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Development Banks

Role and Mechanisms to Increase their Efficiency

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Abstract

Past performance of development banks, has generally been considered poor and the value of state ownership questioned. There are few institutions that achieve the optimum balance of effectively addressing a policy objective while being financially sustainable. Following the financial crisis, there is a renewed interest in the role development banks can play in weathering the crisis.

The purpose of this paper is to highlight the lessons learned following the financial crisis and to present some of the best practices in development banking so that policy makers can be better informed should they be considering how to build strong state financial institutions to address current and future needs in their respective countries.

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Development Banks: Role and Mechanisms to Increase their Efficiency

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1. Introduction

Traditionally, "market failure" to finance certain economic activities has provided an argument to justify state intervention in the financial system, including through state financial institutions and development banks (DBs)[2]. However, in the late 1980s and in the 1990s the development of a vibrant private financial sector led to a wave of privatizations and liquidations of public banks in many emerging countries, and restrictions were placed on the resources available to DBs reflecting concerns regarding their performance. Following this wave of reforms, many remaining DBs refocused their activities on areas that the private sector was not serving.

The first financial crisis of the new century prompted the governments in several countries to take an active role in the face of financial market distortions and the credit crunch arising from temporary market failures. Countercyclical state intervention in the face of a credit crunch could take several forms. For example, in the US the Federal Reserve Board (FED) acted as a commercial bank buying private sector securities to inject liquidity in the economy and provide financing to the private sector. However, the activities of many central banks are restricted to enhancing monetary policy credibility and therefore some governments used other existing state financial institutions, in particular DBs that channel credit to the productive sector. Governments found that institutions already operating in the market on a continuous basis could quickly escalate their activities, taking advantage of their knowledge of the sector in which they operate and lending know-how. While activity to mitigate a temporal market failure maybe warranted, is important to set up mechanisms to ensure that the activity and balance sheet of the institution

[2] Such institutions have been a centerpiece of the basic banking development since the 1800s. DBs usually have a policy objective that is closely related to the economic development of the country or a given sector. Rather than taking deposits from the public, DBs typically fund themselves through other means, including securities issuance and credits from multilaterals. However, some DBs that have as objective the promotion of financial inclusion, do take deposits.

contract as overall financial sector activity recovers to ensure that state intervention will be truly countercyclical, as well as to ensure that these institutions operate efficiently.

This paper aims to contribute to the discussion of the role of DBs and the mechanisms to ensure that these banks effectively serve a clear purpose, are run efficiently and do not create market distortions. In particular the paper addresses how to reconcile the long-term developmental role with the counter cyclical function of DBs. The vision that is being proposed for DBs is that they should ideally be an efficient and effective government policy instrument operating on a quasi-commercial basis, filling both the long-term structural and short-term cyclical gaps in an open market driven economy.

While the discussion of many aspects of the paper could be generalized to all state financial institutions, we focus on DBs as these are the only public financial institutions remaining in several countries following the wave of privatizations of the 1980s and 1990s. Moreover, while the long-term structural gap filling argument provides a rationale for the existence of DBs — DBs tend to offer long-term capital finance to projects that are deemed to generate positive externalities and hence would be underfinanced by private creditors and finance underserved specific sectors such as agriculture or housing— it is more difficult to justify on this basis the existence of a commercial public bank that engages in the full range of financial sector activities.

Policy makers need to determine how to make the best use of a DB given the local context, culture and history to address economic development and policy objectives. There needs to be an assessment of and conclusions drawn on issues such as whether to intervene directly in the market or to operate indirectly as a second tier bank and whether or not to compete with the private sector, whether to recover costs fully or to subsidize operations. There is a wide spectrum of options with associated pros and cons that policy makers will weigh and formalize when determining the policies involving DBs. Although, in general, successful public bank stories do not abound, some institutions have proved effective in achieving their objectives while preserving their financial position. Their effectiveness has been identified as depending on a range of factors, including the ability to identify and mitigate market failure; the design of a

well-defined mandate; the use of innovative instruments to adapt to evolving circumstances; and the adoption of best practices in corporate governance.

The paper is organized as follows: section 2 reviews the economic literature on the rational for state intervention in the economy including through DBs and the evolving policy consensus; section 3 discusses the countercyclical role of DBs; section 4 elaborates on how to focus DBs' operations through clear mandates; section 5 discusses good practices in DBs' interventions operating directly or through a second-tier structure; section 6 reviews governance arrangements that can strengthen the performance of the DB by ensuring that the institution is professionally run; and section 7 summarizes the main conclusions of the paper.

2. Rationale for DBs and Evolution of the Policy Consensus

There is vast amount of literature regarding the role of DBs as policy vehicles to foster economic growth, particularly in developing economies. The role of DBs is to mitigate market failures arising from a variety of sources including (i) the presence of costly and asymmetric information that for example hampers access to finance for first time borrowers; and (ii) the existence of externalities that result in underfunding of socially valuable projects (as financial profitability does not reflect the overall value of the project) [3]. In countries at incipient stages of development and with weak legal systems, the advantage of the state in contract enforcement has also been provided as a rationale for the existence of state financial institutions.

While market failures may provide a justification for the existence of DBs, state intervention in the banking sector presents risks as well. State-owned institutions that use an unfair advantage to compete directly with the private sector create other distortions and inhibit private sector activity. Some governments believe that the role of DBs is to create competition with the private sector to drive down interest rates to the benefit of the borrowers that in turn will stimulate new investment in the economy. In reality, when the government directly competes with the private

[3] Market failures are defined as situations where the market provides a less than an optimal level of a certain good or service.

sector, for example by offering lower interest rates, already bankable clients will tend to migrate from commercial banks to DBs. Commercial banks would consider that they face unfair competition from the government and therefore will tend not to invest in offering competitive financing solutions in the market. Over time, the government competition with the private sector can lead to the crowding-out of the commercial banks, create distortions in the market and may not necessarily stimulate new investments in the economy.

There have been a great deal of varied experiences involving DBs worldwide and over the last decade there have been many attempts to measure the impact of these institutions, yet empirical evidence has been inconclusive so far: La Porta et al. (2002) failed to find evidence that the presence of state-owned banks promotes economic growth or financial development, However, Levy et al. (2004), revisited the La Porta study and found that its results were not robust. Korner and Schnable (2010) found a negative impact of high DB market share on growth only in countries with a low degree of financial development and low institutional quality, which tends to be the case in developing countries. Andrianova et al. (2010) actually found that higher state-ownership in the banking sector is associated with faster growth.

