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# A framework for successful development banks

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# Contents

1. Introduction ..... 4

2. Role of development banks ..... 5

3. Evolution of development banking ..... 6

4. Successful development banks: Dimensions and principles ..... 7

- 4.1 Enabling environment ..... 7
- 4.2 Mandate ..... 9
- 4.3 Regulation and supervision ..... 14
- 4.4 Governance and management ..... 18
- 4.5 Financial sustainability ..... 24
- 4.6 Performance assessment ..... 27

5. Macro-framework for development banks ..... 30

6. Conclusion ..... 32

References ..... 33

Annexure 1: Summary table: Dimensions and principles ..... 36

## 1. Introduction[1]

The global financial crisis had a particularly severe effect on developing countries. Even those that were in good financial health were dramatically affected by the sudden withdrawal of foreign investment and the escalating costs of funding worldwide. The effect on their fragile economies was devastating. As the environment grew increasingly risky, banks needed to strengthen their financial positions. This led them to curtail lending, often sharply, leaving firms without access to finance. The shortage of finance for firms exacerbated the economic downturns in these countries.

Governments recognised the need for a countercyclical source of finance that would continue to provide finance to firms during recessionary times. Several of them turned to national development banks – government-owned banks that are tasked with addressing market failures in the financial system. Being supported by the government, they are able to provide countercyclical funding, assisting firms at exactly the time that private banks are forced to curtail their lending.

But this strategy is not without risks. National development banks have a long history of failure, although there have been some successes more recently and these banks are starting to play an important role in the development of some emerging economies. In the 1970s and 1980s, many governments in developing countries established development banks patterned on the successful development banks of the post-World War II era. However, these banks were poorly controlled and managed, and their profligate spending contributed to fiscal crises in several developing countries, while delivering little in the way of development. De Aghion (1999:3) points to '[h]igh arrear ratios, poor cost-benefit evaluations, and widespread evidence of mismanagement and corruption' among development banks. They were often used to pursue overtly political rather than developmental goals. As a result, many of these banks failed. Some were privatised, restructured or closed, and the future of development banking seemed uncertain. According to Krahnen and Schmidt (1994:6), 'Development banks still have to find their proper role in a world where financial repression is on the retreat… They might not find such a role and gradually die.'

However, despite the failures in the second half of the 20th century, governments have been reluctant to let go of this policy instrument: there are still over 500 development banks worldwide. The main reason given for their continued role is the persistence of market failures, such as a shortage of long-term funding, funding for poorer regions or groups, or funding for high-risk sectors such as new technologies or small and medium enterprises. Governments have remained keen to have some source of funding under their control, the risks notwithstanding.

Against this backdrop, there is a clear need for an objective framework for development banking, which can inform government policy and help to prevent a repeat of the problems of earlier development banks. There is no universal model for development banking: it is influenced by a variety of factors, such as a country's level of development and the sophistication of its financial system. Still, a general framework may be derived for the role of national development banks. The application of this framework then depends on a country's particular developmental and financial needs.

This working paper outlines such a framework for what Nembelessini-Silue (2006) calls 'classic' national development banks – state-owned, wholesale banks (which means that they fund institutions

1 A summarised version of this paper was published in *Development Southern Africa*, 26(5):677-694.

or projects rather than individuals). The framework does not address private development banks, deposit-taking institutions, multilateral or regional banks or microfinance institutions. It draws on economic theory and case studies of development banks in Africa, Asia and Latin America (Thorne, 2008). The framework sets out principles for six dimensions of development banking: *an enabling environment*, *mandate*, *regulation and supervision*, *governance and management*, *financial sustainability* and *performance assessment*.

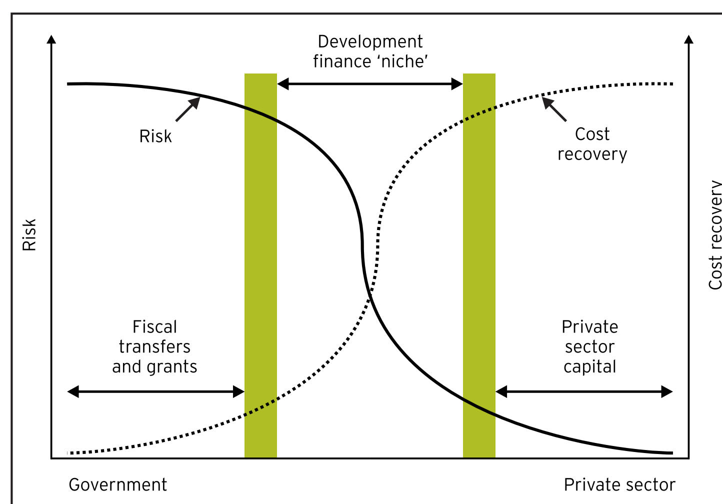
The working paper is structured as follows: section 2 defines development banks and outlines their role, and section 3 briefly reviews the evolution of development banking. Section 4 assesses principles for the six dimensions of development banking, section 5 draws these together into an overall framework, and section 6 concludes by summarising the issues and highlighting areas for further research. The complete framework is attached in table format as an annexure.

## 2. Role of development banks

Development banks are a form of government intervention in the financial system, with the aim of addressing market failures in the provision of finance. They provide finance to those market segments that are not well served by the financial system. These segments include projects whose social benefits exceed their commercial ones; long-term projects or projects with a long lead time; new or risky ventures, such as new technologies; projects in poor or distant regions; and small and new borrowers who lack collateral.

As Figure 1 shows, development finance complements government resources and market funding. In principle, government funding is allocated to projects on which no cost recovery is possible, while private funding is allocated to projects that can generate profits. There is a niche between these two, which is filled by development banks. They focus on projects that can generate limited revenue, are high-risk or have long lead times, for example. The aim is to lower the risks of investment in these projects and crowd in investment by the private sector. In addition to finance, development banks also provide developmental services such as research, advocacy and technical assistance.

**Figure 1: Role of development finance institutions**




*Source:* Jackson (2006).

## 3. Evolution of development banking

Development banks played an important role in facilitating the industrialisation and later the post-war reconstruction of Europe by providing long-term finance. Among the most important early development banks was the privately owned Crédit Mobilier, established in 1848. It played a large role in the economy of Europe and is credited with increasing per capita income on the continent, disseminating skills in long-term finance and fostering competition. It was the model for the Industrial Bank of Japan (1900), which in turn inspired later development banks in poor countries. However, despite its success, the Crédit Mobilier faced a significant problem: its developmental objectives were often in conflict with the need for short-term profit (Cameron, 1953). Now, 160 years later, the issue of conflicting objectives remains at the heart of the problems facing development banks.

The next stage of development banking came in the early 20th century, when two events created the need for development finance: the reconstruction after World War I, and the shortage of long-term funds after the Great Depression of 1929. This led to the establishment of several development finance companies, with government support. A second group of these institutions was set up to finance the reconstruction after World War II. These included the Kreditanstalt für Wiederaufbau and the Japan Development Bank, the forerunner of the Development Bank of Japan (De Aghion, 1999).

The early development banks were generally successful. They were at least partly owned by the private sector and had operational autonomy and hard budget constraints. They co-financed projects with the private sector, had professional management teams and were committed to skills dissemination. They also benefited from the post-war economic stability in developed countries (Diamond, 1996; Siraj, 2004).

The success of these banks encouraged poorer countries to establish their own development banks. But many of these banks failed. In the words of Nellis (1986:ix), they ‘present a depressing picture of inefficiency, losses, budgetary burdens, poor products and services, and minimal accomplishment of the non-commercial objectives so frequently used to excuse their poor economic performance’. A range of financial, political and management problems contributed to their failure (Yirga-Hall, 1998; De Aghion, 1999; Siraj, 2004):

- Governments or corrupt officials often interfered in their activities.
- The institutional environment in developing countries was weak.
- Critical skills in management, finance and operations were limited.
- As a result, the development banks were poorly managed and regulated.
- They did not operate on commercial principles.
- They were stand-alone banks instead of being integrated into the financial system.
- Their mandates were rigid and often inappropriate.
- Even well-managed banks struggled to reconcile their conflicting objectives of maintaining financial sustainability while pursuing socially desirable outcomes. The World Bank (1989:106) sums it up well: they ‘found it difficult to finance projects with high economic but low financial rates of return and remain financially viable at the same time’.

The 1980s and 1990s saw the widespread restructuring, closure or privatisation of development banks, but many governments have been reluctant to give up this policy tool. There has been a resurgence of interest in development banks, for three reasons. First, the global financial crisis underscored the need for countercyclical funding. Second, despite efforts to strengthen capital markets, many countries still lack long-term finance and developmental services such as technical assistance and research. Third, there have been visible successes: a few development banks have maintained financial sustainability while adhering to their mandates. They have provided countercyclical funding, facilitated access to credit, created employment, strengthened the capital market, built capacity in project appraisal and evaluation, and influenced government policies (UN, 2005; Rudolph, 2010).

This history shows that development banks have an unenviable role – they operate as financial institutions within the constraints imposed by the implementation of government policy. Likewise, the governments that own these banks are also in an unenviable position – the banks may incur considerable losses while delivering little by way of development. This raises two questions: on the one hand, how can a government create an environment that ensures the development bank will make the best use of the state's scarce resources for development? On the other, how can the development bank best manage its conflicting objectives and avoid undue government interference? The next section proposes some principles for addressing these problems.

# 4. Successful development banks: Dimensions and principles

The success of the early development banks and the failure of many of the later ones are a rich source of lessons for development banking. Based on these lessons, this section outlines six (interdependent) dimensions of the success of development banks and identifies the principles involved in each of these dimensions.

## 4.1 Enabling environment

A development bank requires an enabling environment within which to operate. Its role is determined primarily by a country's socio-economic environment and its particular development needs and priorities. However, this environment, in turn, affects the bank's ability to carry out its functions. In the words of Diamond (1996:12), 'no factor is more important in influencing a development bank's "success" than the situation of the economy in which it operates'. While the mandate of a development bank may require it to address problems in the economy, it cannot operate in a largely dysfunctional environment. This is one of the paradoxes of development banking – these banks are needed most in poor countries, but the weak economic and political systems in these countries make it harder for them to succeed. For example, Malawi has been described as a 'fundamentally flawed contextual basis' for development banking owing to its poor economic prospects, high levels of corruption and limited political will to foster good governance (BAR, 2006:62).

