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MONETARY AND CAPITAL MARKETS DEPARTMENT

# Regulating, Supervising, and Handling Distress in Public Banks

Prepared by Mark Adams, Hanife Yesim Aydin,  
Hee Kyong Chon, Anastasiia Morozova,  
and Ebru Sonbul Iskender

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# Executive Summary

Effective regulation, supervision, and crisis management frameworks for public banks are as important for financial stability as those for private banks, but do not receive much attention in discussions in policy forums. Public banks exist for variety of reasons (legacy, ideology, public policy) and will likely remain a feature of financial systems in a number of countries. Yet there is no consensus on how to best incorporate public banks in the current regulatory paradigm, in a manner commensurate with their risk profiles. The current conjuncture makes this question particularly timely, as during the COVID-19 pandemic many governments relied on public banks to boost credit to households and firms, which may have adverse effects on their operations and balance sheets going forward. Effective management and oversight of public banks to ensure their positive contribution to financial stability and economic growth is therefore a forward-looking imperative.

While “public banks” is a broad term encompassing any bank owned (partially or fully) by the government, this universe is highly heterogeneous. On one end of the spectrum are non-deposit-taking development banks, or specialized financial institutions, that are set up to address specific market failures or promote certain public policy goals. They are funded by wholesale borrowings drawing upon the explicit guarantee of the state and typically engage in second tier lending operations or disbursal of subsidies to commercial banks or other financial institutions. On the other end of the spectrum are government-owned commercial banks that compete with other commercial banks in the same markets with the same products; these are funded primarily by retail deposits. In reality, most public banks lie somewhere in between these two extremes—some development banks are retail funded and some state-owned commercial banks commit to lend to certain specified sectors or state-owned counterparts. The main recommendations of this paper are intended for public banks that have a retail element in their business model—notably, deposit-taking from the general public—and directly compete with commercial banks, even though they may have a mixed mandate.

Ensuring the safety and soundness of public banks is not only a fiscal imperative—it matters for financial stability and economic growth as well. Public banks are rarely allowed to fail and their continuous recapitalization risk becoming a recurrent burden for the government budget. But persistent weaknesses in their operations and balance sheet also distort financial markets and may hinder credit and threaten financial stability. Where the solvency of the government is in doubt, confidence in public banks may erode and result in deposit withdrawals, potentially leading to a broader loss of confidence in the banking. In countries where public banks dominate the system, or have a monopoly of critical banking services, their weakness can disrupt the smooth provision of credit and/or the uninterrupted flow of payments and their settlements. Further, public banks’ privileged access to certain markets or products creates level playing field issues and undermine competitiveness in the financial system, impacting returns across the system or potentially incentivizing risky behavior by their private sector counterparts.

The inherent challenges in supervising public banks, if left unaddressed, may undermine the effectiveness of supervision more broadly and threaten financial stability. In the absence of effective arm’s-length governance structures between owners and management, public banks remain subject to influence on their operations, particularly in lending decisions. The often-found inability of the supervisor to take enforcement and corrective actions—because of limitations in their legal mandate or practical challenges to their autonomy—renders supervision ineffective. Condoning bad banking practices by public banks may lead to pressure from the industry for similar treatment from supervisors on private banks as well as a dilution of the response from the judiciary in the case of legal challenges to supervisory decisions.

The overarching message of this paper is that deposit-taking public banks directly competing with private banks should be subject to the same expectations and requirements of governance, regulation, and supervision as private banks. The management and board of public banks should identify, measure, and manage risks in the same manner as their peers in private banks, and run the bank with the same objective of integrity and the same regard for financial strength and sustainability of operations. A similar line applies to crisis management approaches: public banks should be full members of the deposit insurance system; be subject to the same resolution powers as private banks; and be eligible for emergency liquidity assistance at the discretion of the central bank and on the same terms as private banks.

This is more easily said than done, however. As the paper brings out, there are often carve outs and exemptions in law or regulation for public banks. Even when they are subject to the same regulation as their private counterparts, in practice the enforcement of these regulations and the effectiveness of their supervision may be challenged by conflicting supervisory mandates and lack of independence. The multiple policy goals the government typically places on public banks lead to a dilution of the governance arrangements in those banks and promote a 'business as unusual' paradigm that often flowers under a regime where supervisors lack autonomy to take action on weak public banks. In the face of distress or even insolvency, it is difficult for resolution authorities to take action against public banks that do not truly operate at arm's length.

A key element of any reform agenda should, therefore, be to promote mechanisms so that arm's length distance can be created between the government as the owner and the management of the bank, which can then run the bank on as much a commercial basis as possible. Where mandates are mixed, and policy lending and other government goals are part of the business, mechanisms to adequately and transparently remunerate such activities, such as explicit subsidies, should be put in place, so as to not dilute the resilience and operational capacity of the bank. Sustained political will toward reform of public banks is paramount to achieving these objectives.

Another key element of reform is to promote sound governance and greater autonomy in the supervisory and resolution authorities so that they can carry out their mandate without being intimidated by the owners of the public banks.

# 1. Introduction

Despite waves of privatization over the last 40 years, public banks (that is, banks for which the government is the main or sole shareholder) remain important across advanced, emerging, and developing economies. As of end-2016, they represented 14 percent of banking system assets worldwide. In advanced economies, nationalizations, state-supported recapitalizations,<sup>1</sup> and growth in public banks' credit in the aftermath of the global financial crisis reversed a decade-long decline, with their market share growing from 5 percent in 2005 to 12 percent in 2016. In emerging market and developing economies, there has been a steady decline in public banks' market share over the last two decades, from 25 percent in 1999 to 16 percent in 2016 (Figure 1).

There are several reasons why public banks have maintained an important presence. They may be the fruit of ideology or the legacy of the nationalization of weak banks. They may have been established to promote financial inclusion or otherwise overcome market failures by extending credit for long-term projects (such as infrastructures), or for regions and sectors of the economy that are underserved by private banks (such as small- and medium-sized firms or agriculture).<sup>2</sup> In times of crisis, public banks may respond countercyclically by supporting the continued flow of credit to support the economy as a whole, or to meet specific public policy objectives.<sup>3</sup>

While public banks may act as anchors in financial markets during times of distress, they can also create risks to financial stability. Public banks are vulnerable to political interference, particularly in countries with weak governance and institutional structures, leading to unsound lending practices and inefficiencies. Policy goals may conflict with profit-making and long-term financial viability. Partly as a result, most public banks have historically underperformed private banks and have weaker financial soundness indicators. In countries where public banks dominate the system, or have a monopoly of critical banking services, their distress may lead to disruptions in the smooth provision of credit and/or the uninterrupted flow of payments and their settlements. Moreover, public banks' privileged access to certain markets or products undermines competitiveness in the financial system, impacting returns across the system or potentially providing incentives for risky behavior by their private sector counterparts. Explicit or implicit guarantees to public banks further unlevel the playing field and can constrain the conventional options available to solve problems in their balance sheets. Finally, doubts about the solvency of the sovereign can erode confidence in public banks known to be weak and cause depositor flights, potentially leading to a broader loss of confidence in the banking system (for example, due to interconnectedness between public and private banks).

The COVID-19 pandemic has regenerated interest in public banks. During the pandemic, several countries stepped up credit to the economy through public banks.<sup>4</sup> A recent IMF note indicates that public banks—if financially sound and sufficiently well resourced—can be a useful policy tool to provide credit (IMF 2020a). This is particularly relevant when private banks are reluctant to lend, even with government guarantees, given high risks or operational costs. While it is early to draw firm conclusions on the effectiveness of

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<sup>1</sup> For selected examples of public interventions in support of banks during the global financial crisis, see IMF (2014).

<sup>2</sup> There is a sizeable economic literature on the rationale for public banks. See for example Stiglitz (1994); Cull, Martínez Peria, and Verrier (2018); Anson and others (2013); and Behr, Foos, and Norden (2017).

<sup>3</sup> See Bosshardt and Cerutti 2020. IMF (2020b) notes that public bank lending has been less procyclical than private bank lending, on average, in the past 20 years, but not in developing countries with high public debt levels. During the global financial crisis, public banks contracted lending less than private banks (Brei and Schclarek 2013; Cull and Martínez Peria 2013; and Bertay, Demirgüç-Kunt, and Huizinga 2015).

<sup>4</sup> Lending programs through public banks included: (1) injecting capital into public banks to rollover or expanding credit to affected sectors and segments (Bulgaria, Chile); (2) raising the credit ceilings of public banks or setting-up new credit facilities (Brazil, Germany, Korea, Hungary); and (3) setting up guarantee programs (Italy, France, the United Kingdom, Saudi Arabia) for public banks to support key sectors and segments.

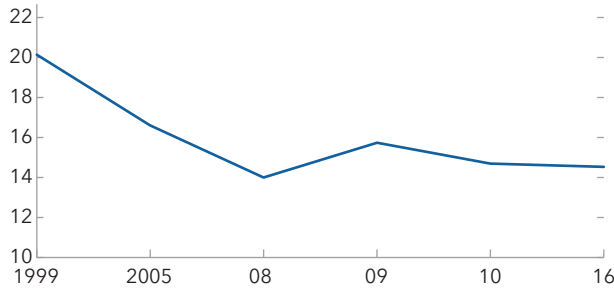


**Figure 1. Public Banks (PBs)–Relative Size and Recent Trends**

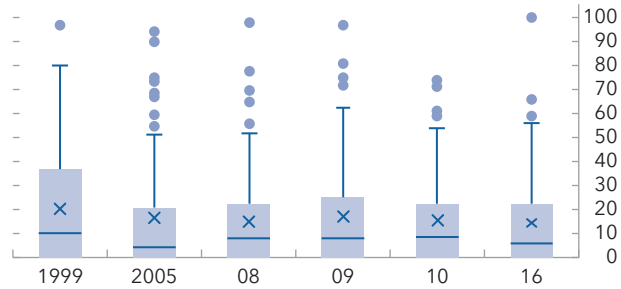
Globally public banks’ assets share declined between 1999 and 2008 and experienced an increase during the global financial crisis due to nationalizations and recapitalizations.

The share of public banks’ assets represents about 14 percent of total assets, on average, but there is wide variation across countries.<sup>1</sup>

**1. Share of PBs’ Assets to Total Bank Assets (World average)**



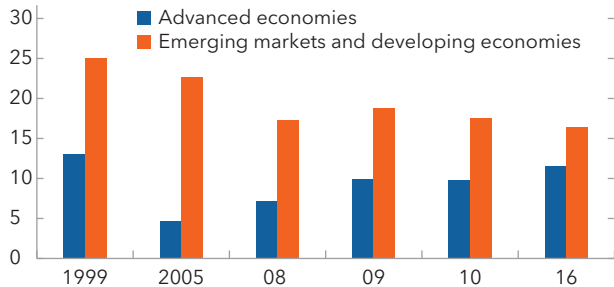
**2. Share of PBs’ Assets**



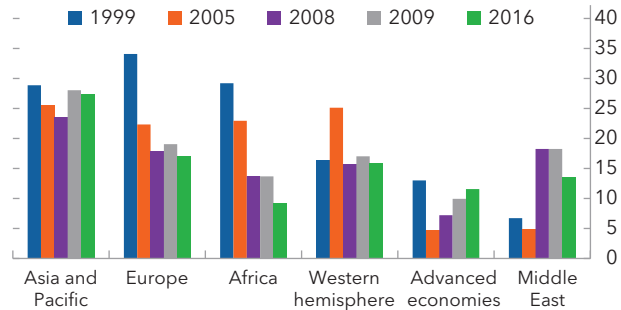
Public banks gained market share in advanced economies with the impact of the GFC. In emerging market and developing economies public banks exhibit downward trend.