The presence of market failures alone is not enough to justify the existence of DBs. Although asymmetric information problems are prevalent in financial markets, justifying the action of the public sector requires the public sector to have an informational advantage over the private sector and that such information cannot be shared. Policy makers are challenged to determine if there are not other types of interventions that could address the market failures directly in a less costly, timelier manner. For example, reforms aimed at improving credit history availability and the ability to pledge collateral could be a more effective public intervention to facilitate access to credit than direct credit provision through DBs. De la Torre and Ize (2010) argued that for this reason information asymmetries do not provide a compelling argument for state intervention. Neither does market failures arising from externalities since budgetary subsidies could be a superior instrument to address these problems. However, some societies see more value in developing a culture of credit and repayment than a culture of subsidy which in turn reflects policy preferences (thus for example student loans are seen by some governments as a preferable

tool than grants to fund education for students without sufficient means). In many cases though, DBs were created to provide subsidies circumventing budgetary restrictions by exploiting their leverage capacity. Clear accounting of any subsidy component is essential to effectively assess the costs of the policy implemented.

In addition, political interference, poor governance, and sometimes outright corruption, has in many cases prompted dismal financial performance and resulted in DBs' insolvency and important quasi-fiscal losses arising from government guarantees of the DBs liabilities (Box 1). In an attempt to implement government priorities, many governments have been tempted to mandate their state financial institutions to finance projects that are on the government agenda, without paying enough attention to the private and social rate of return on these investments, and without an assessment of the impact on the bank capital arising from potential losses as a consequence of these projects.

For all these reasons, the views regarding the role and the need for DBs have evolved in the XX century from a clear case for the need for DBs in the 1950s to the view that DBs created more inefficiencies and distortions to a more eclectic view of market friendly interventions within a general limited role for the institutions and their conversion into development agencies in some cases devoted to promotion rather than funding. In the late 1980s and early 1990s, there was a wave of privatizations and liquidations in many emerging countries, and restrictions were placed on the resources available to DBs reflecting concerns regarding their performance and the justification for their existence given the development of a vibrant private financial sector. Also, DBs were restructured and their governance strengthened to ensure the viability of the institution. Mexico constitutes an example of a country where almost all of the above measures were implemented and is considered a successful example of DB reform.

Box 1. DBs Troubled History: Politically Controlled Credit Decisions and Guaranteed Liabilities

When the government intervenes in the credit allocation decisions of DBs to finance government sponsored projects, the objective of optimal resource allocation disappears, and it transforms into a more obscure mechanism for leveraging the government budget.

An example illustrates this problem. Let's assume that the government with limited borrowing capacity is interested in developing infrastructure. In the absence of interest by the financial sector in financing these projects, the most transparent way of financing the project is through the government budget, which in democratic countries is approved by the Parliament or Congress. Since budget constraints may curtail the government's ability to finance infrastructure projects from the budget, the government may decide to leverage those resources by establishing a DB controlled by the government and with the Minister of Finance serving as chairperson of the board.

The government instead of using the budget to finance infrastructure projects uses budget money to inject seed capital into the newly created DB. Since DBs are allowed to leverage, the establishment of the DB gives the government access to infrastructure finance equal to a multiple of the seed capital subscribed (let's assume three times), where the leverage is financed with the management of the resources of the public sector (equity) plus some access to the interbank market. Subsequently, the DB is authorized to issue government guaranteed debt or to take deposits from the public to increase its lending capacity. Finally, the government then realizes that the projects in the DB's portfolio do not generate enough cash flows. [4] After multiple capital injections the government has to close the DB and to pay off the creditors for an amount equivalent to several times (for example, could be ten or more) the capital.. The privatization of state financial institutions in the past few decades in developing countries is a consequence of poor performance of these institutions, characterized by unsustainable nonperformance loans and continuous process of capitalization to overcome the losses (for specific examples, see Hanson [2002]).

A robust governance framework in line with international standards would have been helpful to stop these losses. For example, merely the appointment of an independent and accountable board of directors could have been enough to avoid investments in projects that did not create enough cash flows. An independent and professional board of directors could have hired a professional CEO and the management for the company, who were capable of analyzing the risks of investing exclusively in these projects, and managing those risks properly to mitigate losses. By managing risks properly, the board of directors can help to build a sustainable portfolio and to take distance from the pure leveraging incentives of the shareholder.

[4] The importance of large banks finds its roots in capitalist and socialist societies. Even Lenin thought that banks were important for building socialsit societies (see La Porta, Lóez de Silanes, and Shleifer).

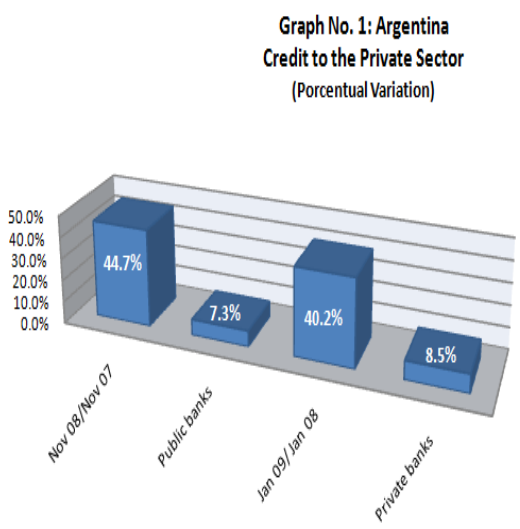
3. DBs and the Economic Cycle

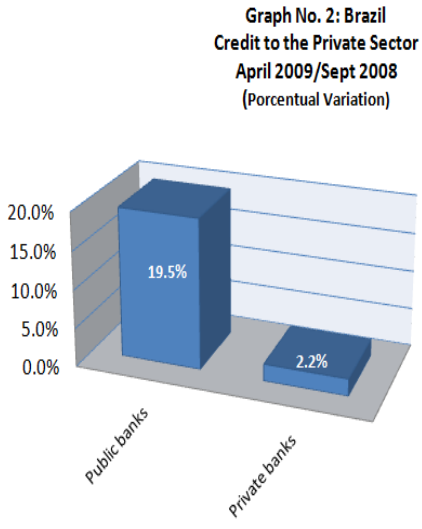
The economic literature points to another source of market failure that justifies direct state intervention in the credit market in a counter-cyclical fashion. For example, Levy et al. (2004) argued that private banks have limited incentives to lend during periods of economic downturns and low interest rates and do not internalize the fact that, by increasing lending, they would push the economy out of recession. Such coordination failure provides justification for DBs - to ensure continued provision of needed credit to the economy in the face of private sector cutbacks. In these circumstances, state intervention could solve a coordination problem and make monetary policy more effective.

The countercyclical role is also justified by the risk-spreading argument proposed by Arrow-Lind which is summarized as follows; as the state is risk-neutral (given its capacity to spread risk both over-time and cross-sectional) while private banks' risk aversion is pro-cyclical (banks are exuberant at the peak of the economic cycle but their risk aversion overshoots at the cycle trough), there is justification for a risk absorption role for the state during economic downturns. De la Torre et al. (2011) argued that this type of market failure provides the best rationale for the operation of DBs.