The following aspects are critical to the success of development banks:

*Macroeconomic conditions:* Macroeconomic stability is a prerequisite for the development of the financial system, as instability increases the risks associated with finance, especially long-term finance. This negatively affects both the price and the availability of such finance. Traditionally underserved

market segments are even less likely to obtain funding in a volatile macroeconomic environment. Stability is also crucial for development banks, particularly if they are exposed to currency risk – macroeconomic instability contributed to the failure of 16 development banks in Francophone Africa during the 1980s (Yirga-Hall, 1998). Similarly, development banks are less likely to raise sufficient funds on the capital market or leverage co-finance from the private sector during periods of macroeconomic instability. Critical elements of macroeconomic stability include the following:

- Sound fiscal discipline
- Balanced economic growth
- Balance of payments stability
- Price stability and limited external and internal price distortions
- The absence of financial repression

*Structural microeconomic conditions:* Development banks have also proved unable to succeed without a reasonably functional microeconomic environment with proper regulation. Critical structural requirements include the following:

- Efficient resource allocation in the economy
- A regulatory environment that supports investment
- Sufficient industrial capacity
- Appropriate and well-maintained infrastructure
- A developing private commercial and financial sector
- Adequate competition and market discipline
- Sufficient skills in the economy, including management skills
- Reasonable levels of technological development

*Political environment:* Banks need a stable political environment with adequate capacity. Important elements of the political environment include the following:

- Political stability
- Political leadership and support for the development bank
- De-politicisation of the role of the development bank
- Absence of strong interest group activity
- Absence of corruption
- A reasonable level of overall government capacity
- Reasonable capacity in other organs of state

*Institutional environment:* Well-functioning legal and regulatory institutions are as much a prerequisite for development banks as for the rest of the private sector. Critical aspects of the institutional environment include the following:

- Legal system: A comprehensive and effective legal system, adequate protection of property and creditor rights, and a reliable, efficient and independent justice system
- Accounting and auditing: Internationally accepted accounting principles, independent audits for larger companies, and proper regulation of the accounting and auditing professions
- Financial infrastructure: An efficient and secure settlement system, and adequate information flows (e.g. well-functioning credit bureaux)
- Regulation and supervision: A market-based regulatory and supervisory framework, good corporate governance and transparency, and procedures for dealing with problem banks
- A public safety net (i.e. systemic protection)

The issue of regulation and supervision is taken up again in section 4.4, in so far as it relates specifically to national development banks. The next section examines the factors that a government needs to consider when setting the mandate of a development bank.

## 4.2 Mandate

A development bank needs an appropriate mandate to ensure that it is correctly positioned within the environment. The lessons drawn from the experience of development banking have highlighted the disastrous effects of inappropriate mandates, but countries such as Canada, Malaysia, Brazil and Rwanda show that banks with appropriate and flexible mandates can contribute significantly to development (BAR, 2006; Rudolph, 2009).

Several principles can be identified for setting a mandate: mandate clarity, local relevance, institutional fit, complementarity of funding, flexibility and an appropriate scope. These are discussed in turn below.

### 4.2.1 Mandate clarity

The first principle is the precise articulation of the mandate of the development bank. A vaguely defined mandate creates uncertainty for both the bank and other institutions, such as the private sector. This has the following disadvantages:

- It allows the bank to pursue activities not intended by the government ('mission drift'), which can increase the risks faced by the government and reduce the effectiveness of the development bank in pursuing its intended goals.
- On the other hand, it gives the bank more scope to avoid difficult or costly activities that the government expected it to undertake ('mission shrink').
- It reduces accountability by undermining the basis for an objective assessment of the development bank's performance.
- It leaves the commercial sector unclear about the role of the development bank, which reduces the incentive of private sector banks to expand into grey areas of funding where they could face (unfair) competition.
- It increases the opportunities for political interference in the activities of the development bank.

### 4.2.2 Local relevance

As shown in Figure 1, the development bank fills the niche between the public and the private provision of finance. The mandate of the bank should consider at least the following aspects, as the interplay between them determines the particular niche for the bank:

- The country's development needs and priorities
- The local financial system's ability to provide finance for underserved segments, as well as its general level of efficiency and effectiveness
- The role of foreign financial or donor institutions in providing such finance
- The government's view of its role in addressing any remaining financing gaps.

### 4.2.3 Institutional fit

The third, related, mandate principle is institutional fit: the development bank must operate within the local economic, political and institutional environment. There are two important considerations in this regard.

First, the development bank cannot operate on its own: the lack of integration with the rest of the financial system contributed to the failure of the early development banks. Diamond (1957:18) puts it well: 'A development bank is one instrument among many, all of which need to be used consistently and in conjunction.' The bank must therefore be structured to complement other local institutions.

Second, the institutional structure should be 'home-grown'. Transplanting successful models from elsewhere is likely to fail, as their success is due in part to complementary institutions, such as legal or supervisory systems. It is almost impossible to duplicate such complementary institutions, as these, in turn, depend on local factors such as norms, values, skills and technology.

### 4.2.4 Complementary funding

This leads naturally to the fourth principle: complementarity of funding, which is linked to the concept of comparative advantage. As an integral part of the larger financial system, the development bank should restrict itself to funding only those activities in which it has a comparative advantage. Typically, the comparative advantages of a development bank are a better understanding of high-risk markets and an in-depth knowledge of the clients in these markets. By restricting itself to funding based on its comparative advantage, the development bank is less likely to compete with and crowd out the private financial sector, and more likely to play a complementary role.

There are two other aspects to complementarity: first, the development bank should aim to mobilise private sector co-funding of its projects, whether through a demonstration effect coupled with the dissemination of knowledge or more concretely through risk mitigation measures. Petersen and Crihfield (2000:71) note that development finance institutions 'should always be looking for an exit strategy and a shifting of obligations to the commercial credit markets'. Second, the development bank should assist borrowers only until they are financially strong enough to graduate to commercial funding. In the words of UN-ECLAC (2002:160): 'they should be run in a way designed to avoid

building up a permanent, stable customer base'. This will help to ensure that the development bank's scarce resources are not captured by stronger borrowers at the expense of weaker ones.

While this sounds reasonable in theory, development banks have found it difficult to adhere to this principle in practice. The reasons for this are mainly related to the moral hazard effect of concessionary finance. Examples of the moral hazard effect include the following:

- Development banks, not least through their advisory role, build up a strong bank-client relationship with their clients, which both may be keen to preserve.
- The client may be disinclined to graduate to market funding. In fact, it may have a perverse incentive to understate its financial strength to ensure continued access to finance on concessionary terms.
- The performance of the development bank may be measured in terms of the volume of its funding rather than its development impact. Hulme and Mosley (1996:183) note that 'lenders who are under strong pressure to meet lending targets have no incentive to be rigorous in refusing a promising borrower'.
- Related to this, since existing borrowers are cheaper to finance because information costs are lower, a bank faces a strong incentive to fund existing larger clients rather than spend time and money developing new clients who have a lower capacity to absorb loans. In this regard, Hulme and Mosley (1996:189) refer to their reluctance, after having built a portfolio of stable customers, to 'walk the tightrope' again to find new clients.
- The development bank may likewise be unwilling to expose itself to the higher risk of dealing with less capacitated clients.
- The bank may be restricted to a particular sector in terms of its mandate, although the private sector may in the interim have built sufficient capacity to fund that sector.
- Finally, the requirement for development banks to be financially self-sustainable creates a powerful incentive for them to compete with the private sector for profitable projects that can cross-subsidise losses on their more developmental projects.

There is clearly a need to balance the requirements of the bank with those of the private sector. One option for striking such a balance would be to create a formal mechanism whereby the private sector could table complaints about any uncompetitive behaviour by development finance institutions (Scott, 2007). Another option would be for co-financing with the private sector to be made compulsory, whether through the development bank's mandate, regulations or self-imposed rules. Such rules could involve annual targets for co-financing, compulsory co-financing of projects above a certain size, and so forth. Enforced co-financing could have a number of advantages, as set out below, which the government needs to balance against the implications that such rules may have for the bank's financial sustainability:

- It could support financial sector development by ensuring that the private sector is not crowded out of potential investment opportunities and scarce development funds are not misallocated.
- It could create certainty among private sector banks about the role of the development bank and the 'rules of engagement', which might increase their willingness to expand into the funding of high-risk sectors.

- It could disseminate expertise in the funding of underserved sectors: as private banks are exposed to these opportunities through co-funding arrangements, their appetite for such projects is likely to increase.
- It could reduce opportunities for political interference in the development bank's lending decisions, while increasing the transparency of its decision-making.

### 4.2.5 Mandate flexibility

The complementarity principle is linked to the fifth one: flexibility. A development bank that encourages private sector participation in its projects will change its own environment: the private sector will eventually be able to provide funding for higher-risk projects without assistance from the bank. The environment may also change because of a deepening of the financial system or new directions in public policy. Therefore, the mandates of development banks should be reviewed on a regular basis to ensure that they operate according to their competitive advantage (Diamond & Raghavan (eds), 1982). There is an increasing awareness of the need to adjust mandates on a regular basis. Malaysia recently reviewed the mandates of its development finance institutions to ensure that they focus on 'niche' sectors, while South Africa regularly reviews the mandates of its development finance institutions.

The role of a development bank in changing its own environment is captured in the life cycle theory for development finance institutions. This theory holds that, once the market failure for which it was designed has been addressed, whether by changes in the environment, in policy or in private sector capacity, the role of the development bank should be reduced and eventually eliminated. Stanton (1999:16) summarises the theory as follows: 'The missing element… is the notion of a life cycle for government sponsorship. [These institutions] are *created* to increase the flow of funds to socially desirable activities. If successful, they grow and *mature* as the market develops. At some point, the private sector may be able to meet the funding needs of the particular market segment. If so, a *sunset* may be appropriate.' (Emphasis in the original.) Given the difficulties of building institutional capacity, the best use of the scarce institutional capacity of a successful development bank may be either to privatise it or to refocus its mandate to another underserved sector, rather than to close it down. Still, the institutional costs of 'refocusing' a development finance institution should not be underestimated. The transformation of the institution is more than likely to result in at least temporary reductions in efficiency, staff morale and development impact, and probably also in the loss of experienced staff. However, these costs are arguably less and the disruption shorter than when a new institution has to be established from scratch.

### 4.2.6 Scope of activities

The sixth mandate principle relates to the scope and level of specialisation of the development finance institution. There are no easy answers as to whether a development bank should be narrowly focused (specialised) or multi-sectoral. Specialised development banks are likely to be smaller and multi-sectoral banks larger, given the extent of their activities. Each form has its advantages and disadvantages, although Diamond (1996) pointed out that most 'successful' development banks provided a broad range of services.