Asia and the Pacific has the highest share of public banks followed by Europe. Since 1999, the share of public banks’ assets has declined across most regions.

**3. Share of PBs’ Assets by Income Level**



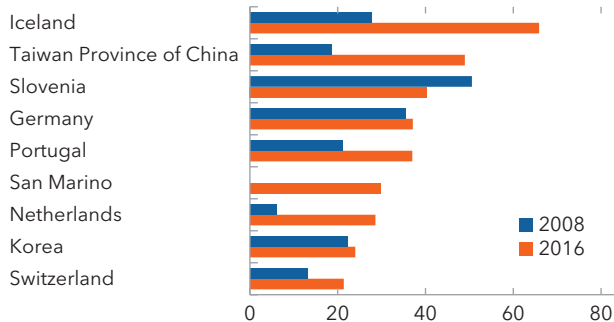
**4. Share of PBs’ Assets by Region**



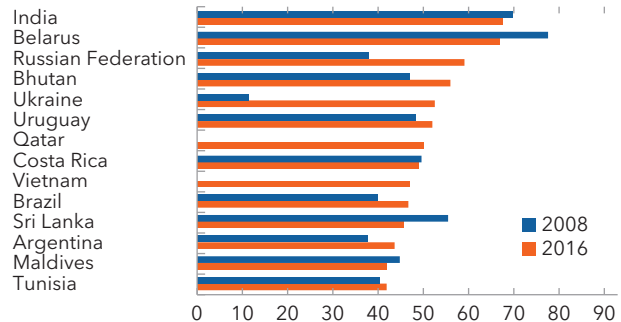
Among advanced economies, only Iceland has public banks with more than 50 percent of banking sector assets.

Public banks dominate the banking industry in some emerging market and developing economies (Belarus, Bhutan, India, Russian Federation, Ukraine).

**5. Advanced Economies with the Largest Share of PB Assets**



**6. Emerging Market Economies with Highest Percentage of PBs’ Assets**



Sources: EconData; and World Bank.

Note: The percentage of “public banks’ assets” is self-assessed by World Bank “Bank Regulation and Supervision Survey” respondents (banking regulation and supervision authorities of the jurisdiction) as a response to the following question: “What percent of the banking system’s assets was in banks that were government-controlled (that is, where government owned 50 percent or more equity)?”. Source of China data is EconData.

<sup>1</sup>In a box and whiskers plot, the ends of the box and its center line mark the locations of Q1 and Q3, and Q2 (or the median). The distance between Q3 and Q1 is the interquartile range. Each whisker extends to the furthest data point that is within 1.5 times the interquartile range. Any data point beyond that distance is an outlier and marked with a dot. Within the box, horizontal line denotes a median and a cross marks the mean value.

these programs, several studies have highlighted strong governance, clear mandates, accountability, and transparency as key ingredients of success.<sup>5</sup> How public banks should be regulated and integrated in the post-COVID recovery effort is critical.

Carefully designed prudential policy responses and financial safety nets are needed to address these risks. Insights from IMF surveillance and technical assistance suggest that the room for improvement in regulation, supervision, and crisis management for public banks remains substantial. In some countries, legal frameworks constrain supervisory powers vis à vis public banks. In others, lack of independence and unclear mandates by supervisory and resolution authorities contribute to regulatory forbearance and delay addressing financial distress, increasing overall losses and, ultimately, fiscal costs.

The objective of this departmental paper is to raise awareness about these gaps and encourage authorities to undertake the reforms necessary to close them. Mitigating the risks to financial stability posed by public banks—notably those involved in retail activities and directly competing with private banks—requires a comprehensive policy response, including an appropriate legal and institutional framework; sound corporate governance and risk management practices; comprehensive and forward-looking supervisory approaches backed by an adequate regulatory framework; and adequate crisis preparedness. In particular:

- Public banks should have well-defined mandates, sound governance structures, and practices that safeguard against political intervention. It is key that public banks have a properly functioning, independent board in place to flag and address issues in the bank's operations, and a well-established and transparent nomination and dismissal process for board members and senior management that consistently nominates knowledgeable and experienced professionals.
- Ownership arrangements should be designed to avoid conflicts of interest. Good practices include establishing an institution (a holding company) to manage the government's stake in public banks (particularly in case of public commercial banks) on an arm's-length basis or creating a separate unit within the government to advise on public banks related issues.
- The legal framework should endow the supervisors with the provisions and tools necessary to exercise full authority over public banks. In practice, these banks' links to the government pose challenges for supervisors, when interests are not aligned. Taking corrective measures over public banks requires not only formal powers and tools but also independent supervisors with a clear mandate to promote financial stability encouraging timely corrective action.
- The regulatory framework that applies to public banks should be no less stringent than the one that applies to private banks. The fundamental principle is that similar risks require similar capital and other prudential requirements across all financial institutions.<sup>6</sup> The principle of proportionality—defined as setting prudential and administrative standards for banks that are commensurate with their risk profile to achieve a desired objective—also applies to public banks.
- Each public bank's operations and risk appetite—reflecting its mandate, business model, and financial strength—should be commensurate with its capacity to manage risks. Public banks often are expected to finance highly complex and risky operations such as project and infrastructure financing and may be exposed to significant concentration risk. Supervisors should ensure that the public banks have the necessary capability to comprehensively understand their portfolio's risk-return profile so as to manage all material risks effectively. Credible recovery plans are important to enhance resilience and minimize the need for eventual fiscal support.

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<sup>5</sup> See IMF (2020a) and McDonald and others (2020).

<sup>6</sup> Under the Basel framework, claims on public sector entities outside the central government, including public banks, are risk weighted as exposures to banks. However, subject to national discretion, claims on certain public sector entities outside the general government may also be treated as claims on the sovereign and hence in practice carry a zero percent risk weight.

- Supervisory intensity over public banks should be proportionate to their risk profile and systemic importance. Systemically important public banks should be subject to enhanced prudential requirements, more intensive supervision, and effective crises management arrangements.
- Resolution should be a credible option for all failing banks, including public ones. As with supervision, public banks' links to government create challenges for crisis management. Still, the resolution framework should be available for these banks in full, as exemptions would jeopardize the level playing field, impair market discipline, and impede restructurings. Strong, well-developed resolution regimes, providing for a sufficiently broad range of powers that can be wielded by operationally independent agencies can help to promote timely responses.

The rest of the paper is structured as follows. Chapter 2 provides a global overview of public banks and their specific characteristics. The next four chapters provide recommendations to strengthen their governance, legal and regulatory frameworks, supervision, and crisis management strategies. Chapter 7 concludes.

## 2. Public Banks: Key Features and Outcomes

The universe of public banks is highly heterogeneous.<sup>1</sup>

- On one end of the spectrum are specialized financial institutions, for example, non-deposit-taking development banks, that are set up to address market failures or promote certain public policy goals; are funded by wholesale borrowings drawing upon the explicit guarantee of the state; and typically engage in second tier lending operations (that is, lend to commercial banks who in turn underwrite individual loans) or in disbursement of subsidies to commercial banks or other financial institutions. There are no internationally agreed standards for how these “second-tier” banks should be regulated or supervised since they are not seen to offer a depositor protection or financial stability motive, though there have been attempts to delineate “good practice” approaches for their governance.<sup>2</sup> Their failure typically is a matter for the fiscal authorities and for the policy domain that they serve, and unless they have substantial interconnections with the commercial banking system, have less impact on financial stability.
- On the other end of the spectrum are the state-owned or controlled commercial banks that compete toe-to-toe with other commercial banks in the same markets with the same products; are funded in the same manner as private banks (primarily by deposits from the general public); and have either been acquired by the state, nationalized, or set-up as commercial banks on ideological grounds or as national champions or where the private sector is still in the process of building the capacity and experience to do so.

The main recommendations of this paper are intended for public banks—that is, banks owned and controlled directly or indirectly by the government—that collect deposit from retail customers and compete directly with private banks even though they may have a mixed mandate. Most public banks lie somewhere in between the two extremes described above. Some development banks have retail exposures on the liability or asset side or both, and some state-owned commercial banks may have policy objectives where they commit to provide banking services to certain specified sectors or state-owned counterparts. The advice that follows applies to all deposit-taking public banks independent of their mandate (including deposit-taking development banks). Specific considerations for non-deposit-funded specialized financial institutions are discussed in Box 3.

Public banks have business model characteristics that affect both their risk appetite and their ability to manage risks. They include noncommercial mandates, an ownership structure that increases the potential for undue political influence, market perception of a safe haven and, sometimes, complex investment portfolios.

- Socioeconomic mandates. Most public banks are, de jure or de facto, mandated to pursue socioeconomic goals—such as policy lending to specific sectors or regions, or provision of deposit and payment services to other public sector bodies. The strength of the socioeconomic mandate varies considerably across banks and countries, being usually stronger in development banks. But even public banks that engage primarily in commercial activities often have mixed objectives. Socioeconomic mandates may be inconsistent with financial viability if they do not generate appropriate returns (directly or through subsidies); and particularly when not well articulated, can facilitate interference in decision-making. Ideally, where mandates are mixed, business lines pursuing socioeconomic objectives should be subsidized separately by the fiscal authorities, or via second tier development banks, so as to not dilute the bank’s profitability goals.

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<sup>1</sup> Nomenclature varies depending on the country and the specific mandate, including state-owned, government-owned, public sector, policy, quasi-narrow or specialized banks and agricultural, housing, industrial, or postal banks, among many others.

<sup>2</sup> OECD (2015).

- Complex portfolios and countercyclical role. Related to the above, some public banks provide funding to high-risk projects, and/or are required to support lending during periods of stress, which generate challenges for risk management. As a result of their mandates, complex products such as long-term, large-scale infrastructure or project financing that may carry substantial credit and market risks commonly represent a large share of public banks' portfolios. These banks may also be exposed to substantial concentration risk and lend to other state entities (possibly on concessional terms) whose viability is at risk, for which insolvency or debt enforcement may not be credible, and adequate provisioning may be even more politically sensitive than for other creditors. Risk management is further challenged by the countercyclical role expected from some public banks, such as increasing lending in a downturn when credit risk is high.
- Ownership structure and political interference.<sup>3</sup> Public banks, like other state-owned enterprises, are frequently subject to political interference, particularly in countries with governance vulnerabilities. They can become vehicles for pursuing short-term political goals that deviate from the long-term commercial and socioeconomic objectives of the bank, resulting in resource misallocation.<sup>4</sup> Vested interests typically have strong incentives to maintain the status quo, preventing improvements in governance and risk management practices.

These characteristics negatively affect the financial performance of public banks. Public banks tend to have weaker financial soundness indicators and performance than private banks. An analysis of recent (2019) financial results across a sample of more than 4,000 private and public (commercial and development banks) reveals that public commercial banks operate with lower liquidity, equity, and profitability than private banks (Figure 2). This is true for both advanced economies and emerging market and developing economies, albeit with significant variation across dimensions of financial performance.