Following this rationale, in order to mitigate the effects of the global financial crisis and the ensuing credit contradiction, several DBs have substantially expanded their balance sheets. Other factors have entered into play as well. For example, legal constraints on the activities that many Latin American Central Banks can undertake —put in place in many cases in response to high and even hyperinflationary histories and aimed at proving credibility to monetary policy— prevent central banks from intervening directly in financial markets with outright purchases of assets to support monetary policy and financial markets as the for example the US Federal Reserve did. Thus, in many Latin American countries such countercyclical interventions had to be undertaken by DBs. In response to the global financial crisis, the public DB members of the

Latin-American Financial Development Institutions Association (ALIDE) for example increased their total assets by 30 percent.[5]





Industrialized countries with specialized DBs considered that such institutions were best placed to help channel credit to key economic sectors. Canadian authorities increased the capital of their DBs to stimulate the economy allowing them to provide loans and other forms of support to credit worthy businesses whose access to financing would otherwise have been restricted. This involved granting additional loans, participation in syndicates and pari pasu loans with commercial banks and purchase of securitization issues (term asset-backed securities such as leases on vehicles and equipment) to increase credit and liquidity in the market. Overall, the government provided resources that allowed DBs to inject US$18 billion dollars in additional credit into the market (about 2 percent of GDP in 2009).

Reconciling the longer-term development role of DBs arising from asymmetric information and externalities with the short-term countercyclical role arising from risk-overshooting or coordination failures is a challenging task, particularly as the private financial system develops.

[5] See ALIDE, November 2009. ALIDE members include private and mixed capital institutions as well as public institutions. The latter constitute the majority, accounting for 70 percent of the members as well as 70 percent of total member assets. As of the beginning of 2009, total assets of the ALIDE public-owned institutions represented 26.5 percent of total assets of Latin America's banking system.

The first role, one of filling a structural market gap, calls for small DBs focused on target sectors, while the second calls for institutions with enough capacity to inject liquidity to mitigate a credit crunch in the economy rapidly.

To comply with both objectives, the capital of the institutions must adjust through the cycle to support a substantial expansion and subsequent contraction of the balance sheet. While several governments around the world have approved capital increases in DBs during the crisis to support their activity, it is often without provisions as to how that capital will be used as the situation normalizes. There is a risk that DBs continue to operate at the same level by using the newly acquired capital to venture in new sectors in competition with the private sector and becoming ever growing institutions. Since markets are dynamic, the DBs' focus and relevance following a shock could be altered. Consideration, therefore, needs to be given to prescribing the means for evaluating the impact of the capital injection and for reviewing the ongoing capital after the crisis has abated. For example, when approving the capital increase, a clause could be introduced indicating that the capital should be repaid within a certain period of time related to the repayment of the loans granted during times of financial distortions, as identified by the board of the institution and reviewed by a panel of independent experts. In countries with well developed capital markets some form of callable capital instrument with a conversion linked to overall credit growth may be a suitable instrument to expand and contract the balance sheet of DBs.

While the long-term developmental use of DBs no longer justifies the presence of a DB once the market failure that provided a rationale for its existence has been addressed, the countercyclical role of DBs requires some limited activity of the institution in the market on a continuous basis. When increased risk-aversion in the private sector is at the core of the problem, DBs need to stand ready to absorb risks either through direct lending, the provision of credit guarantees, or through buying loans and securitized products. To stand ready to increase its activities, the DBs must have already familiarized themselves with the market in which they operate and have experienced professional staff. This argument needs to be understood in a narrow sense, probably for specific sectors of the economy, such as the SMEs, which are sensitive to the

economic cycle. The Conference Board of Canada studied the role of the DBs in the crisis and it concluded:

> *Once a financial crisis hits, it is too late for governments to create institutional capacity to provide fall-back credit support. The institutions must already exist, with a clear operating mandate, experienced professional staff, and the financial capacity to respond to the financial needs and ramp-up their operations when the private market fails*[6].

The Conference Board of Canada appropriately calls this "The Sleeping Beauty." The need to have a well managed DB operating throughout the economic cycle would be in this way analogous to a country maintaining a standing army in peace time; it will be too late to conscript an army when the country is under invasion.

The experience of the global financial crisis has not only renewed the interest in public multilateral financial institutions such as the IMF and the World Bank –whose existence was questioned due the development of global capital markets— but also the interest in DBs in many countries. The previous consensus on the need to limit DBs' leverage capacity to avoid distortions is being revisited. Fiscally sound governments found that DBs' ability to borrow in a context of risk-aversion and flight to safe assets —due to explicit or implicit government guarantees on DBs' liabilities— allowed them to recycle liquidity and absorb systemic risk.

The propagation of financial disturbances through foreign bank ownership has also renewed the interest in public banks. In El Salvador, where the financial system is dominated by foreign banks, the credit crunch experienced following the global financial disturbances in late 2008 was largely prompted by strategic decisions taken at the parent level for the group as a whole. In such environment, the government is reviewing the relative importance of DBs in the overall financial sector.

[6] Conference Board of Canada (2010)

As the recent global financial crisis is associated with excessive leverage, loose credit standards and corporate governance failures in private commercial banks, the political wave is also turning in some countries for a bigger role of the state in the financial sector, and especially at times of distress. However, DBs have had a very troubled history and successful DB histories do not abound. It is essential that authorities, if they decide to maintain or create new DBs for countercyclical reasons put in place mechanisms to ensure their effective functioning and avoid past problems. The sections that follow will present some of the best practices contributing to the existence of successful DBs.

4. Focusing the Operations of DBs through Clear Mandates

In light of all the factors discussed above, it is essential to ensure the successful operation of DBs that (i) a market failure that can be mitigated through public intervention has been properly identified and that a DB is the most effective policy instrument to deal with such failure; (ii) the operation of the DB is not going to cause significant market distortions; and (iii) a robust governance structure for the DB is put in place to ensure its financial sustainability. A clear mandate including a target sector, positioning (vis-à-vis the private sector and other DBs), and financial sustainability objectives help to focus the activity of the DBs and avoid the common tendency of engaging DBs in businesses that are more properly the province of the private sector. Clear mandates also enhance the accountability of the board of directors and management and facilitate monitoring the performance of the institution. Mandates should be preferably stated in the law that creates the institution to underline the importance of remaining focused on the DB's policy objectives. Although each country faces its own reality, this section will address the key elements and some best practices involving the setting of the mandate.

