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Impact of public banks on stability of financial system

Public banks are important components of financial markets in many countries. Their goal is to implement social and economic policies of governments. Their activity should have positive impact on economy and stability of financial sector. After the first phase of the crisis their main stabilization function includes provision of long-term financing and countercyclical policies supporting investment demand in domestic economy.
However, like all public institutions these banks are prone to microeconomic and macroeconomic mechanisms, which distort their actions and may lead to decrease of social welfare. This paper outlines potential inefficiencies, which may arise as an effect of public bank activities, as well as a short description of banks which experienced such events on a large scale. There are also presented recommendations how to prevent materialization of such scenarios in a future.
Keywords: public banks, financial stability, inefficiency of public entities

Introduction

In majority of countries, there exist public banks or government sponsored institutions, which are dedicated to implement economic and social policies of central or local governments as well as stabilize their sources of financing. Due to their size and legislative setup they are important components of financial sector. Their position grew even stronger during the financial and economic crisis which started in 2008. Firstly, during a confidence crisis, they played a role of a trusted market player and a source of capital for troubled banks and sectors. In the second phase they moved to a role of provider of long-term financing and countercyclical policies supporting investment demand in domestic economy.

By definition public banks activity is supposed to increase social welfare. However, like all public institutions these banks are prone to typical performance flaws of public institutions as well as microeconomic and macroeconomic mechanisms, which distort their actions and may lead to suboptimal outcomes. Sometimes, this may even threaten the stability of financial system. This paper outlines these potential inefficiencies. It also contains a short description of banks which experienced such adverse events on a large scale. Based on these observations there are presented recommendations how to prevent materialization of such scenarios in a future. The paper is a summary of wider research.

Characteristics of public banks

Public banks and government sponsored institutions are generally speaking institutions dedicated to perform activities supporting numerous state policies such as stimulation of economic growth, backing strategic or distressed industries, executing social and poverty fighting programs, promoting innovations, and conducting financial transactions and debt management operations for government. Some of them support local governments in carrying out infrastructure projects, especially in housing and health sector. Yet other provide financing for companies in such diverse ways like e.g. guarantees for micro, small and medium enterprises or export finance and contract insurance for high risk countries. Selected banks also participate in student loan programs, aid for flood and natural disasters victims, financial assistance to unemployed or related activities.

Scope of public bank activities differs from country to country. For example they strongly support housing policies in Germany and France, to smaller extent they do this in Spain and Poland, and only marginally in Italy. Majority of public banks offer also commercial banking products and they are important players on their domestic financial markets.

These institutions are usually state-owned. Some of them were privatized e.g. Fannie Mae, Freddie Mac (USA), Depfa (Ireland). However, as a result of recent financial crisis majority of private ones were again taken over by the state. For more detailed description of public banks and government sponsored institutions see e.g. annual reports of European Association of Public Banks.

Enhancing financial sector stability by public banks

Equilibria in market economy may be accompanied with appearance of several market failures. As a result a market equilibria deviate from socially optimal solution.[1] That creates a reasonable space for implementation of policy instruments provided by public banks and government sponsored institutions, which if correctly designed, may create a Pareto improvement for market players.

The first area is a regulatory sphere i.e. creating an institutional framework enabling proper functioning of market economy. This encompasses such issues as e.g. property rights protection, contract execution and debt recovery effectiveness. The second area regards microeconomic aspects of market failures. In particular, they are associated with existence of externalities, incomplete markets and imperfect information. They also arise from public good provision by private markets (inadequate amount) and flaws in competition level (existence of monopolies and oligopolies). The third area covers macroeconomic issues related with business cycles, imbalances on labor market and socially unfair distribution of wealth.

In particular, in case of the second and third area there is a clear room for public banks to play an important role in enhancing stability of financial system. For instance, the risks associated with imperfect information and adverse selection materializing during commercial financing of micro, small and medium enterprises are mitigated by public banks through bond and guarantee programs. Among European public banks such programs are provided by i.a. Austria Wirtschaftsservice (Austria), BGK (Poland), NRW (Germany), IKB (Germany), OSEO (France), Finnvera (Finland). This guarantee activity enables on the one hand to create positive spillovers for a whole economy, in particular for commercial banks involved in financing these entities, and on the other hand protects financial sector against negative shocks and high credit losses during economic downturn.