These findings are in line with a vast literature on the impact of state ownership on bank performance. Micco and others (2004) reported that public banks located in developing countries tend to have lower profitability and higher costs than their private counterparts. Cornett and others (2010) found that public banks in 16 Asian countries operated less profitably, held less core capital, and had greater credit risk than privately owned banks. Berger and others (2005) found that public banks tended to have poorer long-term performance on average than domestically owned private banks and foreign-owned banks, especially very high-nonperforming loan ratios. A recent study on Central, Eastern, and Southeastern Europe finds that public banks (and development banks) are overall less profitable than private banks, though there is significant heterogeneity across countries (IMF 2019). Similarly, a sample of more than 4,000 banks in 125 countries over the past two decades shows that public commercial banks are less profitable and cost-efficient than their private counterparts (IMF 2020b). There is also some evidence on improved financial performance after privatization.<sup>5</sup>

The financial health of public banks is closely intertwined with that of the sovereign. Public bank losses can impact the budget directly if they require the government to replenish capital and, in extreme scenarios—such as failures of systemic public banks—could lead to sovereign distress. Additionally, in a scenario of large public bank losses, rising sovereign default risk could spill over to all banks and the broader economy. In some countries, fiscal constraints (coupled with an inability or unwillingness to privatize) have resulted in chronically undercapitalized or insolvent public banks. In turn, an increase in sovereign risk can feed back into public banks through (direct or indirect) exposures to the sovereign and state-owned enterprises (which are typically large), through the reduced ability of the government to assist banks if they run into trouble and

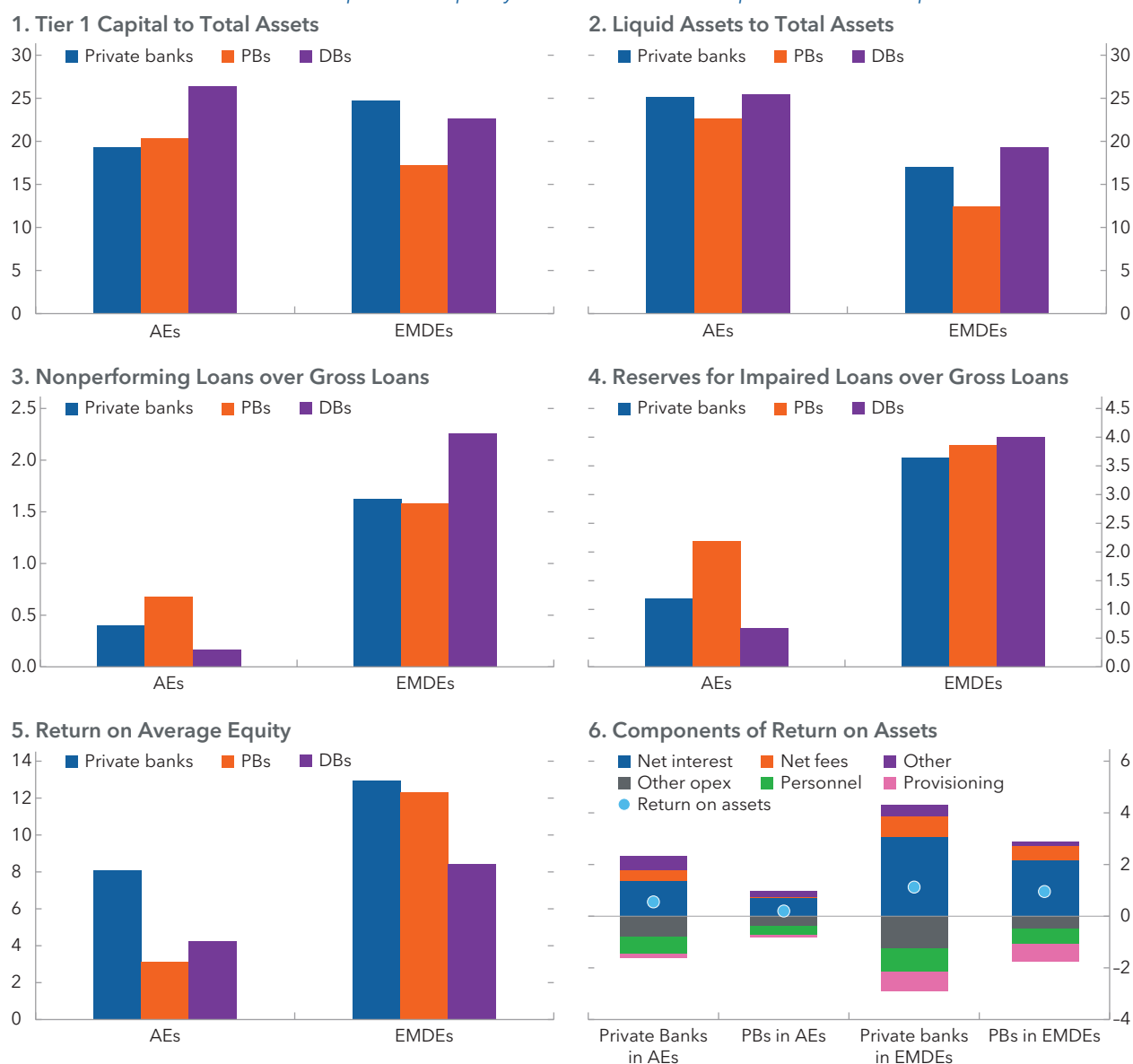
<sup>3</sup> Public banks are typically owned by a central government but may also be owned by state or local governments, central banks, state-owned enterprises, or state (such as sovereign wealth) funds.

<sup>4</sup> See Shleifer and Vishny (1994); Shleifer (1998). Evidence shows that when elections are approaching, public banks lend more to politically strategic sectors or regions and well-connected firms (Sapienza 2004; Khwaja and Mian 2005; Cole 2009; Carvalho 2014; Tan, Huang, Woo 2016; Qu 2018; Dinc 2005; Claessens, Feyen, and Laeven 2007).

<sup>5</sup> See Verbrugge, Megginson, and Owens (1999); Bonin, Hasan, and Wachtel (2003); and Kausar and others (2014).

**Figure 2. Financial Soundness Indicators by Bank Type and Ownership, 2019**  
(Percent)

*Public banks tend to have lower capital and liquidity indicators and weaker performance than private institutions.*



Sources: Fitch Connect; and IMF staff analysis.

Note: The final dataset contains 4,470 banks: 4,307 commercial banks (3,966 privately owned, the rest are at least 25% owned by the government or a state-affiliated entity such as Central bank, Ministry of Economy, state-owned investment fund etc) and 163 development banks. Data on ownership is snapshot data as of 2018, therefore, we tend to use data as of year-end of 2019 to ensure the ownership data remains relevant. For these banks we collect information on 44 dimensions. AEs = advanced economies; DBs = development banks; EMDEs = emerging market and developing economies; PBs = public banks.

the effect this has on funding costs and availability (with the sovereign credit rating influencing the banks' credit ratings).<sup>6</sup> While this relationship is relevant for all banks, it is particularly strong for banks owned by the state. Similarly, the potential liquidation or resolution of a public bank can adversely impact the perceived creditworthiness of the sovereign and propagate confidence shocks—in particular, in situations where the government controls multiple banks.

<sup>6</sup> See IMF (2018).

Given their ownership structure, public banks—de jure or de facto—can unlevel the playing field and generate competitive distortions. Public banks typically benefit from implicit, and at times explicit, government guarantees that shield creditors from losses, or are perceived to do so. Such guarantees provide an advantage in collecting funds. State-owned enterprises and civil servants also tend to deposit their cash balances in public banks, and in some countries, they are captive sources of funds—which results in lower funding costs for public banks compared to competitors. This advantage is particularly evident in times of stress, where public banks can benefit from a “flight to quality” given their perceived safety (Acharya and Kulkarni 2012). The existence of several large public banks in a jurisdiction could also reduce competition if they collude (formally or informally).

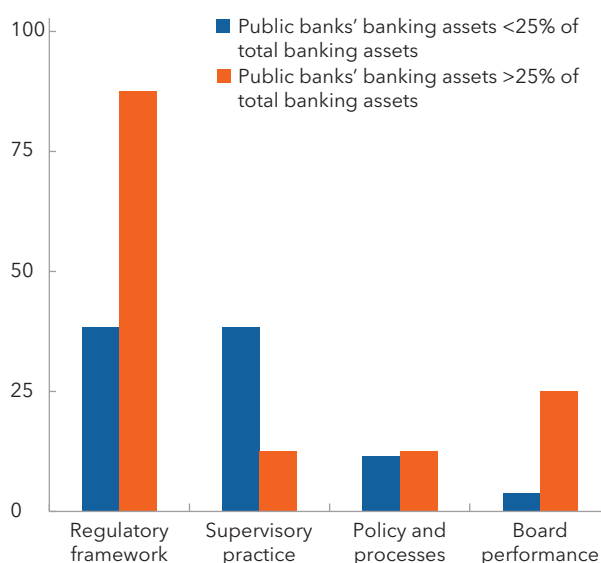
### 3. Corporate Governance

Many banking problems are associated with weaknesses in corporate governance, and this is no different for public banks. Public banks' business decisions are inherently vulnerable to political pressure when board members and senior management are rewarded politically.<sup>1</sup> The reward may be received "on the job" after complying with political demands or through the selection into the job. The likely conflict between political demands and the commercial objectives of public banks typically results in inefficient cost structures and risky investments that may increase the chance of bank distress.

Some weaknesses in corporate governance are relatively common in public banks. The nomination process for senior management and board members of public banks is often not transparent. Government officials acting as shareholders may intervene in day-to-day operational decisions (for example, who to lend to and on what terms, branch location, and pricing policies). Board members may lack the independence, professional skills, and experience necessary to undertake their duties effectively.<sup>2</sup> Lack of accountability may allow senior managers to act unchecked, pursue unintended objectives, and operate in a manner contrary to sound business and/or public financial management principles.

Gaps in corporate governance are often pronounced in countries with a large presence of public banks. Requirements may be weak or lacking regarding board and senior management responsibilities; board composition and structure (in terms of presence or proportion of experienced non-executive members, specialized committees, and application of fit and proper standards, among others); and board performance (for example, implementation of business strategy and risk appetite). Correlation analysis conducted for this paper shows that countries where the share of state ownership in banks is higher are often associated with less effective supervision of corporate governance, as measured by compliance with principle 14 of the Basel Core Principles (Figure 3 and Annex 1). This result suggests that there are gains from improving the quality of corporate governance of public banks and, thus, that this should be a key goal of country authorities.

**Figure 3. Weaknesses in Corporate Governance**  
(Percent of BCP-assessed countries)



Source: IMF staff.

Implementation of sound corporate governance frameworks in public banks remains a key challenge in many countries. Effective corporate governance is a critical ingredient for the proper functioning of public banks. Clearly defined mandates, a transparent and explicit ownership policy properly capturing the role of the state, and professional and independent boards are essential to improving these banks' performance. The following sections review the recommended approaches, based on international guidance.<sup>3</sup>

<sup>1</sup> See World Bank (2013), Chapter 4.

<sup>2</sup> In some cases, public banks, as public entities, are subject to government personnel rules for CEOs and Board members. This can limit the compensation that they can earn, which tends to reduce the size of the pool of qualified candidates.

<sup>3</sup> For international guidance, see BCBS (2015) and OECD (2015, 2020).



## A. Ownership Structure and Mandates

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An explicit and transparent ownership policy should be established, applying to public banks (and other state-owned enterprises as applicable). The policy should define the overall objectives and rationales for state ownership and a strategic vision for public banks. The state's role as an owner should be based on principles of sound commercial practices, good corporate governance, and competitive neutrality to guide the relationship between the state and the public banks. The policy should be reviewed at regular intervals. It is good practice to include information on the state's ownership policy and its implementation in regular reporting (OECD 2018).