Target Sector

When establishing a DB's mandate, the first dimension that the government will address in a market based economy is the failure of the market that it is addressing. The concept of "gap-filling" should be central to the spirit of all DB mandates. Mandates should aim at completing markets, and providing financial services to sectors that have been permanently or cyclically

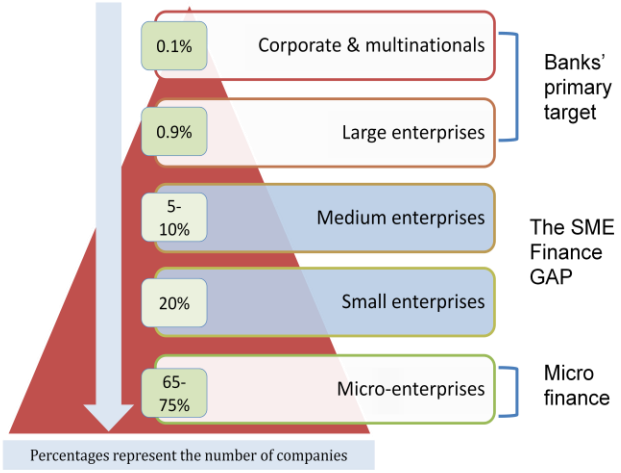
neglected by privately owned financial institutions. A mandate that places the focus on "gap-filling" provides a rationale for DBs' operations in a countercyclical fashion.

In 2009, the Business Development Bank of Canada (BDC) undertook an international benchmarking study. It looked at some 373 development institutions including DBs, Export Credit Agencies, Development Finance institutions, and government programs from 92 countries and 7 economic regions around the world. The study highlighted all the products and services offered and analyzed the data to draw certain conclusions. The study found that the six most common target markets for DBs are: (i) micro-enterprises/start-ups; (ii) small and medium sized enterprises (SMEs); (iii) international trade/globalization; (iv) housing, (v) infrastructure and (vi) rural/agricultural sector.

By far, the most common target market for DBs around the world is the SME market as about 60 percent of the DBs studied target SMEs. By definition, an SME usually means less than 250 employees and typically more than 5 (less than 5 employees would be classified as a micro enterprise). Worldwide, Micro Small and Medium Enterprises represent 95 percent of all firms and are therefore an important source of employment and a key driver of economic growth in a country.[7] However, the market fails to address this all important economic driver adequately. In particular, SME banking requirements are too large for micro-finance solutions and too small to be serviced by corporate banking models because they are considered too risky or too costly to service. This lack of available financing for SMEs has been called the "missing middle."

[7] The SME Banking Knowledge Guide, *IFC*, 2009

Graph 3. The SME Finance Gap



Source: SME Banking Knowledge Guide, *IFC*, 2009

The second most significant target market is international trade. Approximately 45 percent of all DBs consider trade as a target market. Naturally, trade is a key driver for economic development and is a priority for most governments. Even though the majority of exporters tend to be larger enterprises, access to trade financing can still be hampered by the risks associated with the complexity of international trade. Furthermore, trade is not limited to large enterprises, and many SMEs must be able to respond quickly and efficiently to international market signals to take advantage of trade and investment opportunities, so many DBs target both the SME and trade markets together and build their offering around them. Other target markets that DBs typically address include home mortgage financing for low income segment of the economy; availability of large sums of long-term financing for infrastructure projects; banking services in remote areas that are too expensive to service; agriculture financing due to risks associated with crop yields.

DBs can be specialized institutions covering a sole target sector or cover multiple target sectors. The first model, in which the DB targets just one market, has the advantage of having specialized staff in close contact with the sector, and the idea of carving a niche and becoming the expert in

tightly-defined areas is gaining acceptance as the principal guiding vision in development banking. However, the niche needs to able to support the financial sustainability of the bank[8].

The countercyclical role of DBs does not need to be explicitly defined in the mandate. To perform a significant countercyclical role, DBs do not need to expand their target sectors during times of financial distress. Given the size and importance of the target sectors of most DBs, increasing activities in the sector operating with firms or individuals who were previously serviced by commercial banks could help mitigate an economy wide credit crunch. However, governance mechanisms should address when activate and deactivate such role (see section 6). DBs should not expect to dramatically change the target sector as a consequence of a financial crisis. Target sectors tend to be sufficiently broad (SMEs, housing, export-import) so that increase lending activity from the DB could mitigate credit crunches and help support economic activity. Although it is reasonable to expect that a DB specialized in SMEs may serve slightly larger companies during a recessive process, the same DB should not be expected to support developments in the infrastructure or agricultural sectors.

Mandate Review

To hold the DB accountable to its mission, the mandate should make provisions for reviewing the DB's long-term performance. The recommendation is to issue a clear mandate that gives the DB the focus that it needs to succeed with clear objectives and a specific time frame in which to implement and achieve its mission. By knowing that the mandate has a finite term, DBs will be held accountable for staying on mission and for achieving their long-term mission objectives more rigorously. It will be up to the government to decide an appropriate term, but sufficient time must be allotted to allow for implementation and to see results of the DB's efforts under the mandate. At the end of the term, there should be a review of the DB to ensure that the desired outcomes were achieved and that the mandate is still appropriate and relevant to the current and anticipated environment. The government can consult with various third party stakeholders or

[8] For example, as the economy develops the importance of the rural sector declines and while some market failures regarding access to credit may persist, the size of the sector may not justify the existence of a specialized DB. A development agency that distributes targeted subsidies could be a more effective tool than a DB in such a scenario.

external consultants at that time to incorporate their opinions on the past performance of the DB in fulfilling its mandate and on the future role it will play when the mandate is renewed. This promotes transparency and makes the DB accountable not only to the government but also the banks and business community at large with which it needs to collaborate.

This sound practice is applied by several banks, including Canada's BDC and the Development Bank of Southern Africa. Mandate reviews should be led by the shareholder representative and supported by outside expertise. As the economy and financial markets continue to develop, the specialized DBs in the country could merge into a single institution and some of them may be privatized as well. The history of the Spanish DB sector provides an example of such evolution. In Spain, the public financial sector was privatized and a small second tier development bank was created. (See Box 2.)

Box 2. History of DBs in Spain

In Spain, public banks played a key role in economic development prior to Spain's full membership in the European Economic Community in the mid 1980's. There were five large public banks specialised in different sectors; agriculture, industry, housing, local governments and international trade. The Public Credit Institute (Instituto de Crédito Oficial, ICO) was responsible for coordinating and controlling public banks. In 1988, ICO was converted into a stated-owned enterprise that held all the public bank shares.

The development of the private financial system and the maturation of the corporate economic environment called into question the coexistence of public banks with the private system. After re-evaluating the prevalence of the conditions that justified their creation, existing public banks were merged into a banking corporation, Argentaria, set in 1991 to improve public banks' efficiency ahead of privatization. All public sector shares in Argentaria were sold in four public offerings during 1993-1998. Argentaria merged with BBV bank in 1999, creating BBVA.

ICO became a credit institution, the only remaining public credit institution in Spain, with its own legal status, equity and cash assets. It focuses on priority sectors on account of social, cultural, innovative or environmental reasons. It works alongside other financial institutions, meeting the financial needs which the private system does not cover, or does so only in part. ICO is self-governing in the achievement of its end and carries out its activity in accordance with the principle of financial equilibrium. Recently, ICO has increased its capital and expanded its activities on a countercyclical fashion to facilitate continued access to finance for SMEs.