In Poland, a system of guarantees for micro, small and medium enterprises worked properly in its former organizational form and consisted of two funds placed in BGK (KFPK - National Loan Guarantee Fund and FPU – EU Guarantee Fund) and group of local and

[1] See: J. Stiglitz „Ekonomia sektora publicznego". Wydawnictwo Naukowe PWN, Warszawa 2004, p. 90-108.

regional guarantee funds. After modifications of its formula in BGK in June 2009 (closure of KFPK and FPU) the guarantee activity almost entirely was performed by local and regional guarantee funds. For example in 2010 local funds granted guarantees for 869 mln PLN and BGK for less than 20 mln PLN. In November 2012 central government started efforts to revive BGK role by new instrument using de minimis formula – portfolio guarantee lines for banks financing micro and small companies.

Very important area of strengthening and stabilizing market mechanisms is providing long-term financing by public banks for the projects with long payback period (e.g. investments in transport infrastructure, projects securing diversification of energy sources) or creating positive externalities to society. This category of projects is not in a scope of interest for private banks. Specifically, limited private sector involvement results from dried off sources of cheap liabilities and capital, which were available for more than decade in economy before the crisis outbreak.[2]

Some public banks have clear advantage over private ones in such projects. They are significantly more immune to business cycles due to their exclusive funding sources. As the result they may assure stability of financing even in periods of limited supply of credit by commercial banks. Selected public banks created Long-Term Investors Club which is promoting long-term investments and advocating for legal and accounting changes facilitating carrying out such projects.[3] Moreover current crisis prompted several countries to create new investment vehicles. For example in Poland, BGK along with newly established in November 2012 entity PIR (Polish Development Investments) were funded with ca. 10 bln EUR capital for conducting strategic and long-term investments facilitating economic growth. Another example is the Green Investment Bank established in the UK, which started its operations in October 2012. It has been funded with 3 billion GBP of government money to conduct projects in a green economy, which cause positive externalities for entire economy but are difficult to be financed from exclusively private profit maximizing perspective.

Positive impact of public banks is well visible in periods of financial distress both on the assets and liabilities side. In case of deposits, such situation took place in the end of 2008 in Poland. Then there was a tendency to withdraw funds from banks. However, thanks to availability of offer in state-owned BGK and PKO BP deposits remained in the banking sector. Such mechanisms are typically strengthened by systemic solutions. Popular solution is to entrust public banks with servicing accounts of government entities. In selected cases the commissioned mandate is broader. For instance French public bank CDC has exclusivity for managing deposits from institutions and professions of public trusts such as notaries, courts, attorneys, liquidators. In addition, CDC manages the accounts of French pension system. Different model was adopted in Italian CDP. It accumulates savings through postal bonds and savings books. These saving instruments have direct state guarantee.

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[2] "Farewell to cheap capital? The implications of long-term shifts in global investment and saving", McKinsey Global Institute, December 2010.

[3] Members of Long-term Investors Club: European Investment Bank, CDC (Caisse des Dépôts et Consignations, France), CDP (Cassa Depositi e Prestiti¸ Italy), KfW (Kreditanstalt fuer Wiederaufbau, Germany), Mubadala Development Company (UAE), Caisse de Dépôt et de Gestion (Morocco), Bank Gospodarstwa Krajowego (Poland), Turkiye Sınai Kalkınma Bankası (Turkey), Caisse de dépôt et placement du Québec (Canada), China Development Bank (China), Vnesheconombank (Russia), APG (The Netherlands), Infrastructure Development Finance Company Limited (India).