Institutional arrangements should foster management of public banks on an arm's-length basis. One option is to set up a holding company-type structure to manage the government's ownership interest, to ensure institutional separation of the broader economic interests of the government from its interests as a shareholder. Such structures were established in the United Kingdom and The Netherlands, for example, during the global financial crisis to manage government holdings in nationalized banks. Another option is to create a separate unit within a government ministry (often the Ministry of Finance) to advise on matters related to its public bank ownership, as observed for example in Ireland (Box 1). A holding company-type structure is a semi-autonomous agency that has sufficient capacity to properly oversee the operations of public banks while avoiding the excessive intervention of public officials. Holding companies are especially beneficial when their managers have professional expertise and protected from undue political interference. A dedicated unit within a ministry may have an advantage of being better able to integrate public banks' oversight in the budget process and facilitate a broader assessment of fiscal risks.

Public banks should have clear mandates and be subject to transparent mechanisms to ensure long-term financial viability. Mandates should provide a brief overview of a public bank's high-level, long-term objectives and be aligned with the established rationale for state ownership. Clearly defined mandates help ensure accountability at the enterprise level and limit the typically random and idiosyncratic demands from the government that might threaten commercial viability. Clear mandates provide a framework to help the state define and subsequently monitor the fulfillment of a public bank's short-term objectives and targets (OECD 2015). The achievement of socioeconomic goals should not jeopardize the viability of public banks; mechanisms, such as explicit subsidies, should be put in place to adequately and transparently remunerate such activities.

## B. Board and Senior Management

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Transparent nomination processes and clear responsibilities for the board and senior management are critical. Processes for appointment and dismissal should be well-established and merit-based (see Box 2 for the case of Ukraine). The board should be accountable for the bank's business strategy, financial soundness, and key personnel decisions. The board should be fully capable of flagging and addressing problems in the bank's operation. The board charter should clearly define the role and the terms of reference for board members, including the government officials on the board, such as Ministry of Finance *ex officio* members. Special attention should be given to appointment and dismissal of the board and senior management and its composition (see Annex 2).

Supervisors should have clear authority to evaluate corporate governance in public banks. Supervisors should ensure the fitness and propriety of board members and senior management and that they are subject to appropriate conflict of interest rules and confidentiality obligations that are aligned with those applicable to private institutions. Evaluating the quality of corporate governance should be a key component in the supervision of public banks. For example, the supervisor should assess the effectiveness and independence of the bank's internal audit function. The function should provide independent assurance to the board (or audit committee) without management filtering and support the board and senior management in promoting an effective governance process.

## Box 1. Oversight of State Ownership in Banks

### Public bank holding company structures

The UK Government set up in 2008 UK Financial Investments (UKFI), a limited company designed to manage Treasury's shareholdings in Royal Bank of Scotland Group, Lloyds Banking Group, and UK Asset Resolution Ltd. The details of the relationship between the UKFI and the investee companies was described in a framework document<sup>1</sup> specifying that the UKFI would manage investments on a commercial basis and would not intervene in the day-to-day management decisions of the investee companies, including with respect to individual lending or remuneration decisions. To ensure that the UKFI would be managed professionally and independently, the framework document required its Board to comprise a private sector Chairman, the Chief Executive of the Company, up to five further non-executive private sector members, and up to two senior Government officials nominated by HM Treasury.

The Government of the Netherlands established in 2011 Netherlands Financial Investments (NLFI) to manage holdings in ABN AMRO Bank N.V. and De Volksbank N.V. NLFI was modelled on UKFI and aimed at ensuring a clear separation of interests, a credible exit strategy and a commercial, non-political corporate governance. A supervision agreement<sup>2</sup> provided details of the relation of the Ministry of Finance with the NLFI. The agreement stated that the NLFI would provide an additional buffer against unwanted political influence on the relevant financial institutions and ensure that no competitive advantage or disadvantage would arise from the fact that the government was a shareholder of some financial institutions.

### Dedicated unit in the Ministry of Finance

The Shareholding and Financial Advisory Division of the Irish government blends the expertise of the private sector and government officials, and its roles and responsibilities include the oversight of state ownership in public banks, advisory and policy development, and market interaction. For instance, the division develops and recommends strategies for returning banks to private ownership to the Minister, and monitors bank performance and stock market trends through regular interaction with management, investors, and market participants.<sup>3</sup>

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Sources: Country authorities; and UKFI and NLFI websites.

<sup>1</sup> UKFI Framework Document.

<sup>2</sup> Toezichtarrangement NLFI.

<sup>3</sup> Shareholding and Financial Advisory Division (SFAD) Fact Book - April 2021.

## C. Disclosure Requirements

Public banks should be required to provide high-quality, timely, and reliable information to the market and the public. Effective governance is based on information sharing internally within the bank and externally with the government and the public in general. Public banks should be subject to disclosure requirements no less comprehensive than those applicable to private banks so that those who wish may make an accurate assessment of the bank's financial condition and performance, business activities, risk profile, and risk management practices. In addition, authorities should consider expanding disclosures in sensitive areas including: (1) the relationship between the public bank and the state (for example, lending to state-owned enterprises, policy or directed lending, funding from the state or other state-related entity), (2) public banks' activities to fulfill their mandate, (3) assessments of progress in achieving objectives, and (4) any concessions (such as tax exemptions or discounts) provided to the bank. Some countries have also required public banks to be listed on the stock exchange as a way of enhancing transparency and disclosures.

## Box 2. Ukraine: Appointment Process of Board Members in Public Banks

Banks under state control account for a large share of the banking system in Ukraine—51 percent of banking system total assets and 57 percent of household deposits as of end-September 2021. As part of the authorities' goal of strengthening public banks' governance, the legal framework governing the independence and professionalism of state-owned banks' supervisory boards was enhanced in 2018 and operationalized in 2019.<sup>1</sup> In line with the OECD Guidelines on corporate governance of state-owned enterprises, the reforms aimed at limiting undue state influence and political interference. The new article 7 of the Law on Banks and Banking mandated each public bank's supervisory board to have a total of nine members, of which six independent directors and three State representatives.

The process for appointing independent board members became much more rigorous under the new article 7 of the Law on Banks and Banking. It involves: (1) an executive search company recommending a board profile matrix and a long list of potential candidates; (2) a nomination committee set up by the Cabinet of Ministers; and (3) a technical secretariat of no less than three people, selected by the nomination committee, to provide it with organizational and information support. There are strict fit and proper criteria for nomination committee members and procedures for the selection of candidates.<sup>2</sup>

State-owned banks' supervisory board members should comply with the fitness and propriety requirements of the Law on Banks and Banking that apply to all banks. Additionally, Article 7<sup>3</sup> of the law imposes additional requirements for members of the Board of a state-owned bank to ensure their impartiality during the decision-making process and provides criteria for independent directors of the Board of a state-owned bank. Thus, a person cannot be appointed to the Board of a state-owned bank if such appointment may give rise to a conflict of interest. A person who has an outstanding criminal record and/or who has been subject to an administrative penalty for committing an offense related to corruption may not be a member of the Board of a fully state-owned bank.

The criteria for directors of the Board include that the person: (1) is not or for the last five years has not been the top manager (except for an independent Board member) of this state-owned bank/ its branch/its representative office/other separate subdivision or of a legal entity in which this state bank has a significant share; (2) is not or has not been an employee of this state-owned bank and/ or its branch, its representative office and/or other separate subdivision or legal entity in which this state bank has a significant share for the last three years; and (3) is not a related person (except for an independent Board member) of this state-owned bank.

Notwithstanding legal reforms and appointment of majority independent supervisory boards, corporate governance in Ukraine has faced significant challenges. Delays in Cabinet approving strategies for state-owned enterprises and obstructions to the process of renewing management boards have impaired the effectiveness of the supervisory boards, delaying much-needed restructuring and weakening NPL recoveries.

Source: IMF staff analysis.

<sup>1</sup> A public bank that is not 100 percent state-owned is not considered a state-owned bank under the Ukrainian legislation and is not subject to Article 7 of the Banking Law.

<sup>2</sup> The rules of competitive selection of an executive search company, activity, and obligations of it for candidates' search process, the composition of the nomination committee and requirements of its members, obligations of a technical secretariat of the nomination committee etc. are governed by separate acts of the Cabinet of Ministers of Ukraine.

<sup>3</sup> Article 7 of the Law on Banks and Banking also establishes specific fitness requirements to the representative of the State in the Board of a state-owned bank.

Public banks should be subject to periodic independent external audit based on internationally agreed accounting and auditing standards. Public banks are typically inspected on a regular basis by the government to monitor their use of public funds and budget resources. In addition, external audits should be conducted to ascertain the adequacy of financial statements and operations of public banks and therefore contribute to reinforce trust in the internal systems as well as in the information provided by management to the board and the general public.

## 4. Regulation

The fundamental principle of public bank regulation is that similar risks require similar prudential requirements across all financial institutions regardless of ownership. The regulatory framework for public banks should be no less strict than the one applied to private banks. However, prudential approaches may need to be reinforced to address some of the specific risks and challenges that arise from state ownership.

The prudential framework of deposit-taking public banks should comply with the Basel Core Principles for Effective Banking Supervision. Additional risks and challenges that arise due to the state being the main (sole) shareholder of a bank might require additional regulatory considerations to account for certain risk factors, such as excessive lending to state-owned enterprises and an unlevelled playing field, and constraining them with well-targeted rules, as discussed below.

### A. Capital

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Capital is the cornerstone of prudential regulation, and public banks should comply with the same capital requirements applicable to private banks. To maintain confidence in the financial sector, protect depositors, and provide financing to firms and households private and public banks alike must have sufficient capacity to absorb losses and keep operating in the event of shocks without the need for government support. Adequate capitalization of public banks also lowers the risk of bank-induced sovereign distress during financial crises. Maintaining the same set of requirements independent of the ownership structure is also important to foster and maintain competition.

All systemically important banks, including public banks, should hold additional capital, commensurate with the risks and negative externalities that they pose to the system. In addition, as in the case of private banks, supervisors should have the power to impose specific capital charges to address any material risk exposures that result from the operation of public banks.

### B. Liquidity

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Public banks should be subject to prudent liquidity requirements. The liquidity coverage ratio (LCR) designed to promote short-term resilience to liquidity shocks, and the net stable funding ratio (NSFR), designed to encourage a stable funding profile in the long-term, can strengthen the prudential framework, and their proportional implementation should be considered even for banks (both private and public) that are not internationally active (Ferreira, Jenkinson and Wilson 2019; IMF 2021).

A sound set of liquidity risk management guidelines and adequate liquidity monitoring tools are key for mitigating liquidity risk in public banks. Sources of liquidity risk such as concentration of funding, maturity mismatches, and liquidity mismatches in foreign currency, can be meaningful for any bank. To address these risks, which are not typically fully addressed by prudential limits, authorities should develop an appropriate set of supervisory monitoring tools and regulations that require public banks to build sound liquidity risk management policies and processes.

## C. Concentration Risk and Large Exposures

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The mixed mandates of many public banks can accentuate concentration risks. Some public banks are, de facto or de jure, focused on lending and providing other financial services to specific sectors and segments of the economy (for example, agriculture, small- and medium-sized enterprises) or geographic locations, generating large exposures to groups of connected counterparties. These concentrations may amplify credit-related problems and the risk of bank failures.