Positioning

The clear mandate should address the issue of positioning of the DB against private sector institutions. To ensure maximum impact from DB operations and minimize possible distortions, the ideal positioning of a DB is to act complementarily with respect to private banks. Such positioning is consistent with the "gap filling" concept.

In addition to being complementary to the private sector, DBs need to avoid getting into activities more properly the province of government agencies. The capital of DBs should not be a vehicle to transfer government subsidies nor a tool to subsidize government policies. If the DB receives donations from the budget or from donors, any subsidy component in the price of the services provided should be clearly accounted for. Industry promotion activities are at times placed under the responsibility of the DB elevating its operational costs; for example, export-import banks at times function as well as export promotion agencies which require having offices in a number of countries which increases personnel and administrative costs. The responsibilities placed in this case by the government on the DB would create incentives for management to venture into new segments and products, possibly in competition with the private sector, to cover its higher costs.

It is common for a government to have several DBs or agencies operating in the economy designed to address various market failures in different segments. For example, in the case of Mexico, seven DBs that cover a wide range of the economy exist. There is a danger that if there is not strong coordination and clear mandate setting, two or more DBs may overlap leading to government inefficiency. For example, SME banks and DBs focused on international trade usually have overlapping clients since the same target company can be both an SME and an exporter. While the instruments and risks associated with the operations of both DBs are different, some countries combine the two into one institution so that there is one point of contact for the client.

Financial Sustainability

In addition to addressing a market failure, the mandate should establish that the DB shall be financially sustainable over time. The objective is not to maximize profit, since this is the objective that creates the market failure in the first place, but rather to generate enough resources to accomplish their mandate. This way the institution can achieve its policy objectives without being a financial burden on the state. By combining the two objectives in the mandate, there is a clear expression that the institution is expected to add economic value.

By embedding financial sustainability in the mandate, incentives are created for the board of directors and the management of the institution to make proper use of the available resources and manage risks adequately. However, requiring an excessive rate of return may prompt the DB to enter in competition with the private sector or to focus on tail risks that deliver high profits in the short term but could prove unsustainable in the long-run. In the case of Mexico's NAFINSA, the bank is required to preserve its capital. This requirement is interpreted by the board as targeting an average zero real rate of return during a 5 year period to preserve the capital adjusted for inflation. In other cases, the mandate refers to a specific rate of return. For example, BDC must maintain a minimum rate of return on equity equal to the government's long-term cost of funding.

Financial sustainability requirements do not preclude DBs from acting counter-cyclically to mitigate credit crunch. By lending to viable firms that have seen their access to credit curtailed due to increased private sector risk aversion DBs could actually make substantial profits as the economy recovers. What such requirements prevent is acting as a lender of last resort for unviable firms to avoid closing and lay-offs. This not only creates significant financial risk for the national treasury but also may distort the business landscape by propping-up inefficient or poorly managed companies. However, to ensure financial sustainability while acting in a countercyclical way is essential that DBs have in place proper risk management systems. To support additional activity without compromising financial sustainability, shareholders should be prepared to increase the capital of the institution.

5. Instruments That Support the Achievement of the Mandate

Once the mandate lays the foundation regarding the complementary role to the private system to be played by DBs and the need to ensure their financial sustainability, the selection of instruments for addressing the market failures should depend on the market conditions. For example, if the market failure relates to overshooting in private sector risk aversion, the DB may need to absorb part of the credit risk through the direct provision of credit or through the provision of guarantees on the loans provided by the commercial banks, among other options. The mandate should be clear and specific, but should allow for flexibility for the DB to tailor its financial products to the market needs. However, the structure of the financial system and the degree of institutional development of the country should be taken into account when deciding on the range of activities permissible to the DB.

DBs granting loans to customers directly (first-tier DB), can operate through private financial institutions to which they grant loans or guarantees (second-tier DB) or do both (mixed-institutions). When operating as first-tier DBs, the scope to compete with the private sector instead of complementing it increases considerably. Nevertheless, a DB can still act complementarily in a first-tier structure by operating in segments not covered by the private sector. In this case, the DB should only offer financing or services that the commercial bank does not adequately offer such as loans to fund innovation or investment in intangible assets. By doing so, DBs complement commercial banks and act as a catalyst for new investment. DBs can also offer similar services typically offered by banks but are still differentiated by the level of risk taken (such as longer maturities, lower security levels, more flexible repayment terms) or specializing in riskier SMEs with weaker financings as for example does the BDC (see below).

To achieve proper positioning, the first-tier DB needs to operate in segments that are outside commercial banks' risk appetite but that are still viable. For a DB not to take enough risk is as bad as it taking too much risk. However, acting complementarily to the private sector when the bank operates in a first-tier structure requires highly specialized risk management. Governments

often believe that the role of the DB is to finance riskier projects and offer low interest rate financing. But then policy makers need to accept that a high risk - low rate of return model will not be financially sustainable over the long run. If the government wants the DB to address market gaps and thereby take more risk, but it does not want to be continually called upon to bear the cost or subsidize the operations of the DB, the DB must be careful not to under price risk. For first tier DBs, to be able to maintain this delicate balance, they must be professionally managed with strong credit underwriting skills and operate efficiently as commercial enterprises at the risk frontier of the commercial banks. In the case of the BDC, as the bank operates with riskier SMEs that do not have access to private sources, its loan rates are higher than those charged by private commercial banks.

In addition to effective risk-pricing, the provision of technical assistance to borrowers can help managing risks by reducing project risks. For example, the BDC offers in addition to loans, technical assistance to borrowers in the form of management consulting to help strengthen the capacity of its entrepreneurs. As a result, BDC clients who received financing and consulting achieved 60 percent higher revenue growth, employment growth and survival rates than non-BDC clients.[9]

Another way in which a first-tier DB can complement and increase private sector participation in the target market is by participating in syndicated loans or club-deals. In some cases, given exposure limits, domestic funds simply do not have the capacity to fund large projects, and the participation of a DB can solve that constraint. Also, private participants may view the participation of the government in the financing may reduce the project political risks. Thus, DBs become partners of the private system to finance priority sectors (such environmental, or infrastructure) through the use of co-financing instruments where risk is studied and shared jointly. Prohibiting DBs from financing more than certain percentage of a project (and in no case more than 50 percent) ensures that the public sector will not compete with the private sector and that the projects undertaken withstand the sustainability test applied by the private sector.

[9] Full study is available at: www.bdc.ca/smeresearch.

Acting as a second-tier institution presents several advantages. A second-tier structure forces the DB to operate through the private commercial banking sector limiting scope for competition and ensuring it acts complementarily. Moreover, it is a far more efficient structure as it allows the public sector to channel higher volume of resources at lower costs since second-tier institutions use the commercialization network of the private sector. In Latin America for example, at the beginning of 2009, there were 66 first-tier development institutions within the Latin-American Financial Development Institutions Association (ALIDE), 23 second-tier institutions and 12 mixed institutions. On average, second tier institutions intermediated almost twice as many resources as first-tier ones (US$ 10, 334 million versus US$ 5,702 million). Risk-management capabilities at second-tier institutions need not be as sophisticated as in first-tier institutions. Tier-II institutions need only to analyze the risk and risk management skills of the lending institution through which they operate. As private institutions are assessing the risk of the project, the scope for political interference to finance unsustainable projects is also limited.

