Scaling Up Finance for Sustainable Development

Kavaljit Singh

SCALING UP FINANCE FOR SUSTAINABLE DEVELOPMENT

Reshaping the Role of Development Banks and State-Owned Financial Institutions in the New Millennium

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Research Report

September 2018

Published by:

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Photos courtesy of Bru-nO (Pixabay); Adele Payman and Eduardo Prim (Unsplash).

Designed by KS Designers, New Delhi.

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ACRONYMS

AIIB	Asian Infrastructure Investment Bank
BBB	British Business Bank
BNDES	Banco Nacional de Desenvolvimento Econômico e Social
BPI	Banque Publique d'investissement
BRICS	Brazil, Russia, India, China, and South Africa
CAR	Capital Adequacy Ratio
CRAR	Capital to Risk Weighted Assets Ratio
DAC	Development Assistance Committee (OECD)
DB	Development Bank
DEA	Data Envelopment Analysis
DFI	Development Financial Institution
EC	European Commission
ESG	Environmental, Social and Governance
EU	European Union
FDI	Foreign Direct Investment
FI	Financial Institution
GDP	Gross Domestic Product
ICICI	Industrial Credit and Investment Corporation of India
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India
IFD	Instituição Financeira de Desenvolvimento
KfW	Kreditanstalt für Wiederaufbfau
MDGs	Millennium Development Goals
NDB	New Development Bank
NGOs	Non-Governmental Organizations
NIM	Net Interest Margin
NPAs	Non-Performing Assets
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PSB	Public Sector Bank
RBI	Reserve Bank of India
RoA	Return on Assets
RoE	Return on Equity
SBCI	Strategic Banking Corporation of Ireland
SCB	State-owned Commercial Bank
SDGs	Sustainable Development Goals
SIFIs	Systemically Important Financial Institutions
SME	Small and Medium Enterprise
TBTF	Too-Big-To-Fail
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development

DATA NOTES

Dollars are US dollars unless otherwise specified.

Rs. = Indian Rupees.

1 US$ = Rs.70 (as on August 30, 2018).

Introduction

Many economists consider the global financial crisis (GFC) that erupted in the United States in 2007-08 as the worst financial crisis since the Great Depression of the 1930s. The crisis initially began in the subprime mortgage markets in the US but soon grew into a full-blown global financial crisis as financial shocks were transmitted globally due to the financial interconnectedness. The distressed banking system caused significant damage to the real economy.

The global financial crisis has critically exposed the vulnerabilities of a liberalized, privately focused financial system. In a bank-based financial system, banks are the key financial intermediaries as they allocate funds from savers to borrowers. A sound, well-regulated banking system is a *sine qua non* for macroeconomic stability and sustained economic development.

As governments around the world pledged trillions of dollars in loans, guarantees, capital injections, and other forms of assistance to rescue some of the world's biggest banks and financial institutions facing an imminent collapse, the financial crisis has reignited an intense debate on the ownership structures of the banking sector and the desirability of direct state interventions in the financial sector.

In many meaningful ways, the global financial crisis has challenged conventional thinking on state ownership of financial institutions and forced policymakers to reconsider the role of the state in the financial sector, especially state ownership of banks and other forms of financial institutions.

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Besides, the adoption of the United Nation's Sustainable Development Goals (SDGs) in 2015 has given new impetus to governments' efforts to channelize financial resources towards the implementation of the 17 goals of the 2030 Agenda for Sustainable Development. The development banks (DBs) and development finance institutions (DFIs) can significantly contribute directly and indirectly to the achievement of the SDGs at national, regional and international levels.

In sum, both these recent developments have opened up enormous opportunities to explore the potential role of state-owned financial institutions as a catalyst in achieving truly sustainable development in the coming decades.

Massive Direct State Interventions during the Global Financial Crisis

To contain the contagion effects that could seriously impair the financial stability, governments across the world intervened in the financial system by providing support with an unprecedented range of measures including bailouts, nationalization of distressed financial institutions, mergers, and recapitalization. The overall objective of massive state intervention was to avoid widespread bankruptcies in the financial sector and to restore financial stability.

Under bank bailout programs, large amounts of public money and other forms of support were made available to big banks and financial institutions to contain the financial panic during the crisis. Some of the common elements in such state-led bailout programs included: large-scale direct equity injections in banks and financial institutions; purchase of distressed ('toxic') assets by the governments; and issuance of blanket guarantees to a broad range of funding instruments including bank debt. An enormous amount of taxpayers' money was put at risk by these measures. Besides, governments also launched large fiscal stimulus packages to boost aggregate domestic demand.