Supervisors can mitigate these risks by establishing limits on large exposures and enforcing sound concentration risk management practices in public banks. International standards limit the exposure to a party or a group of connected parties at 25 percent of a bank's Tier 1 capital. Supervisors should require public banks to have in place policies and processes that provide a comprehensive bank-wide view of all significant sources of concentration risk and the means to manage them. Appropriate information systems for identifying and aggregating exposures are key. Public banks' concentration risks should be assessed in the context of the supervisory review process of the Basel Pillar 2 framework and, if considered necessary, additional capital requirements should be imposed.

The potential concentration of exposures to state-owned enterprises warrants special attention. Lending to public sector entities<sup>1</sup> often accounts for an important share of public banks' loan portfolio. In accordance with supervisory framework for measuring and controlling large exposures developed by the Basel Committee (BCBS 2014), public sector entities that are not treated as sovereigns should be included in the scope of large exposure limits. However, this standard does not require the aggregation of exposures to state-owned enterprises unless they are connected for a reason other than having the same owner. Thus, the full implementation of the framework would not prevent high exposures to the public sector broadly defined. Supervisors should carefully monitor these exposures including exposures to the sovereign and, on a case-by-case basis, consider introducing additional limits, restrictions or capital charges that mitigate the risks of excessive concentration and encourage diversification.<sup>2</sup> It is also important that supervisors monitor the exposures of public banks to related parties—that is, entities directly controlled by the public bank, Board members, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies—and ensure that they are aligned with Basel Core Principle 20: Transaction with Related Parties.

## D. Risk Management

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The ownership structure and loan portfolios of public banks can bring additional challenges for effective risk management. Their underwriting standards may be impacted by their policy roles and political pressures. Some public banks provide funding to complex and risky projects, such as infrastructure and project financing,<sup>3</sup> and these activities represent an important share of their portfolio. Also public banks are often called upon to increase lending in downturns of periods of stress. All these characteristics increase the challenges and importance of the risk management function.

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<sup>1</sup> The Basel Committee defines a public sector entity as an organization that is: "(1) created by a central or subnational government; (2) owned in full or in part by a central or subnational government, or carries out functions of the government under law; (3) supported by a central or subnational government; and (4) is accountable to a government. Provided that these criteria are met, public sector entities may include commercial and non-commercial undertakings and administrative bodies." BCBS (2017). In addition, the IMF Fiscal Monitor notes that although there is no commonly agreed definition of state-owned enterprise, these entities share some key elements, namely: (1) the entity has its own, separate legal personality; (2) the entity is at least partially controlled by a government unit; and (3) the entity engages predominantly in commercial or economic activities.

<sup>2</sup> In Indonesia, for example, exposures to state-owned enterprises are subject to a legal lending limit of 30 percent of the bank's capital (Tier 1 and Tier 2 capital) (BCBS 2020). In addition, for prudential purposes, they are assigned a minimum risk weight of 20 percent (BCBS 2020).

<sup>3</sup> For infrastructure financing, industry concentration, limited understanding of idiosyncratic risks, and long maturities often increase risk. Long-term, large-scale infrastructure or project financing may carry substantial credit and market risks especially if there are delays in project completion or problems with the commercial viability of projects.

Ensuring an independent and well-resourced risk management function, with direct access to the board, is key to mitigate the risks. The supervisor should ascertain that the duties of the risk management function are clearly segregated from risk-taking functions in the public bank, and that risk exposures are reported directly to the board and senior management. The risk management function should also be subject to regular review by internal auditors.

Supervisors should ensure that a public bank's risk appetite, reflecting its mandate and business model, is consistent with its capacity to manage risks. Some public banks may lack the skills and understanding of risks needed to underwrite complex project financing and infrastructure projects in case this long-term financing is not their traditional business model. This deficiency may render public banks misprice the risks involved and yet be awarded the project given their lower cost of funding, public backing, and political factors. To address underwriting weaknesses, public banks sometimes use third-party appraisers (such as investment banks), but this is often a poor substitute for in-house expertise. Moreover, to the extent that third-party appraisers are hired by the prospective borrower, conflicts of interest arise. It is therefore imperative that supervisors ensure that banks have well-resourced staff and fully understand the risk-return profile of underlying projects before committing funds.

More broadly, there is a need to enhance public banks' risk culture by establishing well-functioning risk management committees and hiring experienced chief risk officers. Banks' boards and supervisors should ensure that public banks' strategies do not lead to excessive risk taking. The board, working with senior management and the chief risk officer, should establish the public bank's risk governance framework and risk appetite statement based on its long-term business strategy, risk exposures, and ability to manage risks effectively. A strong risk management committee should be able to flag rapid growth in risky lending and inadequate pricing of risks. The bank's risk management committee should engage in capital planning, establish risk parameters, and adopt a risk culture aligned with their capital position.

Supervisors should also strongly enforce asset classification and provisioning rules. Public banks may be more prone than private ones to restructuring and evergreening nonperforming loans (NPLs), significantly delaying recognition of such loans and reducing recovery on collateral, thereby increasing the eventual loss (D'Souza and Surti 2020). In some countries, the legal framework discourages public banks from developing and adopting NPLs workout strategies due to risks of personal liability.<sup>4</sup> This may hinder the adoption of remedial actions such as direct sales of NPLs to asset management companies and other third parties, securitization, and debt/equity swaps of NPLs, among others. The legislative framework should provide protection to supervisors or resolution authority staff against such personal liability, provided they act in good faith. The same asset classification and provisioning rules should apply to both private and public banks and enforced with the same intensity. Accurate and transparent data on the amount of NPLs, potential losses, and capital shortfalls is required for authorities and supervisors to make informed decisions when credit risk materializes.

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<sup>4</sup> For example, in India, if public banks offer concessions to the borrower, they could, due to their higher degree of accountability to the public, fall within the scope of provisions in the Criminal Code and the Prevention of Corruption Act, although concessions are not necessarily unlawful.

## 5. Supervision

Public banks' links to the government pose practical challenges for effective supervision. Political pressures may result in forbearance and gaps in the institutional framework often hamper effective supervision. The challenges may be even greater for deposit-taking development banks, which in some cases are not subject to prudential supervision, or where supervisors may be constrained in their capacity to conduct onsite inspection and impose corrective actions, sanctions, and enforcement.<sup>1</sup>

All deposit-taking public banks should be subject to prudential supervision, carried out by the bank supervisor. Supervisors should be free from government and industry interference. Legal clarity in supervisory objectives, adequate supervisory powers, and robust accountability and governance frameworks are critical. As with regulation, public banks should be as stringently supervised as private banks engaged in similar activities, with a focus on addressing financial stability concerns.

### A. Institutional Setting

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#### Supervisory Powers and Enforcement Tools

In many countries the legal framework constrains the powers of bank supervisors over public banks. Evidence from IMF assessments of regulatory and supervisory frameworks suggests that supervisory powers related to licensing, fitness and propriety, lending standards, major acquisitions, changes in business operations, capital level, and senior management may be weakened by state ownership. For instance, key personnel or senior managers of public banks may be selected by ministries without supervisory approval or fit and proper assessment. Supervisors also may not be able to effect changes in lending policies needed to ensure safety and soundness, when lending is directed by the government. In some cases, public banks have been used to acquire other failing financial institutions without satisfying the requirements for supervisory approval (Fiechter and Kupiec 2004). Supervisors at times lack the legal powers to remove government-appointed board members or management, force a merger of weak public banks, suspend or revoke licenses, or trigger resolution of public banks, all of which are important supervisory powers for ensuring safety and soundness.

Supervisors should have a full suite of powers and clear legal authority to examine, set and enforce rules, undertake corrective actions, and sanction public banks. To fulfill its safety and soundness objectives, the supervisor should have full discretion to take any supervisory actions or decisions on public banks—even when it goes against the view of the government as shareholder. If bank management ignores its recommendations, the supervisor should be able to sanction these managers and escalate the measures. The range of possible actions should include, among other things, restricting the activities of public banks, suspending dividend payments, requiring fresh capital, restricting certain individuals from management, and replacing or restricting the powers of directors.

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<sup>1</sup> Weaknesses observed include: (1) onsite inspections are performed by the government only to verify compliance with applicable laws and regulations (not safety and soundness); (2) supervisors' inspections require coordination with the state, and the state can set guidelines on the duration and number of onsite activities; (3) inspections can only be carried out at the request of the bank; (4) supervisors have limited capacity to require the bank to reclassify loans as nonperforming; (5) supervisors can only impose corrective actions through the ministry in charge of the specific bank.

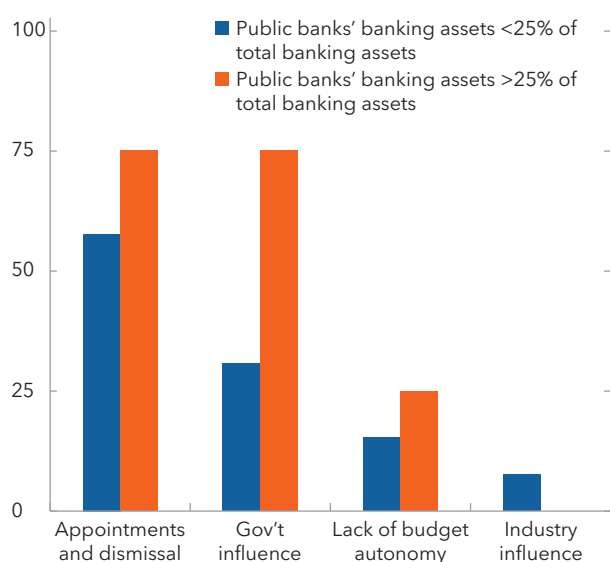


## Independence, Mandate, and Accountability of the Supervisor

Even when supervisors have the necessary legal powers, it may be difficult in practice to take actions against public banks. The presence of government appointed executives and board members may intimidate supervisors and hamper the full exercise of their independent judgment, particularly when issues reflect mismanagement, or a weak board. It could also be difficult for supervisors to require additional capital or adjust asset classification if these actions impact dividends that would be transferred to the state, or the state lacks the fiscal means to inject capital.

Institutional elements that facilitate supervisory actions are often not in place. Unclear mandates, government influence over supervisors,<sup>2</sup> and the absence of a suitable set of powers, are weaknesses found frequently in countries with a large presence of public banks. Assessment of the Basel Core Principles

**Figure 4. Lack of Independence**  
(Percent of BCP-assessed countries)



Source: IMF staff.

conducted by the IMF-World Bank show that in those countries the supervisor often lacks independence, notably with respect to rules governing the appointment and dismissal of the head(s) of the supervisory authority, and government influence over its operations (Figure 4). This suggests that supervisory independence should be strengthened in countries with a substantial presence of public banks.

The institutional framework for supervision of public banks can be strengthened by:

- Separating ownership from supervision. The government's role as an active and informed bank owner is different from the supervisory authority's prudential supervision role. The government monitors the implementation of a public bank's mandate and assesses its performance and governance based on its policy objectives and strategy. In contrast, the financial supervisory authority focuses on the safety and soundness of the bank to protect depositors and

ensure financial stability. Considering their underlying objectives, the shareholder of a public bank should not be the designated as prudential authority—and supervisory authorities (including central banks) should not be owners of banks.<sup>3</sup>

- Ensuring de jure and de facto operational independence of supervisors from government. Governance frameworks and funding mechanisms should not compromise the operational independence of the supervisor. As a general rule, the government should not be represented on the supervisory board of the supervisory agency; if a government representative is in on the board, at minimum he/she should not have voting rights on prudential matters.

<sup>2</sup> Examples of lack of operational independence include that supervisors' decisions can be overturned by other government bodies or the government has legal power to override supervisors' decisions on public banks.