Simultaneously, there were introduced mechanisms ensuring business continuity for public banks. In the above mentioned banks BGK and CDC there exist specific regulations protecting them against insolvency and bankruptcy.[4] This is a vital attribute because in case of financial or confidence crisis in banking sector the savings withdrawn from commercial banks will not leave the system but with high probability will be transferred to public banks perceived as completely safe. As the result, public banks will be able to relend that money to commercial banks via interbank market and eliminate the negative effects on private banks. Thus, the public banks may efficiently play a role of system stabilizer in case of a bank run.

Public banks also help to stabilize the sources of financing for central governments what diminishes the risk of financial meltdown caused by government's inability to refinance its debt. The primary instrument in this area is cash pooling of public sector accounts what reduces the gross borrowing needs of the state, and cost of servicing the existing debt as well as provides complete information on financial resources dispersed in a public sector entities. In Poland, this activity is performed by BGK. It conducts also back-office operations in management of government foreign debt. Even more broad scope of activity is conducted by Portuguese IGCP (Instituto de Gestão da Tesouraria e do Crédito Público I.P.). In addition to government debt management IGCP is also responsible for raising new debt on behalf of government.

On the lending side, public banks play equally important role during periods of slowdown in domestic economy. This encompasses financing corporate investments, municipal infrastructural projects, working capital as well as export activity. The impact may be enormous. For example in Germany public financial institutions in 2010 provided 32% of total corporate funding (420 billion EUR) and 47% of municipal funding.[5] Similar role played in Poland BGK and BOŚ (Bank for Environment Protection) for financing local government investments in the first half of 2009 when almost all banks left this market. BGK and BOŚ provided more than 50% of all new loans successfully closing the market gap in a very crucial moment of increased demand for long term loans required by municipalities for absorption of the UE structural funds. Normally, there are ca. 15 private banks active plus numerous cooperative banks active on this market.[6]

Public banks provide also financing in a form of capital investments.[7] That activity includes an important task of rescuing troubled private banks during financial crises. For example in September 2008 CDC acquired for 2,9 bln EUR a 13% stake in Dexia bank which was on a verge of insolvency.[8] Thus, public banks not only stabilize the economy but they directly support stability of financial sector as well.

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[4] In case of BGK, adequate financing for bank from central budget is secured by art 3 par. 3 of the Act on BGK and prevention from bankruptcy is specified in art. 3 par. 4. In case of CDC similar provisions are in French Commercial Code (art. L631-2 i L640-2) and the Act 80-539 of 16 June 1980. It is important to note that number of public banks have direct state guarantees for its liabilities e.g. German KfW (art. 1a in Act on KfW of 23 June 1969 (BGBl. I p. 573)) as amended (31 October 2006 (BGBl. I p. 2427)).

[5] "Annual Report 2011-2012", European Association of Public Banks, Belgium, 2012, p. 10.

[6] For more detailed description see K. Kluza „Determinanty kosztu finansowania samorządów" in „Sektor finansów publicznych w warunkach światowego kryzysu finansowego" ed. A. Alińska, Wydawnictwo CeDeWu, Warszawa 2011, p. 144-165.

[7] See e.g. "Annual Report 2009-2010", European Association of Public Banks, Belgium, 2010, p. 9-10. In case of capital investments the most active public banks are CDP, CDC and KfW. They hold in their balance sheets investment portfolios of 15-20 bln EUR.

[8] CDC took part in this buyout together with central and regional governments of Belgium) and Luxemburg.

It is worth to notice that stabilizing function of public banks to large extent comes from their acyclic role in economy. Due to a longer time horizon they do not have to adjust to the current stage of business cycle but are able to steady perform their tasks. Moreover, several programs commissioned to public banks may have counter-cyclical nature (e.g. programs for unemployed), which creates automatic stabilizers for economy.