During the financial restructuring, the governments incurred substantial fiscal costs that were ultimately borne by taxpayers. It has been estimated that the amount of support to the systemically important financial institutions (SIFIs) was close to 25 percent of the world's GDP in November 2009.[1] In some countries, government finances came under severe pressure due to the financial support given to banks. In the case of Iceland and Ireland, a crisis that originated as a banking crisis became a sovereign debt crisis.

The Financial Stability Report (June 2009) of the Bank of England noted: "In the highly unlikely event that all the facilities offered by central banks and governments were fully called upon, the scale of support to banking systems in the United Kingdom, the United States, and euro area would exceed US$14 trillion. This is equivalent to around 50 percent of these countries' annual GDP."[2]

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The following two tables show the extent of massive direct state interventions in the banking systems of the US and Europe, not seen for several decades before the 2008 financial crisis. For instance, American International Group (AIG) was offered $180 billion by the US government to prevent it from collapsing while Fannie Mae and Freddie Mac were essentially nationalized in September 2008. In the UK, five banks – Bradford & Bingley, HBOS, Lloyds TSB, Northern Rock, and Royal Bank of Scotland, were placed under partly or wholly public ownership in 2008.

1. Alessandri, P. and Haldane, A. G. (2009), "Banking on the State," based on a presentation at the Federal Reserve Bank of Chicago 12th Annual International Banking Conference, "The International Financial Crisis: Have the Rules of Finance Changed?," Chicago, September 25, 2009. Available at: https://www.bis.org/review/r091111e.pdf.
2. Bank of England (2009), *Financial Stability Report*, Issue 25, June 2009, London: Bank of England, p. 21.

Table I provides the list of selected international banks and other financial firms that were nationalized or received direct support from a government or central bank.

Table 2 summarizes the scale of state aid measures in the banking sector at the EU 27 level between 2008 and October 2011.

Table 1: List of Banks and Financial Institutions Receiving Direct State Support during 2008-12

Announcement date	Acquired company	Acquirer	Value*
September 7, 2008	Fannie Mae and Freddie Mac	Federal Housing Finance Agency	$200,000,000,000
September 16, 2008	American International Group, New York City	United States federal government	$182,000,000,000
October 17, 2008	UBS	Swiss National Bank and the Federal administration of Switzerland	$59,200,000,000
October 31, 2011	MF Global	US Securities and Exchange Commission	$43,000,000,000
September 18, 2008	HBOS	Lloyds TSB	$21,850,000,000
October 13, 2008	Royal Bank of Scotland Group (up to 81.14% Bought)	Government of the United Kingdom	£20,000,000,000
May 25, 2012	Bankia	Government of Spain	€19,000,000,000
October 13, 2008	HBOS (up to 43.5% Bought)	Government of the United Kingdom	£13,000,000,000
September 28, 2008	Fortis	Government of the Netherlands (Dutch assets including ABN AMRO) BNP Paribas (Belgian and Luxembourg assets)	€11,200,000,000
November 2, 2008	Banco Português de Negócios	Government of Portugal	€6,305,000,000
October 13, 2008	Lloyds TSB (up to 43.5% Bought)	Government of the United Kingdom	£4,000,000,000
February 3, 2009	BTA Bank	Government of Kazakhstan	$2,100,000,000
August 26, 2008	Roskilde Bank	Danish Central Bank	$896,800,000
September 28, 2008	Bradford & Bingley	Government of the United Kingdom	£612,000,000

*USD ($), EURO (€), and GBP (£).

Table 2: Approved Amounts of State Aid for EU Banking Sector (2008- 2011)

	Guarantees	Liquidity measures	Recapitalisation	Impaired assets	Total	
Years	€ billion	€ billion	€ billion	€ billion	€ billion	% of GDP
2008	3097	85	270	5	3457	27.7
2009	88	5	110	339	542	4.6
2010	55	67	184	78	384	3.1
2011	49	40	34	0	123	1
2008-11	3290	198	598	421	4506	36.7

Source: High-level Expert Group on Reforming the Structure of the EU Banking Sector, Final Report, October 2, 2012, p. 21.