<sup>3</sup> Ownership interests in banks should be the responsibility of the finance ministry (or a specialized agency). As managers of liquidity to the banking system and sometimes as supervisors, central banks have significant conflicts of interest as owners of banks. In addition, provision of capital funds to some banks can easily create conflict with the central bank's primary mandate of preserving price stability. Resolution authorities may temporarily have control of a bridge bank during a resolution process—potential conflicts should be mitigated by the resolution authority itself being sufficiently independent from the supervisor and aiming for a prompt disposal of any bridge bank. See Dobler, Moretti, and Piris (2020).

- Establishing an institutional framework that promotes supervisor's willingness to act. Key institutional elements include clear mandates,<sup>4</sup> operational independence and a transparent system of accountability; legal protection for supervisory actions taken in good faith; and sufficiency of powers, skills, and resources.

## B. Supervisory Tools and Approaches

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Supervisors should apply tools and approaches equally to public and private banks. While the supervisory approach for a public bank should depend upon the activity it undertakes, the objective of public bank supervision—the identification of risks and timely supervisory actions to secure the soundness of the institution and protect depositors—the same as that of private banks.

A forward-looking, risk-based approach to supervision is even more important for public banks given their mixed mandates and potential countercyclical role. Supervisors should have a process to understand the bank's risk profile both at a point in time and on a forward-looking basis. Systemic risk analysis focused on the interconnectedness between public banks and the rest of the financial system should also be conducted regularly to identify risk transmission channels. Banks should be required to include specific risk concentrations in their stress testing programs. Supervisors should ascertain that the stress testing program captures all material sources of risk of public banks and adopt plausible adverse scenarios.

Supervision of public banks should be comprehensive and use an appropriate range of techniques and tools. The intensity and frequency of supervisory activities should be proportionate to each bank's risk profile and significance in the domestic financial system. Onsite inspection of public banks should provide independent verification that governance arrangements, risk management, and internal control systems are adequate. Supervisors should have full powers to access all requested documentation and information. In offsite monitoring, peer comparisons are critical when analyzing financial conditions, business models, and cross-sectoral issues and linkages. For example, when analyzing cost structures, comparative analysis can help identify sources of inefficiency. Similarly, the asset quality of the same borrower can be regularly benchmarked against peers to ensure proper classification and provisioning.

Regular communication between the supervisor and the board of the public bank is key. The supervisor should share supervisory findings (especially weaknesses) and good practice guidance with the bank's board. The board should stay up-to-date on supervisory findings and concerns. This engagement, including individual meetings with independent board members, will help the supervisor assess the quality of the board and senior management, and ensure that all board members are well informed of any matter of supervisory relevance for the public bank.

Coordination with the government as a shareholder is critical to ensure supervisory findings are addressed without delay. The government should be aware of material supervisory findings, concerns, and emerging risks raised during examinations, and work with the supervisor to address them in a timely manner. If a capital injection is needed, a concerted effort should be made by government and the supervisor to effect it.

Public policy mandates of public banks should be explicitly and promptly recorded as expenditures in the government budget.<sup>5</sup> Governments should provide financial support to these banks for the incurred losses associated with the activities undertaken in the pursuit of their public policy objectives. In some cases, ex post compensation (including recapitalization), or ex ante subsidies for activities undertaken at below-market prices, are stipulated in the law or other arrangements. Where such arrangements exist, supervisors

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<sup>4</sup> Bank supervisors should be afforded legal clarity on the first priority of supervisory objectives (safety and soundness of the financial sector).

<sup>5</sup> Governments often provide support to state-owned enterprises (including public banks) to compensate them for pursuing policy goals. This support can be in the form of budget compensation (such as subsidies or capital transfers) but can also include cheap debt and equity financing and a privileged market position (IMF 2020b).

should carefully examine the feasibility and timeliness of potential government support before recognizing them as risk mitigating factors—as there have been numerous cases where the support, albeit needed, has not been forthcoming in a timely manner. The quality of the capital and the Basel III eligibility criteria (if applicable) should be closely examined and observed.<sup>6</sup>

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<sup>6</sup> For instance, if part of the capital component from government is a “contribution in kind,” its fair value should be accurately calculated. See also the discussion on bank recapitalization in Dobler Moretti, and Piris (2020).

## 6. Resolution and Crisis Management

### A. General Principles

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Public banks, like any bank, can face financial distress; when that occurs, problems need to be promptly addressed by the state to meet its responsibility as shareholder and protect financial stability. Public banks generally benefit from strong implicit or explicit government guarantees, which, as for too-big-to-fail private banks, raise questions about how to limit moral hazard and fiscal risks.<sup>1</sup> However, dealing with financial problems in public banks raises specific challenges, due to the state's role as shareholder, the banks' business models, and, as noted earlier, differences in the legal and regulatory frameworks. Different crisis management approaches will be needed for different types of public banks; however, public banks attracting retail funding should be subject to the same framework as privately owned banks.

The bank resolution framework<sup>2</sup> should be available for all banks that could be systemically significant if they were to fail, including those owned by the state.<sup>3</sup> Bank resolution is a process under which the authorities effect an orderly restructuring or winddown of a problem financial institution that has reached, or is likely to reach, the point of non-viability. The objective of the winddown is to protect depositors, preserve financial stability, and minimize losses, and it does this by adopting actions such as taking over management, overriding shareholder rights, transferring assets and liabilities or initiating liquidation proceedings. The process should recognize losses on the bank's balance sheet, with corresponding write-downs in the value of capital and, when losses are large enough, liabilities. Best practice calls for a legal and operational framework that enables resolution before balance sheet insolvency (that is, before the value of assets falls below that of the bank's liabilities) at the point of non-viability.

Public banks which take retail deposits should be subject to the same prudential standards and early intervention regime as private banks. Authorities should utilize an "intervention ladder," moving from supervisory corrective actions to more intrusive crisis management measures on the basis of clear but flexible triggers. Notwithstanding implicit or explicit guarantees that public banks may benefit from, they should still be subject to the same supervisory early intervention powers as private banks. This "level playing field" approach would help reduce distortions in the lending or deposit markets and minimize moral hazard.

Public banks that take retail deposits should also be members of the deposit insurance scheme (DIS), subject to the same coverage level and deposit insurance levies as private banks. Public banks are likely to benefit from a strong implicit state guarantee, even if the bank is not formally a member of the DIS. This ability to offer safe deposits, without paying deposit insurance fees and meeting other requirements of membership, would give public banks who are not DIS members funding cost advantages over private banks. Where public banks are a significant part of the financial system, the financial strength of the DIS and its ability to cover financial losses would be undermined if they are not contributing members. This may also make "flight-to-quality" dynamics more acute in a near-crisis environment, with creditors withdrawing funds from private banks and placing them with public ones—which could precipitate a crisis of confidence in private banks

Recovery and resolution planning should be required (at a minimum) for systemic public banks. The boards and senior management of public banks, acting within a strong corporate governance structure with adequate internal control systems and well-defined division of responsibilities, should have the primary

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<sup>1</sup> See IMF (2016) for a discussion of the scale of fiscal risks from financial sector implicit guarantees.

<sup>2</sup> Dobler, Moretti, and Piris (2020) summarize IMF staff advice on the appropriate tools to manage resolution and restructuring of banks in general.

<sup>3</sup> See also the Financial Stability Board's Key Attributes of Effective Resolution Regimes.

responsibility to plan for how they would deal with financial stress without resorting to support from the government. Proper analysis and assessment of these recovery plans by supervisory authorities, and supervisory oversight to ensure timely implementation of recovery measures, are critical tools to mitigate the risk of bank management “gambling for resurrection.” Planning for early intervention measures by supervisors, for recapitalization, or for resolution actions should be in place in case the management of the public bank fails to take the necessary steps.

Access to central bank emergency liquidity provision should be provided on the same terms as for private banks. Public banks accessing emergency liquidity (as with private banks) should be required to be regulated, demonstrate solvency and long-term viability, develop a funding plan that provides repayment assurances, present appropriately valued collateral with suitable haircuts and be charged adequate pricing to discourage overuse. This approach will help ensure the protection of the central bank balance sheet and minimize incentives for public banks to run excessive liquidity and funding risks.

While it will often be appropriate for the government, acting as shareholder, to provide additional capital to cover losses, this support should carry conditions and not be a blank check. Banking supervisors normally expect that shareholders of any bank take responsibility for reducing or eliminating its weaknesses, including recapitalization and restructuring if needed. Supervisory monitoring and enforcement tools may be used to incentivize this. The state cannot adopt different expectations for its own banks without undermining supervision of all other banks. Creditors of public banks might typically expect that that public banks should not have to be resolved, because the state should take responsibility for weaknesses in its banks, and restructure and recapitalize them as needed before resolution becomes the only option. However, neither private sector shareholders nor the government have unlimited obligations to support banks that they own. Particularly for commercial public banks with no policy mandates that should operate at arm’s length, it may be appropriate for governments to limit their support in case of distress to what a reasonable private investor would provide (see impact on sovereign creditworthiness below).

Any recapitalization should be well-designed and subject to appropriate governance arrangements. Recapitalization strategies should be based on accurate and up-to-date assessments of banks’ soundness and viability. These have been an important feature of crisis management strategies before, during, and after the global financial crisis to gauge the size of capital shortfalls.<sup>4</sup> The origins of the bank’s problems, such as a nonviable business model, need to be identified and corrected, and this diagnosis needs to be supported by credible projections of the bank’s financial performance, plans for business model restructuring, and changes to bank management and governance. The recapitalization should have clear governance and oversight arrangements, be closely scrutinized by the banking supervisor as well as the government ministry or agency acting as shareholder and other relevant ministries and be conducted transparently and promptly. Supervisors should be able to withdraw banking licenses and/or trigger resolution of public banks if recapitalization does not occur.

## B. Common Challenges in Crisis Management for Public Banks

When considering resolution for public banks some specific challenges come into play, especially where losses would be imposed on creditors.

The independence of the resolution authority may be harder to maintain. Sound governance and independence of the public authority responsible for bank resolution is essential. This can be challenging even when dealing with failures of private banks, but pressures on resolution authorities tend to be stronger when the problem lies with public banks. To ensure that the resolution authority is effective in exercising its mandates,

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<sup>4</sup> Dobler, Moretti, and Piris (2020).

where necessary the legal framework should be amended to strengthen its powers over public banks as well as their de jure independence and appropriate accountability mechanisms (for example, to national parliaments).

Resolution of public banks in which losses are allocated to creditors, may impact the sovereign's creditworthiness. The implications of a sovereign-owned financial entity not honoring its liabilities may be legally unclear as it usually depends on the nature of the liabilities (including deposits), the existence of cross-default clauses, and the explicit or implicit nature of the government's guarantee on those liabilities. But even without explicit contractual provisions, perceptions of the sovereign's credit standing may be negatively affected if creditors of state-owned banks do not recover the full value of their claims. This event would increase risk premiums of the debt issued by the sovereign debt and other state-owned entities (including public banks), affect sovereign ratings, and may impair access to international capital markets. These risks are likely to be highest for public banks that are perceived to benefit from strong implicit guarantees. The government's creditworthiness can also be indirectly impacted if the event disrupts financial stability, for example, through contagion to other banks. Some public banks, and specialized financial institutions (Box 3), may rely heavily on wholesale funding from abroad including from international financial institutions. These creditors are often more experienced in dealing with distressed sovereigns and may have specific characteristics (for example, preferred creditor status) that need to be considered.