Multi-sectoral banks may have the following disadvantages:

- Their operations run the risk of being ineffective and unfocused, and they may even 'spread [their financial resources] too thinly' (Diamond 1957:48).
- Given the volume of their activities, they may be unable to give equal or sufficient attention to all aspects of their work, and thus neglect certain regions or sectors.
- Similarly, they may be able to avoid certain functions that are costly or difficult and hard for the government to monitor.
- They may have difficulty monitoring clients effectively, as they have more clients and it may therefore take them longer to get to know their clients well.
- They may have more corporate governance problems, be less transparent and therefore more prone to political interference.
- The absence of clear boundaries for their activities may lead to mission drift and concomitantly reduce their incentive to build sound working relationships with the private sector.
- Their multiple roles also make it more difficult for the private sector to assess the risk of investing in the institution, which may increase its cost of capital.
- With multiple objectives, they are less likely to be held accountable for the underachievement of any particular one of these development objectives.
- The failure of a large development bank in a weak financial system could have drastic systemic consequences, both financial and fiscal. Even in big countries, the fiscal implications could still be considerable.

On the other hand, specialised development banking may have the following disadvantages:

- A primary argument against specialisation in a small economy is covariant risk. Mistry (1999:7) puts it bluntly: 'the worst thing you could do to any development bank was to mandate it or give it a mandate that automatically led to concentrated covariant risk in terms of portfolio concentration'.
- If a government were to establish several highly specialised institutions in a developing country with limited fiscal, human and managerial resources, it would run the risk of creating undercapacitated and hence ineffective organisations, with a smaller potential impact than a single large, well-staffed organisation.
- The interaction between these specialised development finance institutions needs careful consideration to avoid mandate overlaps, gaps between mandates, competition for projects, political jostling to protect 'turf', and other undesirable outcomes.
- Having a collection of specialised institutions would increase the risk of their development activities being uncoordinated. This implies the need for additional institutional capacity, probably in the form of a coordinating body or forum, to avoid costly duplication.
- Since specialised development banks would have a narrower financial base than a large multi-sectoral development bank, they could find it more difficult to maintain creditworthiness and therefore to mobilise funding on good terms from both donors and the market.

- Their impact on government policy and their effectiveness when interacting with donors might well be less than that of a well-regarded, large multi-sectoral development bank.

There are clearly no hard and fast rules for setting the scope of a development bank. The appropriate scope for a development finance institution will depend on a range of factors. This includes the individual country's macroeconomic conditions and capacity, the strength of the overall financial market and of the supporting institutions, the size of the potential market for the development bank (and hence its ability to diversify its portfolio), and the ability of the government to regulate, coordinate and monitor the activities of the development finance system. A government needs to weigh up the relative advantages and disadvantages of a narrow or a broad mandate in light of these factors.

The next section assesses how the government can ensure, first, that a development finance institution adheres to the rules of the financial and legal system and, second, that it does not undermine systemic stability.

## 4.3 Regulation and supervision

Poor regulation and supervision by governments have contributed to the downfall of many development banks, including the Development Bank of Zambia in the 1990s (BAR, 2006). Even as recently as 2006, members of the Association of African Development Finance Institutions (AADFI, 2006:3) still regarded the policies and practices of their owners (i.e. the government) as their biggest single problem. A primary concern here is that the ownership role of the state creates a potential conflict of interest in the regulation and supervision of development banks. Caprio et al. (2004:8) warn that this 'inherent conflict of interest in both owning and supervising banks is difficult to resolve'. The discussion below examines ways of addressing this issue.

### 4.3.1 State as owner

The corporate governance guidelines for state-owned enterprises of the Organisation for Economic Co-operation and Development (OECD) focus specifically on this potential conflict of interest. Calling on the government to act as an 'informed, accountable and active owner' (OECD, 2004:6), the guidelines suggest that a government should:

- ensure that its ownership role does not distort its policy decisions
- create a clear and simple set of legal rules governing state-owned enterprises
- make the developmental roles of these institutions and any funding for such roles clear and transparent
- ensure that state-owned institutions do not enjoy special privileges.

In addition to such legal rules, best practice is moving towards a formal, published ownership policy that defines the objectives of the state as owner, the legal forms of the enterprises under its control, its role in governance, and how it will implement its ownership role. Several European countries, including Finland, France, Poland and Sweden, have adopted formal ownership policies (Scott, 2007).

The legal rules or ownership policy must establish checks and balances in the way the government exercises its ownership role, generally by sharing the responsibility between different departments. In this process, care should be taken to avoid a regulatory 'overburden' (Reddy, 2006:10): if state-owned institutions are overseen by a range of entities with different requirements, such as the treasury, a line ministry, the legislative assembly, the auditor general or even special commissions, they face a heavy reporting burden or, worse, conflicting instructions.

One option for addressing the problem of conflicting requirements is to create a single ownership entity, which would have the additional benefit of improving coordination between the activities of the various state-owned enterprises. An ownership entity should be independent from government while still being accountable to, say, a legislative assembly. It should have only a limited participation in the boards of the institutions under its control, allowing the management full operational autonomy. To maintain the separation between the government's ownership and regulatory and supervisory roles, the entity should not be involved in any regulatory or treasury functions.

An ownership agency could have the following functions (OECD, 2004; Scott, 2007):

- monitor and report on the activities of state-owned enterprises
- participate in shareholders' meetings and vote on behalf of the state
- set up (and participate in) clear processes for nominating boards of enterprises in which the state has the majority ownership
- establish competitive remuneration systems for board members
- interact with external auditors and other relevant state institutions
- have only a limited participation in the board, to ensure that the management of the state-owned enterprise has full operational autonomy.

Single ownership entities have been established in Norway and Finland, while Sweden, Singapore, Poland and Chile have assigned the ownership responsibility to a single minister acting as shareholder representative. Commonwealth countries often provide dedicated, specialised professional support to these shareholder representatives (Scott, 2007).

### 4.3.2 State as supervisor

The counterpart of the ownership entity is the supervisory entity, which should be separate and independent from the ownership function. Fletcher and Kupiec (2004) apply the Basel principles for banking supervision (BCBS, 2006) to state-owned financial institutions. They suggest the establishment of an independent supervisory capacity, which can protect the state against both credit and reputational risk, while also protecting the private sector from unfair competition from state-owned financial institutions. Their preconditions for successful supervision are sustainable macroeconomic policies, a well-developed legal system, a robust accounting profession and a strong and independent supervisor. The authorising legislation of the state-owned financial institution should set the mission of the organisation; the method of funding, government capital and/or subsidies; prudential standards and accounting

and auditing requirements; specific standards for operations, where required; and performance criteria and the method of assessment. To be effective, the supervisor should have operational independence, sufficient resources, an appropriate legal framework and enforcement capacity, and adequate information-sharing arrangements. They see the role of the supervisor as setting criteria for activities, monitoring operations, evaluating activities in line with the mandate, and instituting corrective measures if required. The supervisor also has to do the following:

- *Capital adequacy:* Define regulatory capital and set capital adequacy requirements.
- *Evaluations:* Ensure independent evaluations of policies and operations, independent internal and external audit and compliance, formal plans with clear responsibility for internal oversight, and appropriate internal separation of duties to avoid conflicts of interest.
- *Transparency:* Ensure adequate financial policies, practices and procedures; the use of appropriate record keeping and accepted accounting policies; regular publication of audited financial statements; and the use of separate accounts for commercial and developmental operations, with the former being subject to the Basel II principles.
- *Risk management:* Ensure a comprehensive risk management process for all material risks and appropriate risk-modelling techniques for interest rate, credit, market, currency and operational risk, for example.
- *Monitoring:* Conduct on-site supervision and independent verification of governance procedures and information accuracy, as well as off-site monitoring of the financial situation based on prudential reports.
- *Corrective action:* Obligate institutions to publish annual reports on safety or soundness issues and take remedial action when institutions fail to meet requirements. There is a need for a mechanism to ensure that the supervisor's recommendations are implemented, and a need for the supervisor to have appropriate legal authority.

Fletcher and Kupiec (2004) argue that the bulk of the supervision and regulation should be along the same lines as the private sector. But should state-owned development finance institutions be subject to the same rules as the private sector? On the one hand, they pose more regulatory challenges than do private firms: for the state, the conflict of interest noted above, and for the institution, the problems of political interference, weak management capacity, and the state's poor regulatory capacity. On the other hand, given that they operate in underserved markets and under difficult conditions, overregulation may be counterproductive as it could inhibit innovation and risk-taking. Thus, the International Monetary Fund and the World Bank (2003:4) call for regulation of specialised financial institutions that has 'a sufficiently light touch so as not to crush them'.

In general, it seems that once the state has clearly defined and separated its ownership and regulatory roles, best practice then requires development banks to be regulated and supervised along the same lines as the private sector, possibly with a caveat around capital adequacy. The main regulatory requirement is arguably that the playing field between state-owned financial institutions and the private sector should be level to avoid unfair competition that may stifle the development of private financial institutions. The remaining requirements are largely similar to those of the private sector: sound corporate governance, including a strong and independent board; high levels of transparency and disclosure; effective monitoring and evaluation; appropriate capital adequacy levels; and sound risk management (Marston & Narain, 2004; OECD, 2004; BCBS, 2006; Smallridge & de Olloqui, 2011).

Returning to the issue of capital adequacy, there is considerable debate about the effect on development banks of adhering to the Basel Capital Accord (Basel II), which aligns capital requirements with risk. There are three concerns about the unintended consequences of Basel II. The first is that it could negatively affect both international investment in developing countries and local investment in high-risk projects in these countries. This could include sectors traditionally served by development banks, such as small enterprises, as well as the banks themselves, as it rates project finance as inherently more risky than corporate lending. Griffith-Jones and Spratt (2003) quote a 2002 study by Weder and Wedow, which estimated that the cost of capital for such enterprises could increase by up to 2000 basis points.

A second concern is that Basel II ignores the risk-reducing effect of portfolio diversification. Some investments may have a higher individual credit risk, but if they are in different sectors, industries or countries than the bulk of the portfolio, they could help to balance the portfolio and reduce its overall covariant risk. Since Basel II would effectively penalise such investments, the supply of credit to developing countries in general and to higher-risk borrowers within these countries could be reduced. The Basel Committee accepted this and intends to 'move Basel in the direction of full credit models' (Griffith-Jones, Segoviano & Spratt, 2004:9).

Third, Basel II has a pronounced pro-cyclical effect: during economic downturns, the risk-sensitive models show an increased risk of default, resulting in higher capital adequacy requirements and a reduced supply of credit. In the words of Reisen (2002:3) 'linking bank lending to bank equity acts as an automatic amplifier for macroeconomic fluctuations'. Thus Basel II exacerbates the effect of downturns and may even undermine financial stability, as it could contribute to the failure of weaker banks and hence to financial concentration. Clearly, this scenario would greatly affect the ability of development banks to provide countercyclical funding, for example (Griffith-Jones & Persaud, 2005; Gottschalk & Sen, 2006).