The national parliaments of the EU member-states committed in total to €4.5 trillion of state aid measures, and the bulk was in the form of guarantees on bank liabilities. The total approved State aid amounts were 36.7 percent of EU GDP. The actually used measures were €1.6 trillion (13 percent) of EU GDP during October 2008 and end 2010. Out of which, €409 billion were used for recapitalizations and asset relief measures while the rest €1.2 trillion for guarantees and other liquidity measures. This is not an insignificant amount of money by any means.

It has been observed that the bulk of approved and effectively used state aid amounts were related to guarantees in the EU whereas in the case of the US, the Troubled Asset Relief Program (TARP) primarily comprised of direct equity injections and distressed asset purchases. The TARP is the largest government bailout program in the US history.

In its final report (October 2012), the High-level Expert Group on Reforming the Structure of the EU Banking Sector[3] noted: "Even where banks did not receive any explicit state aid or liquidity support, they (or their creditors) may have benefited from significant implicit subsidies. While bank equity holdings have been severely diluted, bank debt holders of many failed (and non-failed) banks did not face any losses. To the extent that banks and creditors did not pay for this guarantee, it can be considered an implicit subsidy for banks that are "too systemic to fail.""[4]

Between 2007 and 2010, the UK Treasury also made a series of interventions to support the ailing banks (notably the Royal Bank of Scotland, Lloyds Banking Group, Northern Rock and Bradford & Bingley) with policy objectives to maintain liquidity, to protect retail depositors, and to encourage banks to lend to creditworthy borrowers. According to the National Audit Office of the UK, the total outstanding support provided by the UK government to the banks in the form of cash and guarantees peaked at £1.162 trillion.[5]

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Similarly, governments in other countries – from Japan to Russia to UAE – also offered a variety of support packages to their distressed banks and other financial firms as per their national institutional contexts.

It should be emphasized here that several non-viable big banks and financial firms in the US and Europe would have simply disappeared if they had not received such massive support from the state authorities.

Business as Usual

The overarching objectives of massive direct state interventions in the banking system were to safeguard financial stability and to encourage banks to continue lending during the crisis. Hence, several legitimate policy concerns related to substantial fiscal costs, moral hazard (encouraging excessive risk-taking by bankers as they would assume that taxpayers would pay significant losses in the future), creating an uneven playing field and distorting market incentives were overlooked by policymakers.

After acquiring stakes in ailing banks, most governments did little to use their influence as majority shareholders to introduce fundamental changes

3. In February 2012, the High-level Expert Group on Reforming the Structure of the EU Banking Sector, chaired by Erkki Liikanen (the Governor of the Central Bank of Finland), was set up by European Commission with a mandate to consider whether there is a need for structural reforms of the EU banking sector or not and to make proposals for establishing a safe, stable and efficient banking system serving the needs of citizens, the EU economy, and the internal market.

4. High-level Expert Group on Reforming the Structure of the EU Banking Sector (2012), Final Report, October 2, 2012, Brussels, p. 22. Available at: http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

5. National Audit Office (2011), The Comptroller and Auditor General's Report on Accounts to the House of Commons, July 13, 2011, London, p. 4. Available at: https://www.nao.org.uk/wp-content/uploads/2011/07/HMT_account_2010_2011.pdf.

in the way the banks did business. The public money handed over to big private banks was not fully leveraged to yield better policy outcomes such as forcing banks to change their risky business models or breaking up systemically important financial firms – also known as "Too-Big-To-Fail" (TBTF) institutions – into smaller, simpler entities that are easier to regulate and supervise. Needless to say, many banks are now bigger than they were in 2008, even after adjusting for inflation.

Further, in many instances, bailout measures were not accompanied by a restructuring of the organization or imposing strict restrictions on dividend payments and executive compensations. For instance, close to 5000 traders and bankers belonging to nine financial firms (including Goldman Sachs, Morgan Stanley, Citigroup and Bank of America) were awarded bonuses of more than $1 million each in 2008. The nine financial firms paid $32 billion in bonuses in 2008 while receiving $175 billion in federal bailout money under the TARP during the same year.[6]

However, once the market confidence in the banking sector was restored with taxpayers' money, governments began the process of reprivatization of banks and financial institutions by selling off their stakes to private investors. In some instances, governments also made a profit on the sale of their shares to private owners. The reprivatization of Lloyds Banking Group (UK) is a case in point (see Box 1).

