis period, but it may take years before an institution becomes ready to support government initiatives. Emerging economies have had multiple failed attempts at restructuring poorly designed state financial institutions. Hanson (2004) concludes that while such outcomes can be attributed to timid reforms and regulatory forbearance, the main problem has been the failure of the reforms to address the fundamental problems of the institutions.

Although the empirical evidence leans heavily against an overall positive role for state financial institutions, some have been successful in fulfilling public policy mandates. The effectiveness of their support depends on a range of factors, including a clear and sustainable mandate, high standards of corporate governance, strong prudential regulation and supervision, and reliance on market discipline to provide the right signals to the main stakeholders (Rudolph 2009).

Mandate

Because state financial institutions are typically required to address market failures by providing financial support to sectors inadequately served by private institutions, they must have a clear public policy mandate. The mandate should include at least three elements. First, to avoid the involvement of state financial institutions in

the purely commercial and most profitable parts of the market, the mandate should define target sectors addressing a specific market failure, such as a lack of finance for infrastructure or for small and medium-size enterprises.

Second, the mandate should establish a role for state financial institutions that complements that of commercial banks and set rules of cooperation with them. This is particularly important when state financial institutions receive funding through government lines of credit at subsidized rates, which may then be used to underprice products offered in direct competition with commercial banks.

Finally, the mandate should require financial sustainability by specifying a minimum rate of return on capital. But while the mandate should request a positive rate of return, the board of directors or the shareholders should specify the exact figure. In general, it is difficult to justify a target rate that is much higher than the cost of funding for the government.

The mandate also needs to be sustainable. Broad mandates run the risk of allowing state financial institutions to hide operational inefficiencies and crowd out private market participants through "cherry picking" behavior. But excessively narrow mandates run the risk of being financially unsustainable and leading to dependence on government subsidies. For state development banks the funding of operations is also a controversial issue. Unless their mandate is related to promoting savings or enhancing the payment system in certain market segments, retail funding should generally be outside their scope because it imposes additional challenges in management, transparency, and supervision.

Corporate governance

Corporate governance principles for state financial institutions should be consistent with best practices for private and public companies, as summarized by Scott (2007).[2] Good corporate governance is particularly important for these institutions because they are subject to two major and related threats: political interference and lack of board and senior management capacity. Both threats typically result from lack of operational and financial independence and from opaque communication between the bank and its government shareholders.

The risk of political interference can be reduced by precisely defining the representation of the shareholders. In state financial institutions the individuals functioning as the shareholders' representatives often come from a number of different government institutions. This creates conditions for multiple pressures on the board or management, which can result in credit misallocation and other inefficiencies. Ensuring a transparent, structured process for nominating board members, including minimum fit-and-proper criteria, can also help limit political interference. The board of directors should then select the senior management of the institution and hold it accountable.

Communication between the government and the state financial institution should take place primarily between the government's representative—for example, the minister of finance—and the president of the board of directors. A written record of such communication may help legitimize the role of the board of directors and avoid inappropriate involvement of the government in the management of the institution.

Prudential regulation and supervision

State financial institutions should be subject to prudential regulation and supervision by the relevant authorities. This should apply not only to deposit-taking institutions but also to state development banks and development finance institutions that receive exclusively wholesale or government funding, since they are also highly leveraged institutions that may create systemic risk (see also de la Torre and Ize 2009 and Fiechter and Kupiec 2004). Banking supervisors should put special emphasis on governance arrangements, the sustainability of the business model, and the quality of the bank's management systems. Government comptrollers or audit offices are poor substitutes for specialized banking supervision, since these institutions usually lack the expertise to assess the risks inherent in banking.

Market discipline

Market discipline can be leveraged to create positive incentives for management. State financial institutions can be required to raise funds from public debt markets without explicit

guarantees and obtain (where possible) a rating from a reputable credit rating agency (Moody's Investors Service 2003). These actions introduce an independent source of evaluation of bank management that can be used by the board or shareholders.

Market discipline also represents an important test for the risk management models used by state financial institutions. Under the traditional funding scheme using government lines of credit, institutions lack the incentive to fully develop risk management systems because they basically lend what they receive. By contrast, under a market funding scheme, state financial institutions can lend as much as they can borrow and they need to improve their risk management strategies to reduce their cost of funding. Market funding reduces the potentially unhealthy dependence of the state financial institution on its shareholders, which creates a breeding ground for corruption and government interference. It might be argued that market discipline does not help because of the existence of an implicit government guarantee. But an implicit guarantee is not always priced similar to an explicit one, and it typically includes a premium that reflects how well the institution is managing its risks on a stand-alone basis and compared with its private sector peers. In South Africa, for example, the Development Bank of Southern Africa has paid up to 300 basis points less in yield for bonds issued with a state guarantee than for those issued without one.

Market discipline should be grounded in high levels of transparency and disclosure because they help to increase external monitoring and accountability. For example, some shareholders try to influence credit decisions through opaque interactions with bank directors or managers but take no responsibility for subsequent losses. As the case of the Business Development Bank of Canada shows, transparency results in less government interference and greater participation by the media and citizens in monitoring the activities of a state financial institution (Scott 2007).

Conclusion

In the past 20 years there has been a common belief that the state's role in the financial sector should be limited to supporting the enabling environment and regulating and supervising privately owned financial institutions. But the crisis is leading to a rethinking of this role in favor of more interventionist approaches, including the use of state-owned financial institutions to promote public policy objectives.

State financial institutions can play a useful role in supporting credit growth during a financial crisis under certain conditions. The effectiveness of their support depends in large part on the nature of the shock (whether a credit crunch or a slowdown in credit demand) and on their ability to leverage the infrastructure and expertise of private commercial banks to scale up their impact. Also critical to their successful use is a sound institutional framework—with a clear and sustainable mandate, high standards of corporate governance, strong prudential regulation and supervision, and reliance on market discipline to provide the right signals to the main stakeholders.

While it is too early to evaluate the effectiveness of support by state financial institutions, past experience with their use is sobering and suggests that in many cases their long-term costs could exceed any short-term benefits that they provide. Whether countries will heed the lessons of experience in this area or are condemned to repeat them remains to be seen.

Notes

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1. This role is especially important in countries where central banks take only government paper in their discounting and repurchase operations.
2. These are based on the *OECD Principles of Corporate Governance* (OECD 2004), the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (OECD 2005), and the Basel Committee on Banking Supervision's principles in its *Enhancing Corporate Governance for Banking Organisations* (2006).

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