These concerns about the Basel II capital adequacy requirements underline the need for financial regulation and supervision that take cognisance of the specific needs of development banks. For example, Fletcher and Kupiec (2004) suggest that only the non-developmental activities of development banks should be subject to the Basel requirements, while others imply that they should be exempted altogether (see, for example, Gottschalk & Sen, 2006).

### 4.3.3 Market supervision of development banks

Finally, regulation and supervision are not only the domain of the government but could also usefully be supplemented by market-based measures. The most widely used of these measures is arguably credit ratings. Although credit ratings are not a formal element of external governance, they assist both the government and the development bank in gauging the bank's compliance with financial and corporate governance requirements.

In principle, credit ratings evaluate the ability of a financial institution to meet its debt service obligations. Commercial rating agencies base the credit rating of a development bank on two criteria – the sovereign credit rating and the intrinsic credit quality of the bank, which is influenced by its liquidity, its strategy and management, and its solvency. Factors such as ownership, stakeholder relations, financial transparency and the role of the board also affect the credit rating. The rating

of a national development bank cannot exceed that of the sovereign, although regional development banks may achieve ratings higher than those of individual sovereigns.

There is growing consensus that development banks should submit themselves to the discipline of credit ratings, while also encouraging their clients (especially subnational governments) to obtain such ratings to assist them in accessing private capital markets. Stronger banks such as the Development Bank of Southern Africa and the Brazilian Development Bank already have credit ratings. Weaker development banks may not initially qualify for a commercial rating, but they are encouraged to take interim measures to improve their financial standing until they are strong enough to obtain a rating by one of the independent commercial agencies.

In summary, development finance institutions should in general be subject to regulations and supervision that are similar to those of private institutions, but special attention should be paid to the potential conflict of interest for the state in its dual roles of owner and regulator and to the effect of financial requirements on the developmental roles of the banks. Transparent government regulations and supervisory activities can also be complemented by objective market-based assessments such as credit ratings.

The main interface between the government, as owner but also as regulator, and the development finance institution is the board. It is responsible for ensuring that the development bank adheres to the broader regulatory principles while delivering on its mandate. The next section reviews the role of the boards of development banks.

## 4.4 Governance and management

The quality of governance and management has often meant the difference between the success and failure of development banks functioning in the same environment. For example, while the Brazilian development bank, BNDES, is seen to be successful owing to its strong management, the perception of the management of the Caixa Econômica Federal is far more critical (BAR, 2006; UN, 2006a). The analysis below does not deal with the general principles of governance and management in any detail, but focuses on aspects that are specific to development banks.

### 4.4.1 The role of the board

A properly functioning board is a critical success factor for a development finance institution. Its first role is to prevent undue political interference. In this regard, Diamond (1957:71) calls it 'a very useful screen and protection for management'. The board contracts with the government, annually, on the objectives that the institution should achieve. In terms of its fiduciary duties, the board is then held accountable to the government for performance against those objectives. Its primary functions are therefore to provide strategic guidance and to oversee the management of the institution.

Scott (2007) summarises the functions of the board as follows:

- Appoint executives, evaluate their performance and make succession plans.
- Assist in setting and monitoring the strategy of the organisation.

- Approve important policies.
- Oversee internal financial and operational controls.
- Establish performance indicators and benchmarks.
- Ensure that the organisation's performance is fairly reflected and communicated.

The oversight and monitoring function of the board is particularly important. The board is accountable to both the government and the stakeholders to ensure that the development bank adheres to high standards of corporate governance. It needs to ensure that the bank has a clear performance contract with the government, a strategic plan on how to achieve the objectives of this contract, proper financial controls (including independent auditing) and a high level of transparency and disclosure. It also needs to oversee the ethical functioning of the organisation, and hence should ensure that the bank has a written code of ethics and adequate measures to prevent corruption.

To fulfil this critical role, board members need to be objective and independent, act in the best interest of the bank and all its shareholders, and have the highest levels of integrity and competence. A board also needs an enabling environment, including a well-defined mandate, independence from government, an appropriate balance of skills and experience, a clear legal exposition of its functions and fiduciary duties, written job descriptions, clear procedures, and a code of ethics for board members. These can be combined into a board charter. In addition, the board very specifically needs training. The development bank can provide or fund formal training in corporate governance requirements, and also provide some exposure to the specific needs of development finance institutions and their particular areas of operation. The performance of the board should be evaluated annually, whether through a self-evaluation (e.g. through a peer review process) or else by the shareholder(s). Where weaknesses are identified, further training should be provided.

The usual membership of a board is seven to ten members, although some boards have up to 15 members. Boards may be supported by specialised committees, the most common ones being the audit, risk management and remuneration committees. External members with specialised skills can be co-opted onto these committees.

The principles for board membership in development finance institutions are as follows: board members should preferably be independent from government, to reduce political pressures on the bank. Where government officials are appointed, they should be in the minority, and have the same skills and powers as other board members. They should also not be former members of legislative assemblies (e.g. Parliament). Board members should represent different constituencies to ensure that the bank pays adequate attention to marginalised sectors of society. Employee representation on the board can be considered.

Board members should be appointed after a transparent nomination process and according to clear and objective criteria. They should have a sufficient understanding of financial and commercial matters, as well as government policy and development needs. The government could establish a database of appropriately qualified individuals for board membership or use a specialised agency to advise on nominations. Board members should not hold too many concurrent directorships, to ensure that they can carry out their fiduciary duties appropriately. Board members should have a term of

about three to five years but their terms should be staggered to ensure continuity. To ensure that the board members have high quality skills, remuneration should be competitive.

Concerning the chairperson of the board, the position of chairperson and Chief Executive Officer should be separate. The chairperson should not be a government official. He/she should have the requisite skills and competencies. The term of the appointment should be stipulated upfront and adhered to; a term of three to five years is the norm. He/she could be required to obtain an annual vote of confidence from the board. As for the Chief Executive Officer, he/she should also have the requisite commercial skills and competencies. The board should appoint him/her in a transparent manner according to a clearly defined job description. The term should be three to five years. He/she should be accountable to the board only and not to politicians or officials.

The next section reviews the role of management in setting up appropriate internal governance systems to ensure that the bank meets its financial and developmental objectives while adhering to regulatory requirements.

### 4.4.2 Internal management

The management of the development bank, overseen by the board, must set up appropriate internal governance systems to ensure that the institution achieves its financial and developmental objectives while meeting regulatory requirements. The principle is simple: adhere to the best practice requirements for private sector banks. From a corporate governance perspective, this implies professionalism in all aspects of operations, as well as fairness, transparency, accountability and responsibility towards staff, government and stakeholders.

The principles for the management of development finance institutions are as follows:

- Transparent process of selection of top management with the requisite skills
- Managerial accountability to board for organisational performance, but independence from the board for day-to-day operations
- Performance-based contracts for the Chief Executive Officer and executive management (their terms should not coincide with political cycles), as well as the rest of the staff
- Appropriate financial and non-financial rewards to retain scarce skills

The principles for the operations of the bank, including human resources, monitoring and evaluation, management information, accounting and control and disclosure are summarised in the table in the annexure.

Sound financial management is clearly critical to the achievement of a development bank's financial objectives, especially the objective of financial sustainability. The primary requirement is that development finance institutions and other state-owned enterprises should adhere to the general principles of sound financial management. At the very least, these include the requirements of their charter or founding legislation. They must also adhere to any relevant central bank requirements and, as far as possible, to international norms or best practice. In this regard, the Basel core principles state that 'in principle, all banks should be subject to the same operational and supervisory standards regardless

of their ownership; however, the unique nature of government-owned commercial banks should be recognized' (Marston & Narain, 2004:66).

The next section briefly lists some principles for the financial management of development finance institutions. On the understanding that these institutions should adhere to financial best practice, aspects that apply equally to commercial entities, such as financial administration and liquidity management, are not listed here. The requirements are as follows:

- *Capital adequacy:* Appropriate capital adequacy standards, and sufficient profit to preserve capital adequacy (adequate interest margin)
- *Asset quality and diversity:* Loan-loss provisioning according to international norms, appropriate single exposure limits and limits on sectoral or geographical concentration
- *Funding:* Mobilisation of donor funding and private funding (e.g. bond issues); investment-grade credit ratings, wherever feasible; and indirect financing as appropriate (e.g. securitisation of assets)
- *Risk management:* Strong culture of enterprise-wide risk management; a comprehensive risk management system, overseen at a high level; commercial principles for determining interest rates; proper asset and liability management policies; appropriate use of financial instruments to mitigate against various risks; and a clear separation of project approval and disbursement functions.

The aim of the governance of a development finance institution is to ensure that it meets its developmental objectives while remaining financially sustainable. The next two sections deal with these two issues – how can the government ensure that the development bank delivers on its developmental mandate, and how can it ensure that the development bank makes the best use of its financial resources in this process?

### 4.4.3 Performance management

One of the most intractable features of the supervision of development finance institutions is the balance between accountability and autonomy. Failure to achieve such a balance could lead to political interference and/or poor funding decisions. This makes performance management a critical part of the governance process.

It is generally agreed that the government should conclude some form of performance contract with the bank (or any state-owned enterprise) that sets out clear objectives, and then give the bank the operational autonomy to work towards achieving these. Shirley and Xu (1998:1) define performance contracts as 'written agreements between… managers who promise to achieve specified targets in a given time frame, and government which (usually) promises to award achievement with a bonus or other incentives'. They therefore set out the 'intentions, obligations and responsibilities' of both parties (Nellis 1989:1).

Performance contracts are intuitively attractive. Shirley and Nellis (1991:69) find the idea 'simple, appealing, and essential'. Contracts are seen to have a variety of benefits:

- Contracts incentivise additional effort and improve performance, and thereby assist in achieving the government's development priorities.

- They enable the institution to clarify the requirements of different stakeholders (e.g. line ministries) and reduce the effect of multiple objectives.
- They assist the government and other stakeholders in monitoring and evaluating the performance of the institution.
- They increase the transparency of the operations of the institution and reduce the opportunity for political interference in its activities.
- They assist both parties in understanding the challenges and opportunities facing the institution.
- They set development objectives up front, ensuring that the institution is not assessed on financial grounds only.