Box 1

The Reprivatization of Lloyds

- September 2008: Lloyds TSB acquires HBOS for £12 bn, creating the Lloyds Banking Group.
- October 2008: Government announces £20.3 bn taxpayer-backed bailout of Lloyds, increasing the public ownership stakes in the bank to 43 percent.
- September 2013: The UK government initiates the first step to returning the bailed-out bank to the private sector by selling about 6% of its shares in Lloyds Banking Group.
- May 2017: The UK government sells remaining shares, returning Lloyds to full private ownership.

The public money handed over to big private banks was not fully leveraged to yield better policy outcomes such as forcing banks to change their risky business models or breaking up systemically important financial firms into smaller, simpler entities that are easier to regulate and supervise.

By and large, the state ownership in distressed banks and financial institutions was temporary, short-term in orientation, poorly coordinated, and narrowly aimed at cleaning up their balance sheets. The public ownership was not conceived to formulate and implement relatively coherent long-term policies towards rebuilding a healthy banking system that can ensure financial stability as well as accomplish broader economic and development objectives.

6. Freifeld, Karen (2009), Banks Paid $32.6 Billion in Bonuses Amid US Bailout, 30 July 2009, Bloomberg. Available at: https://www.sanders.senate.gov/newsroom/must-read/banks-paid-326-billion-in-bonuses-amid-us-bailout-bloomberg.

Types of State-owned Financial Institutions

State-owned financial institutions refer to a broad range of publicly-owned financial institutions, including state-owned banks, leasing firms, credit guarantee funds and insurance companies.

State-owned banks can be broadly classified into three types of financial institutions – state-owned commercial banks (SCBs), state-owned development banks (DBs), and development financial institutions (DFIs).

The SCBs conduct business activities similar to private commercial banks. They raise deposits from the general public and lend money to the businesses and individuals. Many SCBs also have explicit policy mandates. The Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), and the China Construction Bank (CCB) are prime examples of the SCBs.

On the other hand, the DBs and DFIs have an explicit public policy mandate. Some DBs take deposits from the general public. Some prominent examples of DBs and DFIs are KfW of Germany, BNDES of Brazil, IFCI of India, and the China Development Bank (CDB). Some DBs and DFIs lend directly to the public while others lend indirectly through banks and other financial intermediaries.

It is important to point out here that all state-owned banks, development banks, and DFIs are not centrally-owned. A large number of regionally and locally-owned such institutions exist throughout the world, even though they may be smaller in asset size.

State Ownership of Banks: Not a New Phenomenon

In the post-World War II period, state-ownership of banking witnessed a rapid expansion in many European countries which established such institutions for a variety of reasons, ranging from delivering essential banking services to financing infrastructure.

State ownership of banks and other kinds of financial institutions is not a new phenomenon. In the post-World War II period, state-ownership of banking witnessed a rapid expansion in many European countries which established such institutions for a variety of reasons, ranging from delivering essential banking services to financing infrastructure. The state ownership of the banking system was as high as 75 percent in Italy in the early 1970s.

During the 1960s and 70s, a large number of countries from Asia, Africa, and Latin America nationalized their existing private banks and started new banks under full or substantial state ownership to achieve broader social and economic objectives. In diverse countries such as South Korea, India, Algeria, Egypt, and Tanzania, bank nationalization became the primary policy instrument to overcome the limitations of private banking and to pursue national developmental goals in the 1960s. It has been estimated that the state owned 40 percent of the assets of the largest banks in developed economies and 65 percent of the assets of the largest banks in developing economies by the 1970s (Yeyati et al., 2007).

However, bank ownership structures underwent a profound transformation with the implementation of structural adjustment programs and other market-led reforms from the 1980s onwards up to the global financial crisis. In

7. World Bank (2012, p. 103).

particular, the IMF pushed for privatization of state-owned banks as a part of loan conditionalities imposed on borrowing countries.

With an emphasis on privatization, deregulation and financial globalization, banking sector reforms resulted in a sizeable decline in the market share of state-owned commercial banks over time across most regions. Some development banks and DFIs disappeared altogether while others were converted into full-fledged commercial banks. In the case of emerging economies, the share of state-owned banks relative to the total assets of the banking system declined sharply from 67 percent in 1970 to 22 percent in 2009.[7] In particular, a dramatic decline in government participation in the banking sector was witnessed in transition economies (Eastern Europe and Central Asian region) when these economies moved away from centrally planned economic systems to market-based systems.