As in the case of first-tier banks, which have to venture constantly into riskier but viable segments and offer new services to comply with their mandate effectively, second-tier institutions need to innovate as well, as the financial system through with they operate evolves. Financial globalization diminishes the need for the most traditional second-tier product, the long-term funding line. These lines aimed at addressing the shortage of affordable long-term funding by transferring the lower rates of long-term funding that the sovereign has access to in many developing countries. However, foreign private commercial banks operating in a developing country through subsidiaries or branches now account for a significant part of domestic credit to the private sector. Many of these banks are part of large cross-border financial conglomerates and have access to long-term funding at lower rates than the local DB bank as the rating of the parent is better than that of the DB. Funding from DBs would still be attractive for small domestic lending institutions such as credit cooperatives, savings and loans, finance companies and microfinance institutions. As the system becomes more globalized, DBs would need to operate increasingly through these institutions. This requires more careful assessment of the counterparty credit risk as many of these institutions may not be regulated and supervised.

Second-tier DBs are also increasingly providing credit guarantees for target sectors, or managing such programs on behalf of the government. Credit guarantees partially cover the losses incurred by the private commercial bank in case of default of the borrower. The DB typically manages a fund set up for this purpose using its own resources. Guarantees can be applied on a credit by credit basis or to a loan portfolio under a predefined criterion. In the portfolio approach, the guarantor does not perform an individual credit appraisal, relying on the credit analysis performed by the financial institution that grants the loan. This speeds up the entire credit process and facilitates scaling up the program coverage. Pricing the guarantee though should be similar in structure to the pricing of a loan by a first-tier bank and requires taking into account expected losses (which could be based on accumulated experience), operational expenses, and funding costs or opportunity cost of investing resources employed to provide the guarantee.

To enhance the effectiveness of guarantee schemes, the design of the programs should be specific to the market failure that the program aims to address. For instance, if market failure is related to access to the financial market due to special transitory economic circumstances (i.e. downturn of the economic cycle), the programs should have broad qualifying criteria and a sunset clause with an irrevocable date for the end of the program. Programs aimed at fostering first time access to bank credit could include a clause with a progressive decline in coverage or limit the number of years the borrower can receive the guarantee as the individual builds a credit history that can replace the guarantee. To stimulate banks to launch SME specific new products, a portfolio approach in which the bank takes the first loss of the portfolio (e.g. up to 4-5 percent delinquency ratio) and the guarantee fund any additional loss, protects the bank from the tail risk when there is uncertainty about expected losses.

There are interesting experiences in second-tier DB instrument innovations related to the provision of public goods such as financial infrastructures. For example, Nacional Financiera Mexicana (NAFIN) is widely recognized for its successful web-based reverse factoring program that accounts for over 75 percent of its second-tier business. The scheme, which is called *Cadenas Productivas* (productive chains), provides users with an electronic platform to carry out transactions. The program's idea is to build up links between buyer firms and their suppliers and draw the attention of potential lenders to providing funds at attractive costs. Once a chain

supplier sells its product to a buyer, the invoice is placed in the electronic platform and it is opened for bids by the factors. There is a cap regarding the interest to be applied in the transaction and there are no additional fees charged by participants in the scheme. The system helps to ameliorate information problems and the use of an electronic platform reduces transaction costs capturing economies of scale and increasing the speed of transactions. NAFIN is reportedly considering privatizing the electronic platform in the medium-term.

Another interesting example of the use of new-technology by a second-tier DB is the virtual office developed by the ICO. Through its "financial facilitator ", SMEs who have seen their credit applications rejected by private commercial banks can apply for a credit revision to ICO through the internet. If a credit scoring model finds the SME credit worthy, then the documentation is sent to a credit analyst for review. If the analyst finds the project interesting, it will submit it to a private lending institution (other than the one which had rejected the loan) with the results of the analysis for their consideration. If the project is considered too risky, it will counsel the entrepreneur on the need to increase capital or post additional collateral before submitting the credit file to an institution.

ICO has recently started to assume in its balance sheet the credit risk analyzed through the facilitator and has signed agreements with private commercial banks to service the customer needs through their network. As commercializing the ICO loans puts the commercial banks in contact with new potential customers for their own products, private banks have been willing to do this without charging fees either to ICO or the borrowers. Use of the commercial banks network allows ICO to scale up its program while maintaining an extremely lean structure with only one office in Madrid. As the interaction with the client is through a private commercial bank, also in charge of loan collection, the risk that the loan is mistaken with a public sector subsidy, affecting in turn the borrower repayment is mitigated. An essential feature of this program is its finite term. This program will be effective until December 2011. The Council of Ministers needs to approve any extension deemed necessary.

The provision of infrastructure is a promising area for both first-tier and second-tier institutions. For example, in several countries commercial banks indicate they lack the platform and credit

risk capabilities to operate effectively with small and medium-enterprises for which neither balance sheet analysis applied to large corporate or credit scoring models used for consumer and credit card loans are entirely appropriate. A first-tier DB operating successfully in this market could make available its technology to private commercial institutions through partnerships to fulfill its mandate of mitigating market failure effectively.

6. **Governance**

As previously discussed, government interference has been one of the main causes of problems in DBs. Good governance plays an important role in avoiding government interference in credit decisions, as it creates a clear differentiation between the rights and responsibilities of the different stakeholders of DBs, including the shareholders, the board of directors and the management. While good governance is essential for the effective functioning of a DB in all its dimensions, we will focus the discussion on the corporate governance aspects that can limit government interference[10].

In order to achieve efficiency, DBs need to be organized as corporations, with shareholders, board of directors and management. The rights and responsibilities of each of these groups need to be clearly stated. The DB needs to have a clear legal form. In countries with a civil code, DBs are created by a special law. Either the special law or another general law must provide for the appointment of a board of directors and separate and distinct management with well defined roles and responsibilities. The law needs to specify a supervisory and regulatory function that is independent of the shareholders, directors and management.