However, in practice, the effect of performance contracts is open to question. A World Bank (1995:113) study of 12 state-owned enterprises found that performance contracts were linked to significantly improved performance in only a quarter of the cases but had exactly the opposite effect in another quarter. The report concluded that 'explicit performance contracts have frequently been a waste of time and effort'. Likewise, in an assessment of various types of such contracts in 400 state-owned enterprises in China, Shirley and Xu (1998) found no significant increase in productivity; in fact, they frequently found a large negative effect on productivity. While Shirley and Nellis (1991:69) held that a 'flawed or partial system of setting enterprise targets and evaluating results is better than no system at all', a subsequent view was that 'considerable time and effort is being expended on an exercise with neither theoretical nor empirical justification' (Shirley & Xu 1997:34). In the same vein, Obser (2007:16) warns that 'an inadequate system of performance management can provide a false sense of security and accomplishment and in the process may misdirect resources and activities'.

A primary reason for the problems around performance contracts is the existence of an agency relationship between the government and the institution. The government needs the bank to perform a series of interventions that cannot be directly observed. It must therefore incentivise the bank to achieve these objectives. There are three aspects to this principal-agent problem:

- *Information asymmetry:* The government has limited information about the bank's ability, which gives the bank an information advantage over the government.
- *Asymmetry of responsibilities:* The bank may be unable to take specific actions before the government has taken other actions, such as promulgating legislation. This increases the risk that the bank may be unable to achieve certain targets.
- The bank's functions are *multidimensional:* It does not have only a single quantifiable output. On the contrary, there are many different elements to its output, a number of which may be unobservable to an outside party.

This raises the problem of incentivisation. For example, if the government were to design a contract for a development bank based on a set of observable targets, the contract would incentivise the bank to pay less attention to other important but less visible behaviours. These could be, for instance, improving the developmental benefits of projects through in-depth project assessment or encouraging

clients to graduate to market funding. The unintended consequences of setting observable targets could be that the bank would do as little as possible on the unobservable behaviours, probably just enough to create an impression of compliance. If the bank were to be incentivised in terms of the quantity of its output, it would have a strong incentive to reduce the quality of such output. This could lead to a deterioration in the quality of its loan portfolio.

Another problem is that the bank clearly has an incentive to set its targets as low as possible and its rewards as high as possible. Since it has an informational advantage over government, it can try to negotiate soft targets that are easy to achieve or a multiplicity of targets that are hard to monitor. If the bank were to succeed in setting many small targets with a low priority attached to each, it could easily disguise the underachievement of important overarching goals.

There are also elements of a power game between the bank and the government – if the government negotiators are not well capacitated, experienced and high-ranking, they may be at a disadvantage during the negotiations. A strong bank team may even drag negotiations out for such a long time that the targets effectively have to be set at a level that is equal to what has already been achieved. If the bank were to succeed in changing its targets or performance criteria every year, it could quite easily overwhelm an understaffed and ill-experienced government negotiating team.

Shirley and Xu (1998) set three criteria for successful performance contracts: reduce information asymmetry, provide the appropriate incentives, and induce commitment by both parties. The principles for contracting state-owned enterprises are as follows:

- *Contract structure and targets:* Keep the contract short and simple to limit its administrative implications. Clarify the accountability of each party (the government, the board and management). Design mechanisms for regular review of the contract. Specify the overarching priorities (e.g. financial sustainability) and include both financial and developmental objectives (and operational ones). Define a small number of objectives, targets and performance indicators. Reward outcomes rather than inputs and effort. Also, specify the resource requirements of activities undertaken for the government.
- *Information flows:* Ensure that government negotiators have sufficient power to elicit information. Conclude negotiations early, preferably before the contracting period starts. Improve accounting practices to improve information flows. Introduce benchmarks (e.g. through yardstick competition). Ensure consistency in the use of targets and avoid annual changes. Give priority targets a high weight and avoid the use of aggregates that can hide poor performance.
- *Incentives:* Set significant penalties and rewards to induce changes in performance. Clearly define what changes in performance are required. If these are not forthcoming, change the board and/or management. Use increased autonomy as an incentive for better management.
- *Commitment:* Secure credible government commitment to its promises. Ensure that treasury officials participate in negotiations with fiscal implications. Use an independent and neutral agency to resolve conflicts. Create an independent evaluation mechanism. Publish the terms of the contract to increase public oversight.

In conclusion, the main requirement for the governance and management dimension is adherence to principles similar to those of the private sector. In the next section, the focus switches to financial objectives: a critical aspect of the success of a development bank is its financial health, and the section looks at the principles for the financial sustainability of these institutions.

## 4.5 Financial sustainability

The fifth dimension of success is financial sustainability. Diamond (1996:12) defines the financial sustainability of development finance institutions as 'the capacity to attract, on the basis of their own performance, the capital they required to pay their creditors, sustain their shareholders' interest, and support their own growth'. A financial sustainability requirement protects the government against losses and forces a bank to make better use of scarce financial resources. Early on, Diamond (1957) argued that a development bank needed some investments to be profitable since it has to cover losses on socially desirable but commercially less viable investments. These profits would strengthen its balance sheet, which would facilitate future lending; assist it in attracting private funding; and safeguard its independence. Also, by demonstrating that development investment could be profitable, the development bank would be better able to attract private sector investment into socially desirable projects.

But for a development finance institution to be financially sustainable, the cost to its individual borrowers would need to be higher. This would probably be outweighed by the broader benefits to society: a financially self-sustainable institution would have a longer life span and hence be able to serve more customers or offer more or better products. It would also eventually be able to mobilise funding at a lower cost, which it could then pass on to borrowers.

However, there is a fine line between financial sustainability and profitability in the more general sense. Development banks that are obviously profitable may be suspected of not having devoted enough effort to their developmental roles. De la Torre's (2002) Sisyphean syndrome comes into play here: when development banks lose money from unsustainable social investments, the government may put them under pressure to be financially sustainable. Should they then make too much money (possibly by neglecting their development roles), the government may require them to make more high-risk but socially desirable investments. This may lead to increased losses, starting the cycle over again.

One way of treading this fine line is for development finance institutions to aim for a return on investment that enables them to maintain a specific capital adequacy ratio agreed to upfront with their shareholders. An alternative may be for a development bank to earmark returns from specific highly profitable investments for social investment purposes, for example grants. Note that neither of these options addresses the question of project choice: in its efforts to remain financially sustainable or even to expand its overall development impact, the development bank may still take on projects that would have been more appropriately funded by the private sector.

This raises the question of whether there are other ways in which the financial sustainability of the institution could be ensured, which do not incentivise competition with the private sector.

One option is to use fiscal support such as subsidies and tax or dividend exemptions. The primary case for fiscal support is the existence of externalities in the developmental role of the bank. By definition, the role of the bank is to fund activities whose social returns exceed their private ones. Thus, it could be argued in principle that the bank should be reimbursed by the government for generating these externalities.

A blanket approach to providing fiscal support to development finance institutions through annual subsidies has led to disaster in the past and is rejected by development banks as 'hazardous': dependency on the fiscus exposes them to political interference and uncertainty about future income streams. It also undermines their perceived independence, the credibility of their advocacy role, and their ability to influence government policy (UN, 2006b:14). The preferred approach is the use of well-targeted and transparent subsidies or other forms of fiscal support for very specific activities.

There are many risks involved in the use of subsidies, as demonstrated by the widespread failure of heavily subsidised banks in the second half of the 20th century. These risks are similar to the risks of general budgetary funding: to the government, the risk is that of a permanent drain on the fiscus in exchange for a limited developmental return, and for the development finance institution, that of political interference, uncertainty, loss of independence and a loss of credibility. More specific risks include the following:

- The mere existence of the subsidy can reduce the development bank's incentive to manage its finances and operations productively and efficiently.
- It may reduce innovation and hence limit the eventual scope of the bank's activities and outreach.
- It may expose the government to pressure from the bank for unjustified increases in the subsidy amount.
- Government may use subsidies to 'hide' activities off budget or to avoid facing up to the high costs of politically desirable activities.
- Even temporary subsidies may distort the markets.
- The government may decide to withdraw or change the subsidy without adequate consultation, which complicates financial planning.
- It may be hard to calculate the exact amount of the subsidy and agree on appropriate indicators.

Some of these disadvantages can be reduced or avoided altogether by restricting the use of subsidies and other forms of fiscal support to specific activities that can be ring-fenced and separated from the commercial activities of the organisation. Examples are such activities include the following:

- Agency activities on behalf of the state:
  - Unprofitable agency activities undertaken on behalf of the state (direct reimbursement for ring-fenced activities)
  - Research, data collection or surveys undertaken on behalf of the state
  - Evaluations of development projects for the government
  - Advisory services to government
  - General policy development and advocacy

- Once-off costs:
  - Initial capitalisation of the development finance institution
  - Start-up costs of new client institutions with economy-wide benefits (e.g. credit bureaux)
  - Rehabilitation and commercialisation of failing institutions
  - Development costs of significant or high-risk products
  - Specific 'strategic' projects that have large positive externalities
  - Disaster management or support for sectors/regions in crisis
- (Financial) development:
  - Dissemination of information on borrowers or risk mitigation measures
  - Support for capital market development (e.g. niche equity funds)
  - Pilot projects of innovations in development and/or finance
  - Adoption of new technology (e.g. environmentally friendly technologies)
  - Research and development initiatives
- Capacity building:
  - Specific technical assistance to capacitate poor clients
  - Institutional development (e.g. management information systems)
  - Capacity building, training and mentoring

There are several principles for the successful use of fiscal support. Subsidies must help to overcome a market failure or strengthen the market. They must have measurable benefits that exceed the costs. There should be no overt distortion of the market and no interest rate subsidies.

The principles for the design of fiscal support are the following:

- Clear objectives
- Thorough needs assessment
- Targeted, specific and capped fiscal support
- Transparent budgeting and targeting
- Fair and equitable allocation
- Regular monitoring and review
- Short time period or sunset clause

In summary, the commercial activities of a development bank should be financially sustainable. Financial sustainability protects the government against losses, ensures that the bank makes better use of scarce resources, assists it in raising funding at a lower cost, safeguards its independence and,

through demonstrating that investment in developmental projects may be profitable, attracts private investment. However, the financial sustainability requirement has the disadvantage of incentivising inappropriate behaviour, such as a lower risk appetite, competition with the private sector and reduced developmental services.

To avoid this problem, best practice is moving towards targeted subsidies for developmental activities. There is a sound argument for targeted fiscal support for the developmental activities of a development bank, provided that the social value of these interventions exceeds the costs, and that the support adheres to principles such as equity and transparency.

Nevertheless, the issue of fiscal support remains very sensitive. Some governments seem to fear that even small and targeted subsidies would be the thin edge of the wedge. In the next section, the financial sustainability argument is continued in a discussion of the performance measurement of a development finance institution, including an assessment of its reliance on fiscal support.

## 4.6 Performance assessment

This section deals with the sixth dimension of success: ways in which the success or otherwise of a development finance institution can be assessed. Clearly, different observers evaluate the performance of development finance institutions according to different standards, depending on the mandate of the institution concerned. However, it is generally agreed that these standards should include both financial measures and indicators of the institution's adherence to its developmental mandate.