Despite a global decline since the 1990s, the presence of state-owned commercial banks, development banks and other forms of development finance institutions (DFIs) is still substantial in some countries. There are big developing economies like China, India, and Brazil, where such institutions continue to play a dominant role in the financial intermediation. In India, the state-owned commercial banks currently control 73 percent of total banking system despite frequent calls for their full privatization. The market share of state-owned banks is close to 50 percent of total assets in Brazil.

The state-owned commercial banks in China overwhelmingly dominate the country's banking system. The five largest banks in China are majority-owned by the government, and they together account for around one-half of the Chinese banking system assets and deposits. While foreign-owned banks only account for 2 percent of total assets in China. According to Top 1000 World Banks 2017 ranking released by The Banker, a UK-based magazine, four Chinese banks are listed in top 10 for tier 1 capital with the Industrial and Commercial Bank of China is the largest bank in the world in 2017.[8]

Some cross-country studies indicate that greater state ownership of banks is associated with lower levels of financial development, less saving and borrowing, lower efficiency levels, greater financial instability, and slower growth (Barth et al., 2000; La Porta et al., 2002). The World Bank also supported the view that state ownership of banks is not beneficial for economic development in its policy research report titled, Finance for Growth, which concluded: "Whatever its original objectives, state ownership of banks tends to stunt financial sector development, thereby contributing to slower growth."[9] However, Germany's continuing strong economic performance along with a relatively stable banking system despite having substantial state ownership of banks casts doubt on the notion that greater state ownership of banks is associated with poor economic performance and financial instability. There is little evidence to suggest that privately owned banks in Germany are more efficient than savings and cooperative banks (Altunbas et al., 2001).

Germany's continuing strong economic performance along with a relatively stable banking system despite having substantial state ownership of banks casts doubt on the notion that greater state ownership of banks is associated with poor economic performance and financial instability.

8. Danielle Myles (2017), Top 1000 World Banks 2017, The Banker, July 3, 2017. Available at: http://www.thebanker.com/Top-1000.

9. Caprio, G. and Honohan, P. (2001), *Finance for Growth: Policy Choices in a Volatile World*, Policy Research Report Series, World Bank, Washington, DC, p. 123.

Box 2

Germany's Savings Banks

The German Savings Banks Finance Group (Sparkassen-Finanzgruppe) comprises 446 Sparkassen (savings banks), seven Landesbanken (regional banks/wholesale and clearing institutions), DekaBank, nine Landesbausparkassen (central building societies), and 11 regional public insurance entities.

The Sparkassen-Finanzgruppe is one of the largest financial groups in the world, with total aggregated assets of EUR 2.16 trillion in 2015. With roughly 50 million current accounts, the Group serves nearly 60 percent of Germany's population. It has been estimated that close to three-quarters of all German businesses have a banking relationship with the Group. Hence, the Group plays a vital role in the German economy.

Savings banks in Germany work on a business model geared towards fulfilling public interest, rather than maximizing profits. One of their core goals is to enhance economic and community development in their respective regions. Surpluses generated by savings banks are used to strengthen their balance sheets and to finance social and public welfare projects in their regions. Saving banks are well-known for their public welfare mandate which allows all citizens – irrespective of income or wealth – to open an account. Their public mandate prohibits them from engaging in risky financial speculation activities.

Due to their strong regional roots and local community ties, savings banks have a broad deposit base, which enables them to offer stable financing to SMEs and households. Germany has one of the most vibrant SME sectors in Europe. Germany's SME sector, Mittelstand, is the backbone of the economy. Savings banks provide more than two-thirds of SME financing in Germany.

Same is the case with cooperative banks which are significant lenders to Mittelstand, many of them also operate as cooperatives. The co-operative banks have about 18 million members in Germany. Instead of chasing short-term profit opportunities offered by trading in risky financial instruments, savings and cooperative banks are more focused on lending to SMEs based in the local economy.

Since the 1990s, savings banks have posted positive financial results. On several accounting parameters such as net interest margins, RoE, and cost to income ratios, savings bank show better performance than other financial groups in Germany.

It is widely acknowledged that a significant presence of not-for-profit financial institutions – savings banks and cooperative banks – has helped in ensuring financial stability in Germany. As noted by Patrick Behr and Reinhard H. Schmidt: "Before the global financial crisis started in 2007, Germany was almost unique among the industrialized countries in that it had not experienced a major banking crisis after the Second World War."[10] With the onset of the global financial crisis in 2008, however, this trend reversed as some German banks suffered substantial losses due to their exposure to the US sub-prime mortgage markets. The German government spent billions of euros to rescue Hypo Real Estate (HRE) and Industrie-Kreditbank (IKB) and Commerzbank.