In a severe financial crisis, the costs for the government of supporting public banks may be so large as to compromise the sustainability of the sovereign debt and the solvency of the government. If the cost of protecting creditors of a public bank is so large as to compromise sovereign debt sustainability, the feedback loop between public banks and sovereign risk will likely be severe. The problems that would have to be addressed in such a case will go beyond the resolution and restructuring of the public bank. Faced with a dual banking and sovereign debt crisis, the authorities may not have the capacity (or political support) to allocate scarce fiscal resources to recapitalize failing public banks and the limited resources will likely be allocated to more pressing areas (for example, income support schemes or social programs). In such circumstances, and to reduce the probability of sovereign default, the creditors of the public bank may have to bear a greater share of losses even if this increases risks to financial stability. In cases where a sovereign debt restructuring is pursued, there will be feedback loops between haircuts on sovereign assets held by the banks, and the losses that may need to be borne by bank shareholder(s) and creditors. In these situations, the authorities will have to weigh carefully the trade-off between bailing-in bank creditors, bailing-in sovereign creditors, and cutting government spending on other items and act accordingly.

Post-resolution ownership and governance may require changes to the public bank's mandate, legal status, and business model. Where existing shareholders, whether state or private, are not prepared to provide the capital needs of a failing bank, bank resolution will normally result in a change in the ownership of the bank or of a large part of its assets and liabilities –depending on the resolution tool used, ownership may be transferred to another bank or to the bank's creditors. The new owners will often be mostly private, meaning that resolution can result in the bank ceasing to be (majority) state-owned. This may require changes to any policy mandates the bank is responsible for, as new private owners may be unwilling to pursue those government objectives. Governments will therefore need to review whether these public policy functions remain essential. If they are, the state should be prepared to explicitly cover their costs or transfer them to another institution. Public banks may also have a specific legal status, which may need to be changed to allow private ownership.<sup>5</sup>

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<sup>5</sup> For example, in 2018 the German public bank HSH Nordbank was converted to a private bank (renamed as Hamburg Commercial Bank in 2019) as part of a restructuring process following public support.

Many public banks have significant pre-existing vulnerabilities that generally limit the recourse to some resolution or restructuring options. Distinguishing features of public banks discussed in earlier sections, such as financially nonviable socioeconomic mandates, elevated NPL levels, or weak governance can impede their restructuring. Moreover, inadequate loss-absorbing capacity may reduce resolvability prospects.

The consequences of restructuring public banks on state-owned enterprises would have to be addressed. As many public banks specialize in financing state-owned firms, governments should develop a comprehensive plan that addresses the financial sustainability of those borrowers and aims to eliminate unfunded demands on the public banks for directed lending, easing of debt service payments, or provision of services. The goal should be for loans to state-owned enterprises to be properly priced, with any elements of subsidy made explicit and provided by the fiscal authorities.

Coordination among different layers of government can be a challenge. Some public banks are owned by regional or local governments that may disagree with national authorities on the appropriate management of a crisis. In-crisis responsibilities should be made clear in advance to avoid deadlock. Different government actors may attempt to pass on the responsibility for costs of recapitalization or disagree on the scale of the needed restructuring. If mechanisms to resolve these disagreements promptly are not effective, this may result in pressure to delay addressing the public banks' problems—for example, by delaying resolution or asking the central bank to extend emergency liquidity beyond what is prudent—resulting in higher overall costs for society.

### Box 3. Considerations for Specialized Financial Institutions

To the extent that specialized financial institutions (SFIs), including development banks, are pure vehicles of public policy and are fully wholesale funded, drawing upon the explicit or implicit guarantee of the state, or via direct government budget transfers, the potential for contagion to other financial entities and increasing financial stability risks may be lower. In such circumstances, the prudential framework becomes less relevant from a financial stability perspective, but rigorous regulation and supervision would still be beneficial for the operation of the SFI and the government budget, by fostering SFIs' health, sound governance and risk management practices, and transparency and accountability in the SFIs' activities. A sound prudential framework becomes necessary if these institutions are systemic in view of their size, type of services provided, and interconnectedness with financial markets.<sup>1</sup>

While practices vary across countries, it is good practice for prudential supervision of SFIs to be carried out by the financial supervisor.<sup>2</sup> In many cases, government ministries do not have the same level of expertise as financial supervisors to properly monitor and assess the risks associated with the financial business of the SFIs. Further, as with public banks, due to conflict of interests, government agencies are likely to delay corrective actions and disclosures when significant problems arise, which may cause large fiscal burden in case of failure and costly corrective action. Overall, the application of the bank regulatory and supervisory framework is likely to result in a stronger SFI sector.

<sup>1</sup> Basel Core Principles, footnote 2 states that in countries where nonbank financial institutions provide deposit and lending services similar to those of banks, many of the principles set out in the document would also be appropriate to such nonbank financial institutions. However, it is also acknowledged that some of these categories of institutions may be regulated differently from banks as long as they do not hold, collectively, a significant proportion of deposits in a financial system.

<sup>2</sup> Examples include German development bank KfW and French Caisse des Dépôts et Consignations. These institutions were put under the direct prudential supervision of the banking regulators (BaFin, ACPR), with their prudential framework to be brought into line with standards. (Source: IMF Staff Country Report No.19/325.)

### Box 3. Considerations for Specialized Financial Institutions *(continued)*

**Corporate governance.** The mandates and operations of SFIs can be particularly challenging from a corporate governance perspective given the multitude of government agencies typically involved (for example, ministries of finance, housing, industry, agriculture). It is important that public officials serving on the board be limited in number, meet the necessary fit and proper criteria, and have the same obligations as other board members. Transparent nomination processes for senior management and board members are also critical.

**Capital.** The absence of deposit funding should not exempt SFIs from a sound capital requirements framework, similar to the one applied to banks, so as to safeguard their financial strength and ensure their financial capacity to carry out operations in accordance with their mandate. For instance, China Development Bank is one of the largest 10 banks in China and does not offer retail deposits; yet it has been subject to the same capital adequacy rules as commercial banks since 2018. Similarly, the capital adequacy regime set forth in the European Union Capital Requirements Regulation (part 2 titles I through III and part 3 titles I through VI) has become applicable by analogy to German development bank KfW since early-2016 (by regulation adopted in 2013).

**Liquidity.** The funding profiles of SFIs often consist of long duration investments, with few short-term liabilities. These characteristics may make the LCR and NSFR less binding. Even so, as noted previously other sources of liquidity risk exist, such as concentration of funding, maturity mismatches, and currency mismatches. Adequate supervisory monitoring tools and regulations that require SFIs to build sound liquidity risk management policies and processes therefore remain important.

**Large exposures.** SFIs focused mandates may be incompatible with the BCBS large exposures limit—as concentration risks may be inherent to their business models—requiring alternative prudential approaches. In such cases, close supervisory monitoring, enforcement of sound risk management practices, and proper account of risks in the capital requirements framework become even more important. In particular, regulations should explicitly ensure that SFIs' policies and processes require all material concentrations to be regularly reviewed and reported to the board. Country regulatory practices reflect the challenges posed by different mandates and business models.

The German development bank KfW and most African development banks are compliant with the large exposures framework (ADB 2013). Turkey's non-deposit-taking development banks are not subject to large exposures limits, but concentration risk management guidelines apply. Brazil's systemic development bank, BNDES, is in a transition regime that exempts certain exposures from the large exposures limits until 2027.

**Supervisory approach.** Supervisory tools may need to be adjusted to reflect SFIs' specific characteristics, including the applicable methodologies, supervisory focus, and key risk indicators used for risk assessment and ratings of banks. Examples include the following:

- SFIs have different funding structures from commercial banks, relying heavily on long term bond issuance (in local or foreign currencies) and interbank funding. Supervisors should therefore focus their liquidity analysis on bond issuance planning and rollover risk. For agricultural development banks that provide seasonal financing to farmers, short-term liquidity management is particularly important. In the case of export-import banks (that is, government-backed export credit agencies),



### Box 3. Considerations for Specialized Financial Institutions *(continued)*

foreign exchange liquidity risk management and foreign currency bond issuance should be a focus of supervision.<sup>3</sup> Different liquidity risk metrics or thresholds in the supervisory risk assessment methodology could be applied based on the specific funding model.

- The profitability-related component of the supervisory rating framework may be given lower priority in the case of SFIs.<sup>4</sup> Supervisors use selected indicators (for example, return on assets, net interest margin, net operating income) to assess the adequacy of earnings and gauge the institution's capacity to maintain sound profitability. At the same time, profit maximization is typically not a goal of SFIs, beyond what is necessary to cover expenses and credit losses; as such, it is to be expected that the profitability of SFIs is lower than for commercial banks. The risk matrix and assessment thresholds may be adjusted down to reflect expectations on profitability and earning power.

**Crisis management:** the lack of deposit funding and specialized business models of SFIs implies that specific features of bank resolution regimes will typically be less relevant. Distressed SFIs should, however, still be dealt with promptly, identifying and allocating losses where necessary and developing a plan to restore long-term viability, to prevent further deterioration of their financial condition.

<sup>3</sup> In some countries, export-import banks are not subject to the LCR standard (Japan, United Kingdom, United States).

<sup>4</sup> Compared to profitability assessment, supervisors may put more weight in assessing portfolio quality, loan loss provisioning, risk concentrations, capital adequacy, funding structure/cost and liquidity position, foreign exchange exposures, etc.

## 7. Conclusions

While public banks may play an important role in mitigating some market failures and broadening access to finance, their ownership structure, mandate, and other specific characteristics can create unique risks to financial stability and public finances. Public banks are frequently subject to political interference, particularly in countries with weak governance, which typically results in dubious lending practices, weak balance sheets and numerous market inefficiencies. Historically, public banks have underperformed private banks in standard bank performance metrics. Policy goals present in most public banks' mandates may conflict with long-term financial viability and facilitate undue interference in their decision-making process. Market distortions and the potential to induce sovereign distress in case of failure or substantial losses are other important consequences.

Effective governance, regulation, and supervision are necessary to ensure that public banks are safe and sound while achieving their public policy objectives. Areas where gaps are typically large and where reform efforts are most needed: (1) giving public banks clear and well-defined mandates; (2) adopting best practices in corporate governance and risk management; (3) providing supervisors with clear mandates, operational independence, and a transparent system of accountability and legal protection for supervisory actions on public banks; (4) enabling full supervisory powers over public banks; (5) adapting and aligning regulation and supervisory tools with risk profiles; (6) implementing safeguards against political intervention (including ownership policy); and (7) reducing market distortions to create a level playing field for public and private banks.

Countries where public banks have an important presence in the banking system should step up efforts to close gaps in their regulatory and supervisory frameworks. The COVID-19 pandemic will significantly stress asset quality and profitability of banks, especially public banks that actively expanded credits to hard-hit sectors, over the next few years, and require supervisors to demonstrate a more proactive stance. Supervision and regulation should have an increased focus on financial stability, governance structure, transparency, and the appropriateness of mandate and powers to supervise the sustainability and suitability of public bank operations.

Authorities should give priority to fix public banks with impaired balance sheets, as delaying remedial actions would only aggravate the banks' position and the market distortions. Public banks should be given the same access to financial support or guarantees from the government, central bank, or deposit insurance system as private banks and should not be subject to a preferential treatment. Any state recapitalization should be transparent and based on credible asset valuations and business plans to minimize risks to taxpayers. Resolution planning and tools, widely adopted since the global financial crisis, should also be made available for all public banks whose failure could have systemic implications—notably those attracting retail deposits. Strong legal regimes and independent resolution authorities are critically important to ensure that problems are not allowed to linger.