The evaluation of the performance of a development finance institution has several benefits, the main one being its potential impact on government and management decision-making. Yaron (2004:3) argues that the lack of appropriate performance measures has led to 'partial and often misleading' assessments of development finance institutions. Misleading assessments may have prolonged the life of fundamentally unviable institutions and increased the overall loss to society. Clear performance measurement contributes to clear policy decisions. When both the public and the government are well informed about the costs and benefits of the activities of development finance institutions, these institutions have a powerful incentive to increase the efficiency of their operations. Those that are unable to do so may well be closed, while the stronger institutions may benefit from receiving transparent fiscal support and being held accountable for delivering appropriate services that meet real needs.

The value that a development finance institution adds should be measured through both financial and social criteria, so that institutions cannot 'hide behind social mission to cover for poor financial and/or social performance' (Woller, 2001:24). The financial and developmental performance of development finance institutions is often assessed based on the twin measures of sustainability and 'outreach' (Schreiner, 2002; Yaron, 2004). Although these measures are generally used for microfinance institutions, they can also be applied to other development finance institutions. The measures of outreach and sustainability are discussed in turn in the rest of this section.

### 4.6.1 Measures of outreach

An exhaustive assessment of the development impact of the activities of a development finance institution would be prohibitively costly. Schreiner's (2002) well-known 'six aspects of outreach' are a proxy measure for the social benefits or impact of development finance. The six aspects are:

- *Worth:* The value of the service to the clients, here defined as their willingness to pay for the services (a proxy could be the increase in their profits)
- *Cost:* The combined value of the costs to the client, including the price of the services, the transaction costs and the opportunity costs (e.g. time)
- *Depth:* The poverty status of clients, as reflected in the size of the loan
- *Breadth:* The number of people reached
- *Length:* The sustainability of the institution (i.e. the period of its operations)
- *Scope:* The number of distinct financial services (e.g. loans with different terms or different instruments).

Based on Schreiner's model, Woller (2006:21) proposes a 'social performance measurement tool', which consists of two elements:

- *Social performance scorecard:* Rates the organisation on indicators for each of the aspects of outreach to derive an overall score for social performance.
- *Social audit:* Evaluates operational processes and their ability to align the activities of the organisation with its mission.

The first element, the *social performance scorecard*, is based on Schreiner's six aspects of outreach, to which Woller adds outreach to the community or corporate social responsibility. The second element, the *social audit*, consists of a desktop review of documentation and interviews with management, the board, staff and stakeholders by independent external parties. The audit includes an assessment of five internal processes:

- *Mission statement, communication and leadership:* Must clearly express the objectives and values of the organisation, and be communicated by an 'active, committed, and consistent' management (Woller, 2006:48).
- *Staff retention and development:* Ensure that prospective staff have values that are in line with those of the organisation, and train existing staff in ways that underpin the organisational culture.
- *Performance management incentives:* Ensure that the system rewards behaviours that are in line with the mission of the organisation.
- *Performance monitoring:* Use this management tool to align operational activities with the mission of the organisation.
- *Strategic planning:* Ensure that goals, priorities and action plans support the mission of the organisation.

The audit report provides a narrative overview of performance in terms of processes, as well as a social performance scorecard rating, and an overall social performance rating, which is an 'informed estimate of the likelihood… [of a] significant social impact both now and in the future' (Woller 2006:52).

Yaron (2004) advocates a somewhat less arduous assessment, the outreach index, which is customised to reflect each institution's (or preferably its shareholders') assessment of the relative priority of the different aspects of outreach. The index is based on a selection of quantifiable indicators, such as the size and growth of the portfolio or average loan sizes. Since priorities change over time, the index can be adjusted in line with new requirements or areas of emphasis.

### 4.6.2 Measures of financial self-sufficiency

As financial institutions, development banks are often assessed against standard ratios such as return on capital, total assets, equity and average net assets, as well as cost-to-income ratios. But standard financial analysis does not take into account the subsidies or grants that development finance institutions receive from government and other donors, nor the social and developmental goals of these institutions.

It is a particularly costly and complex task to evaluate all the social benefits of a development finance institution and the social opportunity cost can therefore be a useful proxy. Yaron's (1992) subsidy dependence index (SDI) takes account of all sources of funding of the development finance institution, including transfers and equity.

The SDI is calculated as follows:

$$\frac{\text{Annual net subsidies received } (S)}{\text{Average annual yield obtained on the loan portfolio } (LP*i)}$$

$$SDI = (A(m-c)+[(E*m)-P]+K)/(LP*i)$$

Where:

$A$ = Average amount of concessional funds (annual)
$m$ = Market interest rate for borrowed funds
$c$ = Weighted average interest rate actually paid on $A$
$E$ = Average equity (annual)
$P$ = Annual before-tax profit (adjusted for loan loss provisions and inflation)
$K$ = All other subsidies received (annual)
$LP$ = Average loan portfolio (annual)
$i$ = Average yield on $LP$ (annual)

The SDI can take three basic values:

- A negative value implies that the institution's profit minus its equity at market interest rates is enough to cover all subsidies.
- A zero value shows that the institution is fully financially (self-)sustainable.
- A positive value indicates that the institution requires subsidies to survive; the larger this number, the higher its dependence.

The SDI is a useful decision-making tool, which shows the following (Yaron 2004):

- The percentage by which the average lending rate needs to change to make the institution sustainable (to inform pricing policy decisions)
- The cost to society of subsidising the institution (to benchmark the institution against others and to assess alternative service delivery options)
- The annual subsidy required to keep the institution's loan portfolio the same (to inform policy decisions, especially if tracked over time).

The SDI has attracted some criticism. De Aghion and Morduch (2005) argue that development finance institutions have to prioritise their developmental mandate. When they have access to additional subsidies, they should make use of these to provide more or better services, despite the fact that accepting such subsidies would affect their SDI.

Proposed modifications of the SDI relate mainly to additional sources of income or fiscal support. Sharma and Timiti (2003) note that the SDI does not consider income from off-balance-sheet activities, such as fees for training or advisory services. For some development finance institutions, these sources of income can be significant. Helms (1998) adjusts the SDI for such non-financial or developmental services; his model applies in particular to services that are provided by separate cost centres. He identifies the costs to be allocated to the different cost centres, as well as decision rules for costs incurred at a central level. In similar vein, Khandker and Khalily (1998) develop a variant of the SDI called the subsidy dependence ratio model, to assess the sustainability of individual programmes. It defines a programme as economically viable if it can meet the opportunity cost of its credit (and its supporting operations) with the income it generates. If individual programmes by and large are not viable, the development finance institution as a whole is unlikely to remain sustainable. This model can assist an institution in identifying programmes that require particular attention in this regard.

The social audit and SDI are useful proxies for the financial and developmental performance of the development finance institution. But the SDI only assesses financial outcomes: for occasional broader reviews, such as periodic mandate reviews, the assessment needs to extend beyond development and financial performance to include issues such as internal operational efficiency, strategy and the like.

## 5. Macro-framework for development banks

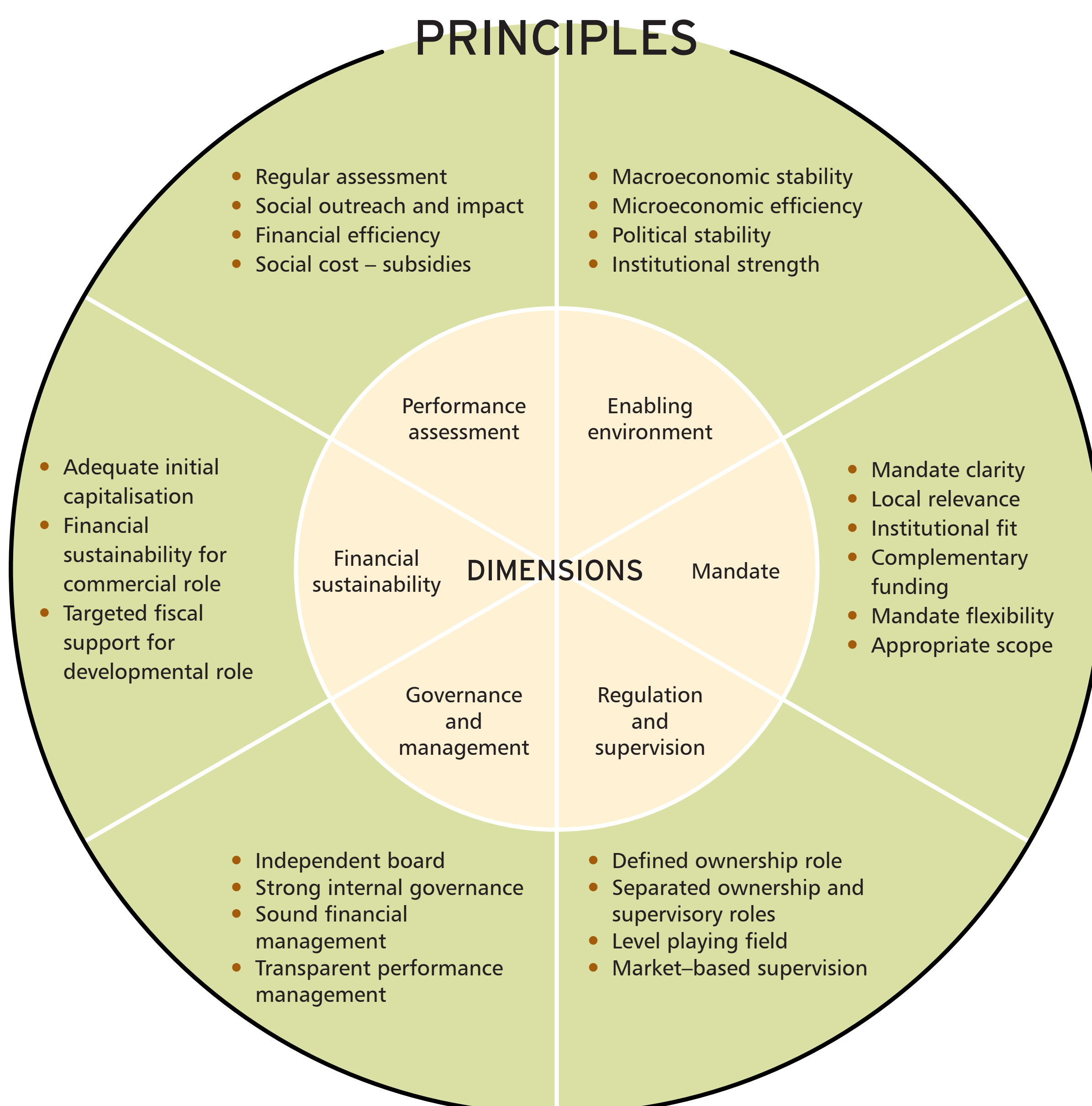
The preceding sections have shown that the success of a development bank depends on a variety of dimensions, and that failure in any one of these can significantly undermine the bank. Drawing on the principles for these dimensions, a macro-level framework can be derived for the success of development banks. The framework is illustrated in Figure 2 and can be summarised as follows:

- *Their environment:* Development banks need a climate of macroeconomic stability without too many microeconomic distortions; they require political stability and a variety of complementary institutions. Although by definition their role is to address some of the weaknesses in the environment, they cannot succeed in a largely dysfunctional climate.
- *Their role in it*: They must be integrated into the financial system and operate along commercial lines, with a flexible mandate. Their potential role in countercyclical spending should be recognised. They must not compete with the private sector, but rather aim to develop it. Once the private sector has the capacity to fund sectors previously funded by a development bank, the latter should be refocused on other areas of operation.
- *How they are controlled:* The ownership role of the state needs to be carried out circumspectly, allowing the bank to have operational autonomy while ensuring that it adheres to its mandate. The combined ownership and oversight role of government creates a potential conflict of interest that requires careful management. In general, the regulation and supervision of development banks should be along private sector lines.
- *How they are run:* Sound governance and management may be the single factor most likely to determine the success of a development bank. This involves issues such as the role

and independence of the board, the accountability and capacity of management, the availability and retention of skilled staff, and sound operational, risk and financial management.

- *How they are funded:* The government needs to capitalise new (or restructured) development banks adequately, and then limit additional fiscal support to ring-fenced non-commercial activities undertaken on behalf of the state. Development banks should be encouraged to approach donors and obtain a credit rating to enable them to raise funds on the capital markets.
- *Do they make a difference?* Development banks should be assessed on a regular basis against an agreed set of objectives, both financial and social or developmental. Government must also be convinced that it could not have achieved these socially desirable outcomes in another (less expensive) way.

**Figure 2: Macro-framework for development banks**



Although adhering to these principles should contribute significantly to the success of a development bank, some caution is required. In the words of Diamond (1996:11): 'There is no such thing as permanent "success". Perhaps success may be applied to a particular period of time but too much depends on the economic environment and on government policy, over which the institution has no control, and on its own (changing) management to apply the characterization of "success" over a very long period or with assurance that it will long continue to apply.' This underlines the need for continued vigilance and flexibility in the governance and operations of a development bank.

## 6. Conclusion

The failure of many national development banks in the 1970s and 1980s led to them all but disappearing from the development agenda. However, many governments persisted with these banks, with mixed results. Some banks have succeeded in stimulating development, especially in countries such as Brazil and South Africa, and are poised to play a growing role in the development of these economies. Also, the global financial crisis has rekindled interest in national development banks, in particular their role in countercyclical spending. However, without a clear understanding of the role of these banks, more failures could occur. This paper offers a starting point for understanding development banks by providing a macro-framework for their successful functioning. The analysis focused specifically on wholesale, state-owned, national development banks.

The framework sets out principles for six dimensions of development banking: an enabling environment, mandate, regulation and supervision, governance and management, financial sustainability and performance assessment. Since development banks operate under different conditions and in different markets, the framework can be adjusted to suit the development priorities of individual countries.

Although it serves as a useful starting point, the framework would be enriched by additional detailed research on a range of concerns, including the following:

- A detailed study of each dimension and of particular principles, such as the appropriate conditions for a narrow or broad mandate
- The interaction between development banks and regional or multilateral institutions such as the World Bank
- The interaction between the various development banks in a country and the shaping and coordination of their activities
- Benchmarking the efficiency of development finance institutions
- Sectoral analysis, for example of agriculture or infrastructure development banks

The renewed focus on development banks is risky. The dangers inherent in their conflicting objectives mean that development banking remains an uncertain initiative for both the government and the bank. However, under the right circumstances, with appropriate supervision and governance, development banks can be a useful instrument for achieving the development objectives of a government and society. The macro-framework outlined above could help create such an appropriate set of circumstances for these banks.

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# Annexure 1: Summary table: Dimensions and principles

| 1. **Enabling environment** | |
|---|---|
| Summary | • *Key principles: macroeconomic stability, microeconomic efficiency, political stability, institutional strength*<br>• Development banks need to operate in a climate of macroeconomic stability without too many microeconomic distortions.<br>• They require political stability and support, as well as a variety of strong complementary institutions (e.g. the legal system).<br>• Although by definition their role is to address weaknesses in the environment, they cannot succeed in a largely dysfunctional climate. |
| Macroeconomic conditions | • Sound fiscal discipline<br>• Balanced economic growth<br>• Balance of payments stability<br>• Price stability and limited external and internal price distortions<br>• Absence of financial repression |
| Structural microeconomic conditions | • Efficient resource allocation in the economy<br>• Regulatory environment that supports investment<br>• Sufficient industrial capacity<br>• Appropriate and well-maintained infrastructure<br>• A developing private commercial and financial sector<br>• Adequate competition and market discipline<br>• Sufficient skills in the economy, including management skills<br>• Reasonable levels of technological development |
| Political environment | • Political stability<br>• Political leadership and support for the development bank<br>• De-politicisation of the role of the development bank<br>• Absence of strong interest group activity<br>• Absence of corruption<br>• Reasonable level of overall government capacity<br>• Reasonable capacity in other organs of state |
| Institutional environment | • Legal system<br>  ▪ A comprehensive and effective legal system<br>  ▪ Adequate protection of property and creditor rights<br>  ▪ A reliable, efficient and independent justice system<br>• Accounting and auditing<br>  ▪ Internationally accepted accounting principles<br>  ▪ Independent audits for larger companies<br>  ▪ Proper regulation of the accounting and auditing professions<br>• Financial infrastructure<br>  ▪ An efficient and secure settlement system<br>  ▪ Adequate information flows (e.g. well-functioning credit bureaux)<br>• Regulation and supervision<br>  ▪ A market-based regulatory and supervisory framework<br>  ▪ Good corporate governance and transparency<br>  ▪ Procedures for dealing with problem banks<br>  ▪ A public safety net (i.e. systemic protection) |

| **2. Mandate** | |
|---|---|
| Summary | • *Key principles: mandate clarity, local relevance, institutional fit, complementary funding, mandate flexibility and appropriate scope*<br>• Development finance institutions must be integrated in the local financial system and operate along commercial lines.<br>• Their mandates must be clearly articulated and flexible, with regular reviews.<br>• They must be complementary to private funding and aim to promote the development of the private sector.<br>• Once the private sector has gained the capacity to fund sectors previously funded by a development bank, the latter should be allowed to move to other areas of operation. |
| Precise articulation | • Prevent mission drift and an undesirable expansion of activities<br>• Prevent mission shrink (avoiding difficult or costly activities)<br>• Provide certainty to the private sector<br>• Increase transparency and accountability<br>• Reduce potential for political interference |
| Local relevance | • Concentrate on local development needs and priorities<br>• Supplement existing fiscal capacity<br>• Complement and mobilise foreign and donor finance |
| Institutional fit | • Integrate with rest of financial system<br>• Complement other local institutions |
| Complementarity of funding | • Define role in line with private sector weaknesses<br>• Ensure mobilisation of private sector funding by mitigating risk<br>• Set criteria for co-funding with the private sector or a formal mechanism for addressing private sector concerns<br>• Enforce graduation of stronger borrowers to commercial funding |
| Flexibility | • Regularly review mandate in view of changing environment<br>  ▪ Changes in policy<br>  ▪ Changes in external environment<br>  ▪ Growing private sector capacity<br>• Refocus operations when required<br>• Preserve institutional capacity |
| Scope | • Ensure appropriate market (portfolio diversification)<br>• Limit systemic risk<br>• Consider governance, coordination and regulatory capacity<br>• Complement macroeconomic, financial and institutional capacity |

| 3. Regulation and supervision | |
|---|---|
| Summary | • *Key principles: defined ownership role, separated ownership and supervisory roles, level playing field, market-based supervision*<br>• The combined ownership and oversight role of government creates a potential conflict of interest that requires careful management through the separation of the ownership and supervisory functions.<br>• The ownership function should allow the development bank full operational autonomy while ensuring that it adheres to its mandate.<br>• Regulation should be along private sector lines and comply with the relevant international codes.<br>• Capital adequacy requirements should take cognisance of the developmental role of the bank.<br>• Government oversight should be supplemented with market supervision in the form of credit ratings. |
| State as owner | • Separate ownership and supervisory roles<br>• Publish a clear ownership policy or at least legal ownership rules<br>• Consider the establishment of a single ownership entity<br>• Provide professional support to the ownership function |
| State as regulator | • Create an independent supervisory capacity, separate from ownership role, to protect the state against credit risk and the private sector from unfair competition<br>• Provide supervision and regulation along private sector lines<br>• Create a level playing field with the private sector<br>• Adhere to relevant international codes<br>• Consider a caveat around capital adequacy requirements |
| Market-based supervision | • Supplement government supervision with credit ratings<br>• Assist weak institutions in moving towards credit ratings<br>• Explore intermediate codes to strengthen financial management |
| **3.1 Government supervision** | |
| Authorising legislation (permissible activities) | • Mission of the organisation<br>• Method of funding, government capital and/or subsidies<br>• Prudential standards and accounting and auditing requirements<br>• Specific standards for operations, where required<br>• Performance criteria and method of assessment |
| Supervisor's capacity | • Operational independence<br>• Sufficient resources<br>• Appropriate legal framework and enforcement capacity<br>• Information-sharing arrangements |