In contrast, the savings and cooperative banks survived the financial crisis unscathed without seeking government bailouts. Although five Landesbanken suffered losses and were subsequently recapitalized and merged. Whereas big commercial banks and some Landesbanken reduced lending during the financial crisis in 2007-08, savings and cooperative banks together increased credit volume by €13.7 billion during this period to stabilize overall credit supply.

Since savings and cooperative banks in Germany have proven to be resilient during the financial crisis, there is a renewed interest in such institutions in the post-crisis period. Some of their positive features such as public mandates and business models are worth considering.

10. Behr and Schmidt (2015, p. 14).

In Germany, state-owned banks still play a significant role in its three-pillar banking system consisting of private commercial banks (e.g., Deutsche Bank), saving banks and cooperative banks. Both savings and cooperative banks in Germany have a long history. The first savings bank was established in Hamburg in 1778 while cooperative banks first appeared in the mid-19th century. The publicly-owned savings banks – consisting of smaller savings banks (Sparkassen) and large regional banks (Landesbanken) – are an enduring feature of Germany's banking system (see Box 2). There are about 1100 cooperative banks currently operating in Germany. Like savings banks, cooperative banks are also rooted in the local economy and follow a business model of raising local deposits and lending them to local enterprises, startups, and households.

Not long ago, several other European countries, including France, Spain, Austria, and Italy, also had publicly-owned savings banks. However, their roles and institutional structures changed following financial deregulation starting in the 1980s. Consequently, some savings banks in Europe completely disappeared while others followed the business model of commercial banks.

A part of Switzerland's banking sector is still controlled by local public banks (Cantonal banks) owned by the local authorities like municipalities. For instance, Zurich Cantonal Bank is the largest cantonal bank and fourth largest bank in Switzerland wholly owned by the Canton of Zurich.

In India and China, two recent "success stories," state ownership is still overwhelmingly dominant in the banking system, as discussed earlier.

State Ownership of Banks: Three Theoretical Views

Broadly speaking, the theoretical literature on the existence and the role of state ownership of banks has three main views – social, agency, and political.

According to the "social" view, state-owned banks are created by social welfare maximizing governments to overcome the market failures in the credit and financial markets (Atkinson and Stiglitz, 1980; Stiglitz and Weiss, 1981; Stiglitz, 1993). The "social" view underscores that state-owned banks can channel resources to socially desirable projects with high social returns or to strategically important firms or sectors that the private sector is unable or unwilling to finance, hence promoting overall economic development and general welfare in a country (Gerschenkron, 1962; Stiglitz, 1993). The "social" view played an instrumental role in the nationalization of existing commercial banks and the establishment of new state-owned banks in the post-World War II period.

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Whereas the "agency" view accepts the "social" viewpoint that governments create public financial institutions to cure market failures but it concludes that misallocation of resources may happen as managers of state-owned banks will exert less effort than their private counterparts to achieve socially desirable objectives due to weak managerial incentives (Tirole, 1994; Banerjee, 1997; Hart, Shleifer, and Vishny, 1997). According

11. La Porta, López-de-Silanes, and Shleifer (2002, p. 266).

to the "agency" view, managers in state-owned banks are likely to work less hard or may divert resources for personal benefits such as career advancement, which may lead to adverse effects on bank performance. It emphasizes that corruption and misallocation of resources can happen even when the governments create state-owned banks to maximize social welfare.

Nevertheless, both the "social" and the "agency" views recognize the vital role of the government in performing economic functions that markets are unable or unwilling to perform.

In contrast, the "political" view highlights the political considerations influencing the lending decisions of state-owned banks. According to "political" view, the state-owned banks and other enterprises are used by politicians "to provide employment, subsidies and other benefits to supporters, who return the favor in the form of votes, political contributions, and bribes."[11] As a result, funds will not be channeled to economically efficient uses, resulting in higher non-performing loans, lower levels of financial development, lower banking-sector outreach, greater financial instability and slower economic growth (Shleifer and Vishny, 1998; Barth, Caprio, and Levine, 2000; La Porta, López-de-Silanes, and Shleifer, 2002; Sapienza, 2004; Dinc, 2005; Khwaja and Mian, 2006; Beck, Demirgüç-Kunt, and Martínez Pería, 2007; Claessens, Feijen, and Laeven, 2008; Cole, 2009). It is important to emphasize here that the "political" view has been a major contributor in policy development and debate on bank ownership in recent decades. The findings of a cross-country econometric study by La Porta et al. (2002) that backed the "political" view – by showing a negative association between state ownership of banks and average growth rates – have been often used by the IMF to support the privatization of state-owned banks in the poor and the developing world.