Private sector participation in the ownership of the DB can provide an additional layer of assurance about implementation of good corporate governance practices, but at some cost. However, the process for selecting the private sector partner requires serious consideration, and priority must be given to "Smart money" investors that can add value to the firm and share its objectives. Private sector participation in the ownership of the DB should be seen as a mechanism of technology transfer and increasing corporate governance standards, rather than

[10] For a comprehensive discussion of governance of state financial institutions see Scott (2007).

simply a mechanism for increasing capital.[11] The downside of including private capital is the greater emphasis of these companies on maximizing profits rather than fulfilling policy objectives. These risks might be mitigated by a clear mandate of the DB with the expected returns of the DB, and a shareholders' agreement that may clarify the objectives of the private partners. In addition, at the risk of moving the DB more in the commercial direction, listing of the DB at a stock exchange may help to increase transparency and enforce good governance practices inside the institutions.[12]

However, private ownership should not be considered as a substitute for putting in place high corporate governance standards. For example, private sector participation would add value as long as the regulatory framework promotes protection for minority shareholders' rights, otherwise minority shareholders can be abused, and their opinions not considered. Shareholders' agreements may also help to give private sector shareholders more responsibility in certain areas of the business. For example, the shareholder agreement may establish that the private sector counterpart should play a prominent role at the audit committee and in the standards of disclosure of the DB.

The Shareholder Representative

Of prime importance is the need for the shareholder to be identifiable. Since a government has multiple ministries, agencies, and senior officials, governments need to designate a shareholder representative. When shareholders are not properly identified, any minister or senior official of the government may feel the right to call the DB to request support for a specific program. The shareholder representative needs to be identifiable as a person or an institution, for example the President of the country through the Minister of Finance, the Minister of Economy, or a Committee formed by the Minister of Finance and the Minister of Trade. The relationship

[11] Selling 20 percent of the shares of the SFI to specialized private equity fund is not the same as selling to a thousand peasants. While the first one has the potential to play an active role in improving the management practices and adding value to the SFI, the second group is unlikely to organize themselves and to bring value to the SFI management.

[12] This could be useful when governments are unable to enforce high levels of transparency and good governance practices.

between the government and the DB should be exclusively through the shareholders assembly and communications made directly between the shareholder representative and the Chairperson of the Board of the DB.

The statutes governing the DBs are an effective mechanism for communicating the shareholders' expectations to the board of directors. The board statutes should specify financial and non-financial objectives and targets; the Board's mission/mandate, including its overall responsibilities and duties including recordkeeping and reporting requirements. The shareholder representative may want to fine tune the objectives and the expectations placed on the board of directors, through annual letters sent from the shareholder representative to the Chairperson of the board. These annual letters concern specific objectives which help to avoid sudden changes in the mandates, and make the shareholder accountable for the overall definition of objectives.

The shareholder representative should be empowered to appoint the members of the board of directors. The shareholder should aim to define the technical qualifications of each of the board members and these should be made explicit each time a vacancy on the board is being filled. To the extent possible, the shareholder should avoid nominating government officials as board members. Government officials are typically seen as having a disproportionate influence in board discussions since they are perceived as synonymous with the shareholder. Senior government officials may be motivated to please the shareholder rather than act in the best interests of the DB (*stewardship*). For example, in the cases where the Minister of Finance is member of the board and also the representative shareholder, his/her opinions may be considered more important than the opinions of the rest of the members, mainly because in most of the cases is up to him/her to renew their appointment. In addition, the presence of the Minister of Finance at the board may confuse his/her opinion with instructions from the shareholder. Also, the presence of senior government officials (i.e. Minister of Finance) as a member of the board creates issues in countries with both developed and underdeveloped legal and judicial systems. In the former, it exposes the Minister to having to make decisions that may be contrary to the objectives of the government; and in the latter, the immunity that is perceived by the presence of the Minister is extended to the rest of the board members.

The fact that governments are accountable for the actions taken by the DBs does not imply that they need to micromanage the companies. Through the representative shareholder, the government signals the board of directors the expectations on each of the DBs. The government is free to change the board when these expectations are not fulfilled.

Board members should be selected by the shareholder according to their competence and experience. Although the decision should be taken by the shareholder, the input provided by the board of directors (or a specialized board committee) and communicated through the Chairperson of the board to the shareholder representative can be very useful when reviewing prospective board candidates. Board members are expected to have complementary expertise that can be formally developed in a board skills profile that will help in decision making and in building value added for the DB by establishing clear board member selection criteria. For example, a DB that specializes in the business of SME lending would be interested in having some experts in finance, in innovation, in technology, and entrepreneurship. The search for prospective candidates by professional firms (headhunters) is a good practice that can be encouraged, although it is not essential.

While it is reasonable for the shareholder to use the DB to support government programs, for example in the areas of infrastructure, housing, or SMEs, it is not reasonable for the government to request the DB to provide financial services to a specific investment project sponsored by the government. Specific projects should be technically evaluated by the DB and approved by either by the management or the board of directors, according to the bylaws of the DB.

Undue pressure to finance specific projects sponsored by the government should be discouraged. Canada's BDC and Chile's BancoEstado have interesting mechanisms to discourage political intervention in the credit decisions.[13] In the case of BDC, the Referral Policy states that whenever a Member of Parliament, Senator, or fellow board member exerts undue pressure on a BDC employee, the board of directors is notified. The person who made the referral is notified in writing that client confidentiality supersedes all third party involvement, and that BDC retains

[13] See Rudolph (2009)

sole authority for its decisions. In the case of BancoEstado, its law bans the possibility of lending money to public institutions. In addition, the members of the supervisory board, which are typically politically appointed, are not allowed to participate in credit decisions.

The shareholder representative should also obtain information from the DB that can be useful for evaluating the performance of the board of directors. In profit maximizing companies, the shareholders obtain the information from the financial statements of the company and public releases by the management or the board of directors. However, in the case of DBs which are not profit maximizing, more qualitative information might be needed, which can be reported on a more periodical basis. The shareholder representative needs to specify the information needed and its periodicity. For example, BDC develops an annual corporate plan with specific quantitative and qualitative objectives that are presented in a *balanced score card.* The bank's performance is evaluated annually against the scorecard. The appointment of the external auditor to the DB needs to be approved by the representative shareholder.

The shareholder representative can also play an important role in coordinating the activities of different DBs and the interactions of DBs with government agencies. Management of the holding company is the main function of the representative shareholder. Governments typically provide a number of subsidies and incentives that can be used by some DBs, and it is not rare to find duplication of effort among different government agencies. The shareholder representative can play an important role in coordinating the efforts and using the feedback provided by the DBs to increase the efficiency of the government programs. For example, Finland's Ministry of Employment and Economy has one department exclusively dedicated to the proper coordination of agencies and programs that support economic development and to enhancing the potential role of DBs through the use of public instruments.

Regarding the countercyclical role of the DB, the shareholder representative plays an important role in communicating the change in government priorities to the DB, and also the areas that the government is interested in supporting. In order to avoid compromising the financial stability of the DB, the shareholder representative should be willing to support these additional risks with capital. In order to respect the governance structure, the representative shareholder should avoid

making requests to support specific companies as previously discussed. Nevertheless, in extreme cases in that they do so due for strategic reasons, the government should be prepared to increase capital equivalent to no less than 100 percent of the lending.