<table>
<tr><td>Supervisor’s role</td><td>• Set criteria for activities<br>• Monitor operations<br>• Evaluate activities in line with the mandate<br>• Institute corrective measures if required</td></tr>
<tr><td>Capital adequacy</td><td>• Define regulatory capital<br>• Set capital adequacy requirements</td></tr>
<tr><td>Requirements</td><td>• Evaluations<br>▪ Independent evaluations of policies and operations<br>▪ Independent internal and external audit and compliance<br>▪ Formal plans with clear responsibility for internal oversight<br>▪ Appropriate internal separation of duties to avoid conflicts of interest<br>• Transparency<br>▪ Adequate financial policies, practices and procedures<br>▪ Appropriate record keeping and accepted accounting policies<br>▪ Regular publication of audited financial statements<br>▪ Separate accounts for commercial and developmental operations, with the former being subject to the Basel II principles<br>• Risk management<br>▪ Comprehensive risk management process for all material risks<br>▪ Appropriate risk-modelling techniques for interest rate, credit, market, currency and operational risk, for example<br>• Monitoring<br>▪ On-site supervision and independent verification of governance procedures and information accuracy<br>▪ Off-site monitoring of financial situation based on prudential reports<br>• Corrective action<br>▪ Obligation to publish annual reports on safety or soundness issues<br>▪ Remedial action when institutions fail to meet requirements<br>▪ Mechanism to ensure supervisor’s recommendations are implemented<br>▪ Need for supervisor to have appropriate legal authority</td></tr>
<tr><td colspan="2">4. Corporate governance</td></tr>
<tr><td>Summary</td><td>• Key principles: independent board, sound internal governance, proper financial management, transparent performance management<br>• Sound corporate governance may be the single factor most likely to determine the success of a development bank.<br>• Corporate governance should be in line with private sector principles on the role and independence of the board; the accountability and capacity of management; the availability and retention of appropriately skilled staff; sound operational, risk and financial management; and adequate transparency and disclosure.<br>• Transparent and objective performance contracting should allow the government and the public to oversee the activities of the bank.</td></tr>
</table>

| 4.1 Board of Directors | |
|---|---|
| Functions | • Appoint and evaluate executives<br>• Set and monitor strategy<br>• Approve important policies<br>• Oversee internal controls; fiduciary duties<br>• Set performance indicators and benchmarks<br>• Ensure fair disclosure of performance<br>• Remain accountable to government |
| Needs of the board | • A board charter<br>• Code of ethics<br>• Clear performance objectives<br>• Annual self-evaluation<br>• Training<br>• Specialised committees<br>• Co-opted external skills for committees |
| **4.1.1 Board membership** | |
| Membership | • Generally seven to ten members, maximum 15<br>• Chosen on the basis of competence, objectivity and integrity |
| Stakeholders' interest | • Board members independent from government<br>• Government officials in the minority, with similar skills and powers<br>• Different constituencies represented<br>• Employee representation considered |
| Appointment | • Transparent nomination process and clear and objective criteria<br>• Thorough understanding of finance, commerce, government policy and development needs<br>• Database of appropriately qualified individuals or possibly specialised agency to advise on nominations<br>• Not too many concurrent directorships<br>• Term of about three to five years, staggered to ensure continuity<br>• Competitive remuneration |
| Chairperson | • Position of chairperson and Chief Executive Officer separate<br>• Not a government official<br>• Requisite skills and competencies<br>• Term of three to five years stipulated upfront<br>• Possibly annual vote of confidence from the board |
| Chief Executive Officer | • Requisite commercial skills and competencies<br>• Transparent appointment according to clearly defined job description<br>• Term of three to five years<br>• Accountable to the board, not politicians or officials |

<table>
<tr><th colspan="2">4.2 Internal governance</th></tr>
<tr><td>Management</td><td>

- Transparent process of selection of top management with the requisite skills
- Managerial accountability to board for organisational performance, but independence from board for day-to-day operations
- Performance-based contracts for the Chief Executive Officer and executive management, as well as for the rest of the staff
- Appropriate financial and non-financial rewards to retain scarce skills
- Functions of top management:
  - Set strategy in consultation with the board
  - Translate the strategy into operational goals
  - Take responsibility for operational and financial performance
  - Review operational policies and procedures as the environment changes
  - Create an organisational structure with a clear separation of authority
  - Set up effective communication channels
  - Build partnerships with the private sector and other development institutions
  - Motivate and incentivise staff
  - Establish succession plans and provide mentorship to potential candidates

</td></tr>
<tr><td>Human resources</td><td>

- Appropriate level of staffing (avoiding both under- and overstaffing)
- High-level professional skills, with specific emphasis on:
  - Asset and liability management
  - Risk management and credit analysis
  - Project design, appraisal and monitoring (e.g. financial, institutional, environmental, technical, economic and social assessment)
- Training and capacity building, whether internally, externally or in partnership
- Competitive remuneration and performance-based incentive schemes
- Removal of underperforming staff (possibly using fixed-term contracts)

</td></tr>
<tr><td>Operations</td><td>

- Project appraisal based on economic, financial and developmental criteria
- Criteria for leveraging co-funding
- Proper credit assessment of borrowers, with clear minimum equity requirements
- Clear delegations of authority for approval of projects
- Policies to ensure that performance targets do not undermine portfolio quality
- Clear procedures for overdue loans or defaults, including rescheduling principles, a ‘workout’ unit and procedures for legal action

</td></tr>
<tr><td>Monitoring and evaluation</td><td>

- Regular monitoring of project implementation
- Specific monitoring of projects that are overdue or in default
- Independent evaluation of projects, policies and processes
- Feedback of lessons learnt into operations to stimulate innovation

</td></tr>
<tr><td>Management information systems</td><td>

- Monthly reporting on performing and non-performing loans, on uncommitted approvals or lines of credit, and on the project pipeline
- Well-developed systems to monitor staff and operational performance
- Appropriate cost accounting system that distinguishes between commercial and development activities undertaken on behalf of government

</td></tr>
<tr><td>Accounting and control</td><td>

- Adherence to international accounting and banking standards
- Independent external audits
- Strong internal audit function reporting to the board
- Formal procedures to combat corruption (e.g. a whistle-blowing policy)

</td></tr>
</table>

<table>
<tr><td>Disclosure</td><td>• International best practice financial disclosure standards, including:<br>▪ Material risks<br>▪ Off-balance sheet commitments (e.g. guarantees)<br>▪ Financial support from the state<br>• Transparent reporting on non-financial matters and risks related to objectives, policies, performance and development impact, for example</td></tr>
<tr><td colspan="2">4.3 Financial management</td></tr>
<tr><td>Overall financial management</td><td>• Adherence to international norms or at least to relevant central bank requirements</td></tr>
<tr><td>Capital adequacy</td><td>• Appropriate capital adequacy standards<br>• Sufficient profit to preserve capital adequacy (adequate interest margin)</td></tr>
<tr><td>Asset quality and diversity</td><td>• Loan-loss provisioning according to international norms<br>• Appropriate single exposure limits<br>• Limits on sectoral or geographical concentration</td></tr>
<tr><td>Funding</td><td>• Mobilisation of donor funding<br>• Mobilisation of private funding (e.g. bond issues)<br>• Investment-grade credit ratings, wherever feasible<br>• Indirect financing as appropriate (e.g. securitisation of assets)</td></tr>
<tr><td>Risk management</td><td>• Strong culture of enterprise-wide risk management<br>• Comprehensive risk management system, overseen at high level<br>• Use of modern techniques for modelling risks<br>• Commercial principles for determining interest rates<br>• Proper asset and liability management policies and sound asset and liability management<br>• Appropriate use of financial instruments to mitigate against various risks<br>• Clear separation of project approval and disbursement functions</td></tr>
<tr><td colspan="2">4.4 External performance management</td></tr>
<tr><td>Contract structure and targets</td><td>• Keep the contract short and simple to limit its administrative implications<br>• Clarify the accountability of each party (government, board and management)<br>• Design mechanisms for regular review of the contract<br>• Specify the overarching priorities (e.g. financial sustainability)<br>• Include both financial and developmental objectives (and operational ones)<br>• Define a small number of objectives, targets and performance indicators<br>• Reward outcomes rather than inputs and effort<br>• Specify the resource requirements of activities undertaken for government</td></tr>
<tr><td>Information flows</td><td>• Ensure that government negotiators have sufficient power to elicit information<br>• Conclude negotiations early, preferably before the contracting period starts<br>• Improve accounting practices to improve information flows<br>• Introduce benchmarks (e.g. yardstick competition)<br>• Ensure consistency in the use of targets (avoid annual changes)<br>• Give priority targets a high weight<br>• Avoid the use of aggregates that can hide poor performance</td></tr>
</table>

| | |
|---|---|
| Incentives | • Set significant penalties and rewards to induce changes in performance<br>• Clearly define what changes in performance are required<br>• If these are not forthcoming, change the board and/or management<br>• Use increased autonomy as an incentive for better management |
| Commitment | • Secure credible government commitment to its promises<br>• Ensure that treasury officials participate in negotiations with fiscal implications<br>• Use an independent and neutral agency to resolve conflicts<br>• Create an independent evaluation mechanism<br>• Publish the terms of the contract to increase public oversight |
| **5. Financial sustainability** | |
| Summary | • *Key principles: adequate initial capitalisation, financial sustainability, targeted fiscal support for developmental role*<br>• The government needs to capitalise new (or restructured) development banks adequately.<br>• It must refrain from providing additional fiscal support, except to reimburse non-commercial activities undertaken on its behalf.<br>• The development banks should be required to be financially sustainable in all other aspects.<br>• They should be encouraged to approach donors and to obtain a credit rating to enable them to raise funds on the capital markets. |
| **5.1 Fiscal support** | |
| Criteria | • Only for agency activities undertaken on behalf of the state, specific once-off costs, financial development or capacity building<br>• Must overcome a market failure or strengthen the market<br>• Must have measurable benefits that exceed the costs<br>• No interest rate subsidies<br>• No overt distortion of the market |
| Design | • Clear objectives<br>• Thorough needs assessment<br>• Targeted, specific and capped fiscal support, possibly ring-fenced<br>• Transparent budgeting and targeting<br>• Fair and equitable allocation<br>• Regular monitoring and review<br>• Short time period or sunset clause |

| 6. Performance assessment | |
|---|---|
| Summary | • *Key principle: regular assessment of social and financial outcomes*<br>• Development banks should be assessed on a regular basis against an agreed set of objectives.<br>• They cannot be assessed only on their financial objectives, since part of their mission is to achieve developmental goals. Hence, their social impact should also be considered.<br>• Government must be convinced that it could not have achieved these socially desirable outcomes in another (less expensive) way. |
| Social outreach | • *Worth:* Outstanding loan portfolio and annual growth<br>• *Cost:* Cost to clients of using the service<br>• *Depth:* Poverty status of clients<br>• *Breadth:* Percentage of the target market that is served<br>• *Length:* Sustainability of the institution<br>• *Scope:* Range of financial services |
| Social audit | • *Mission and leadership:* Express objectives and values; active management<br>• *Staff development and retention:* Values of new staff aligned to mission; training underpins culture<br>• *Performance incentives:* Reward behaviours in line with the mission<br>• *Performance monitoring:* Use to align operational activities with mission<br>• *Strategic planning:* Goals, priorities and plans support mission |
| Financial assessment | • *Financial ratios:* Return on capital, on total assets, on equity and on average net assets, and cost-to-income ratios, among others<br>• *SDI:* Annual net subsidies received/average annual yield obtained on the loan portfolio |