Unlike privately-owned banks which are driven by profit-maximizing goals, state-owned banks pursue welfare maximizing goals.

The Rationale for State Ownership of Banks

As compared to private banking, there are numerous advantages of state-owned banks and other types of public financial institutions – some of which are discussed below.

Firstly, there are significant differences between private banks and state-owned banks. Unlike privately-owned banks which are driven by profit-maximizing goals, state-owned banks pursue welfare maximizing goals. Profit imperatives may encourage privately-owned banks to undertake excessive risks to generate higher profits in the short-term. In a market economy, seeking profits is considered legitimate, but a private bank's business model aimed at short-term profit maximization at the expense of inducing greater financial and macroeconomic risks can be highly problematic, as witnessed during the 2008 financial crisis.

On the other hand, state-owned banks may not maximize profits because their principal goal is to maximize social welfare. Their primary task is not to generate short-term profits but to finance strategic industries or sectors (such as agriculture, SMEs, and cooperatives), provide banking and other financial services – especially to underserved sections of society – and support development initiatives that private banks are unable or unwilling to finance.

For private banks, profitability is the key to success, and therefore they may not support projects with high social returns. Whereas state-owned banks and DFIs can indeed survive for years without earning a profit. While private banks fail to take social returns into account, state-owned banks can channel financial resources to socially desirable projects (that may be financially unprofitable) or lend money to firms that do not have access to other sources of funds.

By investing in financially unprofitable projects with positive externalities or lending at subsidized rates to poor borrowers, state-owned banks may earn lower profits and, therefore, may perform poorly by conventional financial parameters (such as returns on assets) as compared to their private sector competitors. However, there are many notable examples across the world of state-owned banks performing at par or even better than private banks on key financial parameters.

The success of a state-owned bank should not be purely evaluated only on the basis of financial results (the profit and loss account). Instead, a state-owned bank should be evaluated on how it contributes to social and economic development, taking a holistic view of its broader impact on public service and social outcomes in a region or a nation. If non-commercial objectives such as providing vital banking services to the underserved sections of society, creating jobs and economic prosperity, and social value creation are taken into account, state-owned banks may outperform their private counterparts. Therefore, there is a need for developing a new scorecard which goes beyond the financial results to capture the broader impacts of state-owned banks on the economy and society.

The success of a state-owned bank should not be purely evaluated only on the basis of financial results (the profit and loss account). Instead, a state-owned bank should be evaluated on how it contributes to social and economic development

Unlike profit-oriented private banks, state-owned commercial and development banks can address credit market failures by catering the credit requirements of small borrowers and unorganized enterprises located in unbanked and under-banking areas, thereby expanding access to affordable credit and other financial services to underserved and disadvantaged (but creditworthy) sections of society.

Quite often, governments across the world established state-owned banks because private banks were unable or unwilling to finance critical social and developmental projects. In India, one of the key policy objectives behind nationalization of large commercial banks in 1969 was inspired by larger social purpose "to serve better the needs of development of the economy in conformity with national policy and objectives."[12]

In India and many other developing countries, state-owned banks have played a key role in providing access to affordable banking services to rural poor and weaker sections of society because the profit-oriented private banks (domestic and foreign) have been reluctant to open branches in the rural and unbanked areas where small ticket size of transactions is not profitable enough for such banks. In such circumstances, state-owned banks take on the social responsibility to ensure that poor people are not forced to borrow from moneylenders who charge usurious interest rates. Financial

12. Quoted from the text of Banking Companies (Acquisition and Transfer of Undertaking) Act, 1969.

Box 3

State-owned Banks and Financial Inclusion in India

The nationalization of 14 largest privately-owned commercial banks in 1969 was a significant development in the post-Independent India. In 1980, seven more private-sector banks were nationalized while foreign banks operating in India were not nationalized. Before nationalization, the entire banking system was in the hands of the private sector. Most of the privately-owned banks were in the form of joint stock companies controlled by big industrial houses. More importantly, there were several bank failures due to imprudent bank lending in the absence of regulatory safeguards. During 1947-58, for instance, as many as 361 banks of varying sizes failed in India. The failed banks were either amalgamated or ceased to exist.