Potential inefficiencies arising from public banks' activities

The above described activities performed by public banks consisting of implementing government policies, supporting selected industries and business segments, and stabilizing economy are usually justified and socially desired. However, there is a risk of creating inefficiencies in economy while performing those tasks. Some of these inefficiencies are related to limited performance of public institutions and other regard negative macroeconomic and microeconomic consequences of implemented policies, frequently contrary to the initial intents.[9]

Limited performance of public institutions comes from four basic areas. The first one is a limited knowledge possessed by government institutions. It affects their ability to determine the scope of the problem which should be solved by certain policy, to channel given solution to relevant group and in relevant quantity and to measure and control performance of conducted activities (e.g. from social welfare perspective). It is important to note that public institutions do not have clear advantage over private sector in terms of costs of information gathering and similar transaction costs. The second performance flaw comes from limited control over actions on private markets. Outcome of policies is strongly dependent on behavior of private agents being influenced by these policies, which are not directly controlled by politicians. Thirdly, there are the limitations arising from bureaucracy i.e. unclear and not optimal from process perspective legislative solutions, that hinder implementation and goal achievement ability, and potentially low competences of public servants. And the fourth factor - political constraints and ideological issues. This also encompasses pursuing the interests of certain lobbies being not in line with needs of whole society.

From microeconomic perspective the key risk associated with public banks activity arises from moral hazard issue, which in their case emerges from direct or implicit guarantee of state support. Equally important is a phenomenon of adverse selection, which especially in asymmetric information environment hinders identification of relevant beneficiaries and achieving positive program results (specifically in bonds and guarantees for small companies). In addition, the challenge is to create such provision of public good that will increase overall social welfare and will not replace the private resources already employed on the market.[10]

The last group of inefficiencies is related to macroeconomic topics. There are two essential issues – procyclicality and speculation bubbles. They usually reveal themselves with large-scale programs. Procyclicality in government programs means that in periods of good business climate they create incremental demand or supply, and in recession time they additionally limit the demand or supply. As a result, instead of stabilizing the economy public banks may cause negative effects for economic growth, provision of certain goods and

[9] See J. Stiglitz „Ekonomia sektora publicznego" Wydawnictwo Naukowe PWN, Warszawa 2004, p. 10-12.
[10] See e.g. Neutrality Theorem by P. G. Warr "The private provision of a public good is independent of the distribution of income", Economic Letters, 13, 1983, p. 207-211.

employment. These kinds of effects are produced e.g. by some housing support programs. Some public policies which stimulate demand may result in creating bubbles. Bursting of such a bubble causes strong distortion to asset prices, to carrying out investment projects and causes a decline in trust between players on financial market.

Historical study shows that in several situations public banks and related government sponsored enterprises played a negative role, contributing to deepening of imbalances in economy and destabilizing financial markets. The above mentioned risks materialized in case of such institutions like Fannie Mae, Freddie Mac, IKB, Depfa, Dexia, MFB and Savings & Loans Associations in the US. Examples of inefficiencies occurred in the past are shortly described below. In all cases, the described institutions technically went bankrupt and required injection of new capital on the expense of taxpayers.[11]

- IKB (Germany) – it conducted investments in risky and long-term assets, financed by short-term liabilities. In addition, these investment were separated from balance sheet to off-balance sheet operations. As a result there was an inappropriate assessment of credit risk and liquidity risk, large term mismatch between assets and liabilities, and bypassing of supervisory norms. The inefficiencies that occurred in this case were mostly related to moral hazard and bureaucratic limitations.
- MFB (Hungary) – carried out program of financing venture funds. Due to relatively subjective criteria of employing public funds, forced lending and diversified expectations and goals of individual stakeholders it contributed to a distortion of allocation process in economy. Inefficiency that occurred in this case were mostly related to limited knowledge, bureaucratic limitations, adverse selection and problem with optimal supply of public good.
- Savings & Loans Associations (USA) – in the eighties the state took on the business risk of these institutions without securing an appropriate corporate governance mechanisms. It resulted in such inefficiencies as moral hazard, political limitations and distortions on macroeconomic level.
- Fannie Mae and Freddie Mac (USA) – following government stimulation policies and legislative changes related to mortgage loans, a price bubble was created on housing market in the long-term. Additionally, these institutions operated on very high leverage and incorrectly assessed the risk level of their portfolio as well as individual transaction (risk of individual loans turned out to be correlated). Inefficiencies which occurred in this case were as follows: procyclical and asset price bubble creating activities, bureaucratic limitations, political limitations, adverse selection and moral hazard.