## Annex 1. Econometric Analysis

The authors investigate whether compliance with some Basel Core Principles correlates with the government share of bank ownership. To do this the authors estimate the following linear regression equation using OLS:

$$Z_{ij} = \beta_0 + \beta_1 X_{1j} + \beta_2 X_{2ij} + \beta_3 X_{3j} + \varepsilon_{ij},$$

Where  $i$  indicates a bank and  $j$  indicates a country:

$Z_{ij}$  = state-controlled share of a bank<sup>1</sup>

$X_{1j}$  = compliance score on a specific Basel core principle in country  $j$

$X_{2ij}$  = vector of bank characteristics (see below for a list of bank-level controls)

$X_{3j}$  = vector of country characteristics (see below for a list of country-level controls)

Main explanatory variable of interest ( $X_{1j}$ )

BCP compliance grade on 1-4 scale (where Non-Compliant /NC/=1, Materially Non-Compliant /MNC/=2, Largely Compliant /LC/=3, Compliant /C/=4).

Controls ( $X_{2ij}$  and  $X_{3j}$ )

- *bank level* ( $X_{2ij}$ ): bank size (total assets), capitalization (equity ratio), profitability (return on assets - ROA), cost efficiency (overhead costs to total assets), liquidity (liquid assets to total assets).
- *country level* ( $X_{3j}$ ): country size (GDP), development level (GDP per Capita and GDP per Capita Growth), inflation, rule of law (World Bank's WGI database).

This econometric analysis focuses on two Core Principles (CPs)—CPs 2 and 14—that are particularly informative about the institutional set up and independence for supervision and governance of banks and, therefore, build the foundation for compliance with other CPs. Importantly, these CPs also have sufficiently high variation in grades in the regression sample of banks to enable meaningful econometric testing.

### Data

For the estimation the authors use data from the IMF *Standards and Codes Database* on Basel Core Principles assessments between 2013 and 2017; internationally standardized data on bank financial indicators from Fitch Connect and macroeconomic data from the IMF *World Economic Outlook* and World Government Indicators. The sample is restricted to commercial, savings and development banks (the authors also perform a robustness check dropping development banks and the results do not change significantly). The resulting sample used in the regression comprises 1,356 banks from 39 countries (see Annex Table 1.1).

To alleviate concerns of the sample being unevenly distributed across countries, the authors perform a robustness check where they drop the US banks, which account for 47 percent of the sample. In doing so, the direction and the strength of the relationship remain the same.

<sup>1</sup> Data come from Fitch Connect as a "snapshot" variable indicating the state-controlled share of bank ownership as of June 2018. Notably, although public bank ownership is a dependent variable, it is not an outcome of interest interpreted normatively within the scope of this correlation model.

**Annex Table 1.1. Country Sample—Number of Banks per Country**

Country Name	Freq.	Percent
Albania	2	0.15
Armenia	6	0.44
Australia	2	0.15
Austria	11	0.81
Azerbaijan	7	0.52
Bahrain	6	0.44
Brazil	48	3.54
Bulgaria	3	0.22
Canada	14	1.03
China	40	2.95
Denmark	5	0.37
Georgia	6	0.44
Germany	43	3.17
Guatemala	4	0.29
Hong Kong SAR, China	15	1.11
Iceland	2	0.15
India	57	4.27
Ireland	7	0.52
Italy	15	1.11
Japan	34	2.51
Kazakhstan	14	1.03
Korea	23	1.69
Moldova	3	0.22
Namibia	3	0.22
Nepal	4	0.29
New Zealand	11	0.81
North Macedonia	1	0.07
Norway	21	1.55
Peru	16	1.18
Poland	4	0.29
Romania	4	0.29

**Annex Table 1.1. Country Sample—Number of Banks per Country** *(continued)*

Country Name	Freq.	Percent
Russian Federation	31	2.28
Singapore	3	0.22
South Africa	11	0.81
Switzerland	136	10.02
Tanzania	4	0.29
Turkey	40	2.95
United Kingdom	59	4.35
United States	641	47.24
Total	1,357	100.00

Source: Fitch Connect; and IMF staff estimates.

## Interpretation of Results

The estimated coefficients are taken to represent correlations between the dependent variable and our main explanatory variable of interest, rather than necessarily a causal relationship. Although the authors control for a rich set of covariates, endogeneity issues may still arise, including omitted variable bias from factors the authors could not control for (or do so fully), and reverse causality.<sup>2</sup>

Annex Table 1.3 presents the regression results. The results suggest that there is an association between the rating of compliance on CP14 (corporate governance) and the share of state ownership in a bank. Higher compliance ratings tend to be associated with lower levels of state ownership in banks. This result is statistically significant and robust. The results for CP2<sup>3</sup> point in the same direction but are not statistically significant.

<sup>2</sup> The results of the Breusch-Pagan test along with the residuals plot indicate that heteroscedasticity may be present in the model, so the authors employ a Weighted Least Squares (WLS) model as a robustness check with bank's total assets as weights. The results of the WLS specification are presented alongside the OLS result. Similarly, the authors test whether the results are robust at country-level using average state-owned share per country as the response variable. Recognizing the small sample limitations and the inability to control for bank-level variation, the authors observe that the results for CP2 and CP14 still trend in the same direction despite losing statistical significance.

<sup>3</sup> CP2 covers diverse criteria including independence, accountability, resourcing, and legal protection of supervisors. Operational independence in countries with high public bank presence is typically weak, but the grading could be watered down due to other criteria.

**Annex Table 1.2. Descriptive Statistics of Sample**

	Observations	Mean	Median	Min	Max	Std. dev.
<b>BANK LEVEL</b>						
Share of state ownership	1,298	7.42	0	0	100	23.43
Bank size (millions of US dollars)	1,356	43,160	1,730	5.68	4,309,000	241,200
Equity to total assets	1,356	12.34	10.68	0	98.63	10.52
Return on assets	1,356	.01	0.01	0	.72	.03
Overhead costs to total assets	1,356	.03	0.02	0	.80	.04
Liquid assets to total assets (percent)	1,356	14.46	9.56	0	99.92	16.58
<b>COUNTRY LEVEL</b>						
GDP (millions of US dollars)	39	11,350,000	14,300,000	11,970	21,430,000	9,837,000
GDP per capita (US dollars)	39	50,001.64	65297.52	1,071.05	81,993.73	25,714.92
GDP growth	39	2.05	2.16	-1.25	7.60	1.31
Inflation rate	39	2.48	1.81	0.36	15.18	2.69
Rule of law index	39	1.13	1.46	-1.05	1.99	.80
CP 2 compliance	39	3.15	3	2	4	.89
CP 14 compliance	39	2.96	3	2	4	.38

Sources: Fitch Connect; World Bank DataBank; and IMF staff analysis.

**Annex Table 1.3. Regression Estimation Results**

<b>CP 2 (Independence, Accountability, Resourcing and Legal Protection for Supervisors)</b>		
	OLS	WLS
Compliance with CP 2	-2.913 (1.805)	-11.54*** (2.746)
Adjusted $R^2$	0.2050	0.4634
<b>CP 14 (Corporate Governance in Banks)</b>		
	OLS	WLS
Compliance with CP 14	-8.294*** (2.138)	-22.23*** (2.459)
Adjusted $R^2$	0.2127	0.4889
Observations	1,280	
Standard errors in parentheses	* $p < 0.10$ , ** $p < 0.05$ , *** $p < 0.01$	

Sources: Fitch Connect; and IMF staff analysis.

Note: Dependent variable is state share of a bank ownership. The additional controls for bank characteristics include:  $\ln$  [Total Assets], equity ratio, Return on Assets, overhead costs to total assets, liquid assets to total assets. The controls for country characteristics include: GDP, GDP per capita, GDP growth, inflation, rule of law.

## Annex 2. Good Practices for Board Independence and Effectiveness

### Appointment and Dismissal of CEO and the Board Members<sup>1</sup>

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The process to nominate senior management and board members of financial institutions should be well-established, transparent, and merit-based. The selection decision on senior managers and board members should be based on their professional and technical backgrounds. The Basel Committee on Banking Supervision principles stress the need for board members to collectively possess knowledge in capital markets, financial analysis, information technology, strategic planning, risk management, regulation, corporate governance, and management skills.

Special care is needed when the government appoints the CEO and board members. Such arrangements are typically articulated in law. The Ministry of Finance often plays an active role in choosing senior managers and board members of public banks, and former or current government officials are often selected. Government officials are typically seen as having a disproportionate influence in board discussions, not least because the renewal of appointment of other board members may depend on the views of government. A cooling-off period for senior supervisory staff members looking to join banks that they have previously supervised should be applied regardless of bank type (public or private).

Boards should have the authority to appoint and dismiss the CEO and senior management. It is difficult for a board to fully exercise their monitoring function and assume responsibility for public banks' performance without this authority. In some cases, this might be done in concurrence or consultation with the government. In cases where the government appoints a CEO directly, at a minimum the board should be consulted before the appointment is made to ensure that the integrity of the board is maintained and the views of the board on the adequate profile and skill set are considered. In addition, to empower the board to take more responsibility for the operations of public banks, it is important that senior staff promotions be decided without interference from the government.

Setting up nomination committees comprised of individuals from outside of government strengthens the nomination process. Commissions with recommendation powers could be established to foster the independence and professionalism of public bank boards and senior management. Proposed nominations should be disclosed in advance of the general shareholders meeting, with adequate information about the professional background and expertise of the respective candidates (see Box 2 for the case of Ukraine).

Board members in public banks should be appointed for a fixed term and the terms of individual members should be staggered. Fixed terms of no less than three years allow board members to vote at board meetings in a manner that is independent of the views of the shareholder (as opposed to a situation where board members can be removed by the government at any time). This prevents frequent/rapid turnover of board members and allows bank boards to develop and implement long-term strategies. Staggered contracts allow the institutional memory of the board to be maintained and give continuity to the public banks.

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<sup>1</sup> Sources: OECD (2015), BCBS (2015).

## Board Composition and Dynamics

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To enhance the objectivity of public bank boards, it is important to have a minimum number of independent board members. The board should have a variety of skills, competencies, and experiences. Public officials should only be elected to these banks' boards if they meet the required competency level for all board members and if they do not act as a conduit for political influence that extends beyond the ownership role.

Public banks' boards should consider setting up specialized committees, composed of independent and qualified members in line with Organisation for Economic Co-operation and Development guidance. Specialized board committees, especially in large public banks, are needed particularly in the areas of audit, remuneration, and risk. The board should also proactively appoint nongovernment and independent members to key functions. A strong and independent Risk Management Committee is necessary to reduce concerns over the bank's long-term business strategy, risk exposures, and the bank's ability to manage risks effectively. The remuneration of public banks' personnel should be in line with market conditions and be exempt from government personnel pay scale to attract qualified personnel.

Separation of the board chairperson from the CEO could be particularly important in public banks, where the balance of powers and independence is crucial. Separation of the two roles reinforces the board's ability to make objective decisions without undue influence from management. Further, the head of the management board (where applicable) should not become the chair of the supervisory board upon retirement.

The accountability of the public bank's board to the government should be based on a clear and objective assessment framework. The board should develop performance indicators to measure the accomplishment of policy objectives and the financial soundness of the public bank. The board should incorporate financial sustainability in their mandate. Necessary safeguards should be established to prevent the use of the accountability framework to pressure the board to endorse politically motivated decisions. Commissioning the assessment task to an independent external group of experts would be desirable.



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