The Board of Directors

Board members should be appointed for a fixed term, and terms of individual members should be staggered. Although their opinions might be contrary to the views of the shareholder, within the framework of its mandate, board members should act in the best interests of the DB. Fixed terms of not less than three years allow board members to vote at board meetings independent of the views of the shareholder. This situation contrasts with that where board members can be removed at any time by the shareholder. In such a case, directors have the incentive to align their views with the views of the shareholder. Staggered contracts allow t institutional memory within the board to be maintained, and give continuity to the DB.

Board members should have the same responsibilities and liabilities as directors of corporations under company law, mainly the obligation to act in the best interests of the DB. Since board members have to protect the financial sustainability of the institution, the best interests of the DB may not be congruent with the objectives of the shareholder. For example, while the shareholder may be interested in providing low cost house financing for low income people in a particular region of the country, board members may perceive that the risk of such operations goes beyond the risk tolerance of the DB, and may decide not to operate in that segment of the market. Board members have to ensure the DB has the resources to expand their operations when needed for countercyclical reasons and should be prepared to make proper capital calls that might be needed in times of stress.

The board should approve, shape and ratify the strategy of the DB. While the policy objectives are defined by the shareholder, the board should be able to transform these objectives into a strategic plan for the DB. In this context, the board of directors should be able to design and establish performance indicators and benchmarks to ensure the accomplishment of policy objectives and financial soundness of the DB.

The board should have the authority to appoint and dismiss the CEO and the Head of Internal Audit. The CEO of the company needs to be appointed by the Board of directors and not by the shareholder representative. When the CEO is appointed by the shareholder, the CEO does not feel accountable to the board of directors, and it dilutes the responsibility of the board of directors. In addition, it makes it harder for the board of directors to enforce and become accountable for their decisions. Breaking the linkage between the management and the shareholder is essential for reducing government interference in credit allocation. Any agreements between the board and the shareholder representatives related to the appointment or dismissal of the CEO need to be disclosed publicly. The performance of the CEO needs to be appraised, at least annually.

Management contracts may help to increase the efficiency of the DB, but its success depends on a proper definition of the mandate and the government's willingness to maintain independence of managerial decisions.[14] Management contracts are a mechanism for bringing managerial expertise to the DB on a contractual basis. In theory, managerial contracts can be useful to avoid government interference in the management decisions. Although it was not possible to find a textbook case study in a DB, the theory and experience suggests that these contracts can succeed as long as the mandate of the DB is properly defined, and the government is committed to avoiding interference. As some governments may have vested interests in the DBs and may want to use the institution as an extension of expansive fiscal policies, management contracts may end up being unsuccessful. To make sure the contractor follows the government's objectives, the mandate would also need to specify the objectives for the contractor and evaluation mechanisms.

The monitoring of the internal and external auditing functions should be conducted by an audit committee, which is a board committee. The Chairperson of the Audit Committee should not be the Chairperson of the board, and the Board of the Audit Committee should be composed only of non executive members. The Audit Committee should approve the scope of the internal audit plan, including the frequency of the audit activities and ensure that the management takes the appropriate action on the recommendations of the auditors.

[14] Management contracts outsource managerial functions to a separate company for a fee.

The levels of transparency and disclosure should be comparable with those of public listed companies. Timely financial statements and annual reports are essential for making DBs accountable to the Parliament and the public in general for their actions. Conflicts of interest of the board members and senior management need to be publicly disclosed, including transactions with related parties

Whether a bank is public or private, it should be regulated and supervised as a bank. The regulatory framework should provide for a level playing field between DBs and the rest of financial institutions that perform the same or similar functions. By treating DBs as banks, a number of problems are avoided, including predatory pricing and crowding out the commercial banks; such treatment promotes a fair relationship between the DBs and the commercial banks. The influence of the supervisory agency will depend on the degree of independence of the supervisor as well as the independence of the Chairperson of the board.[15] A DB subject to bank regulation is more likely to develop proper systems of risk management that may end up increasing its efficiency.

7. Summary

The purpose of this paper is to highlight some of the lessons learned following the financial crisis and to present some of the best practices in development banking so that policy makers can be better informed should they be considering how to build strong state financial institutions to address current and future needs in their respective countries, and the countercyclical role that DBs can play during the economic cycle.

The global financial crisis prompted DBs in several countries to take an active role in the face of financial market distortions and the credit crunch. However, reconciling the longer-term development role of DBs with the short-term countercyclical role is a challenging task. The first role calls for small DBs focused on addressing market gaps in target sectors and whose mandate is periodically reviewed to ensure that they always remain on mission, or their presence in the

[15] In cases where both the head of the supervisory agency and the Chairperson of the board are politically appointed, the value added of supervision is likely to be low.

market is no longer justified. The second role calls for institutions to have enough capacity to inject liquidity in systemically important markets and to mitigate the credit crunch in the economy. To ensure institutions are ready to act, they should have a constant, albeit modest, presence in the market to ensure knowledge of the sectors in which intervene. Some have called this latent state of readiness "The Sleeping Beauty" strategy. To comply with both roles, the capital of the institution should be adjusted through the cycle to support a substantial expansion and subsequent contraction of the balance sheet.

While successful public bank stories do not abound, some institutions have proved effective in achieving their objectives while preserving their financial position. The effectiveness of their support has been identified to depend on a range of factors, including a well-defined and sustainable mandate, use of innovative instruments to adapt to evolving circumstances and the adoption of best practices in corporate governance. A clear mandate including a target sector, positioning (vis-à-vis the private sector and other DBs), and financial sustainability objectives help to focus the activity of the DBs and avoid the common tendency of engaging DBs in business that are proper of the private sector ("mission creep"). The concept of "gap-filling" should be central to the spirit of all DB mandates. Clear mandates also enhance the accountability of board of directors and management and facilitate monitoring the performance of the institution.

Market failures can be addressed by providing loans directly or through the provision of credit lines and guarantees to private sector institutions. However, when providing loans directly, the scope to compete with the private sector instead of complement it increases considerably. To achieve the proper positioning, the first-tier DB needs to operate in riskier, but viable segments than do commercial banks, requiring highly specialized risk-management skills not to under price risks. Since they target sectors that are not addressed by the private sector, DBs' pricing strategies may look expensive compared to sectors with better quality of information. The political consequences of "headline risk" might be sizable, and governments may consider providing targeted subsidies on lending transactions that address the needs of selected sectors of the economy (e.g. SMEs). DBs should abstain from subsidizing operations with their capital.

Finally, best practices in DB governance call for clear definition of the roles of shareholders (i.e. the government), the board of directors, and the management, as well as a separation of their functions to avoid conflict of interests. The shareholder representative should be clearly identifiable (for example, the Minister of Finance), provide broad policy guidelines and appoint the board of directors, but it is advisable to avoid the presence of ministers at the board of DBs. The board should be professional and independent. The board provides strategic vision to ensure compliance with the policy objectives and establish indicators to monitor performance. It should also ensure the financial sustainability of the institution is preserved and should appoint and dismiss the CEO. In addition, is important that DBs are supervised and regulated as any other bank by the financial supervisory authorities.

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