Designing specific programs and management mechanisms in public banks requires paying high attention to curb the above described inefficiencies. Otherwise a history tends to repeat itself. For example in case of strategic investment vehicle created in November 2012 by BGK and PIR there are still no defined criteria for project selection, which will be financed by public funds. This may result in similar scenario as in the case of MFB.

[11] For more details see K. Kluza, P. Łysiak, R. Wasak „Banki rządowe jako potencjalne źródło pogłębienia nieefektywności w gospodarce" in „Rynek kapitałowy a koniunktura gospodarcza" ed. A. Szablewski, I. Wojciechowska-Toruńska, Monografie Politechniki Łódzkiej, Łódź, February 2010, p. 10-28.

An example of institution which correctly designed its policies and control systems is Export Development Canada (EDC) established to support Canadian export. EDC offers guarantees, export contract insurance and trade finance products. Its efficiency is evaluated by the owner based on its performance in execution goals regarding i.a. the amount of supported export contracts, profitability of operations, share of commercial banks in product distribution, cost efficiency. The Table 1 shows briefly how EDC reduces potential inefficiencies in its activities.

Sources of inefficiencies		Methods of reducing/mitigating the risks in EDC
limited performance of public institutions	limited knowledge	- better access to information on foreign risks acquired through embassies and trade promotion institutions - assessment of political risk based i.a. on information acquired on intergovernmental level
	lack of control of private markets	- distribution of majority of products through private banks as intermediaries
	bureaucracy	- clearly defined set of goals, taking into consideration calculation of EDC (positive) impact on economy - lack of specific instructions (constraints) regarding the methods of fulfilling EDC mission
	political limitations	- stable mandate and mission objectives since establishment of EDC - no influence of government officials on procedures and products in EDC
microeconomic issues	moral hazard	- verification of each transaction from the perspective of EDC mission and benefits for Canada - specialized risk assessment competencies; focus on portfolio profitability - OECD Consensus regulations establishing bottom limits for offered prices for long-term loans
	adverse selection	- complete risk assessment of individual transaction - unique set of products and services, attracting leading exporters for cooperation
	optimal public good provision	- distribution of majority of products through private banks as intermediaries
macroeconomic issues	procyclicality	- filling a gap on financial market during periods of crises when commercial banks more than proportionally reduce their risk appetite
	price bubbles	- stabilizing and lowering market prices due to intensifying competition level - risk assessment conducted as in private institutions (no mitigations)

Table 1. Inefficiencies and methods to reduce them implemented by EDC
Source: Based on K. Kluza, P. Łysiak, R. Wasak „Poruszyć machinę", Bank Monthly, no. 6 (212), June 2010, p. 20.

Recommendations

The tasks performed by public banks are focused on support of economic development, performing social policies and improving stability of markets. These goals, generally very legitimate, are not always achieved, also with respect to improvement of stability of financial sector. Public banks peruse these goals by such activities as guarantees systems, cash pooling for public accounts, providing long-term financing, implementation of acyclical or countercyclical programs, acting as capital investor in domestic companies and related actions.

However, public banks activities may be accompanied with several inefficiencies, which ultimately not strengthen but distort financial stability. Therefore it is very important to eliminate moral hazard issue arising from implicit state support for their operations. In particular that implies implementation of regulations controlling the level of leverage in public banks. Public banks should be also fully covered by capital adequacy norms. Currently European Commission allows excluding them from these regulations, in line with EAPB expectations.

In case of public banks with mostly wholesale sources of financing, key issue is liquidity management, including a securing of access to long-term stable liabilities. In particular one has to abolish an occasional practice of financing long-term investments with issues of short-term commercial papers. It is also important to observe the principle that public policies performed by public banks cannot have a procyclical nature and must generate positive external effects. Then, their impact on stability of financial sector will be clearly beneficial.

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