In those times, the limited outreach of banks coupled with weak regulatory framework represented a classic case of market failure in the Indian banking sector. Before nationalization, privately-owned banks were predominantly in metropolitan and urban areas. The population covered per branch was 136,000 in 1951. Much of bank lending was concentrated in a few organized sectors of the economy and limited to big business houses and large industries. Whereas farmers, small entrepreneurs, laborers, artisans and self-employed were dependent on informal sources (mainly traditional moneylenders and relatives) to meet their credit requirements. The share of agriculture in total bank lending was a meager 2.2 percent during 1951-67.

There were several policy objectives behind the bank nationalization strategy including expanding the geographical and functional spread of institutionalized credit, mobilizing savings from rural and remote areas and reaching out to neglected sectors such as agriculture and small-scale industries. Another policy objective was to ensure that no viable, productive business should suffer for lack of credit support, irrespective of its size. In sum, the bank nationalization drive was inspired by a larger social objective to sub-serve national development priorities.

The Positive Outcomes

Before nationalization, banks were reluctant to open small accounts as these were not considered profitable. Between December 1972 and June 1983, as many as 212 million new bank loan accounts were opened up, out of which nearly 93 percent were small loan accounts (Rs.10,000 or less).

At the time of nationalization, scheduled commercial banks had 8,187 branches throughout the country. However, the branch network increased to 59,752 in 1990. With such a rapid increase in bank branches across regions, the population covered per branch, which was 65,000 in 1969, also decreased to 13,756 in 1990.

In 1990, out of 59,752 bank branches in the country, 34,791 (58.2 percent) were located in the rural areas. In contrast, the share of rural branches was 17.6 percent in 1969. Such a massive expansion of bank branches in the rural and unbanked areas was the result of 1:4 licensing policy of 1977 under the nationalization regime. Prior to nationalization, branch licenses were issued on the financial strength of the banks. The 1:4 licensing policy changed the focus to providing banking services throughout the country, particularly in remote and unbanked areas. Under the 1:4 licensing policy, banks were given the incentive to open one branch in metropolitan and one branch in urban areas, provided they open four branches in the rural areas.

This policy led to the rapid growth of bank branches in the rural and remote regions of the country and thereby helped in correcting the urban bias of the banking industry. Between 1977 and 1990, more than three-fourths of bank branches were opened in the unbanked areas.

The rapid expansion of the branch network led to massive deposit mobilization by banks, which in turn, contributed to a higher saving rate. The household financial savings increased manifold as nationalized banks enhanced public confidence in the banking system. For instance, household sector financial savings increased from Rs7950 million in 1969 to Rs.60810 million in 1980. Similar trends were witnessed in bank credit too. The bank credit-GDP ratio witnessed a sharp rise, from 10 percent in 1990 to 24 percent in 1991.

Apart from licensing policy, the establishment of regional rural banks (RRBs) in 1976 also widened the reach of banking services in India. The mandate of RRBs was to serve small and marginal farmers, agricultural laborers, artisans and small entrepreneurs in the rural and remote areas. In rural areas, there was a significant rise in bank deposits and credit. According to official data, the share of rural deposits in total deposits increased more than five times, from 3 percent in 1969 to 16 percent in 1990. The share of credit to rural India in total credit jumped from 3.3 percent to 14.2 percent during the same period.

In addition, banks were directed to maintain a credit-deposit ratio of 60 percent in the rural and semi-urban branches to ensure that rural deposits are not used to increase urban credit. The credit-deposit ratio in rural areas increased from 37.6 percent in 1969 to over 60 percent in the 1980s and 1990s. In the early 1970s, the concept of priority sector lending (also known as directed lending) was evolved to ensure that adequate credit flows to the vital sectors of the economy and according to social and developmental priorities.

The nationalization regime witnessed the substantial flow of credit to all sectors, including the neglected sectors of the economy such as agriculture and small and medium enterprises (SMEs). The share of agriculture credit in the total bank credit increased from 2.2 percent in 1968 to 13 percent in 1980 and further to 15.8 percent in 1989. The share of small-scale industry in the total bank credit which was negligible before nationalization reached 15.3 percent in 1989, a significant achievement by international standards. There is no denying that the banking system under the nationalization regime was not perfect as it could not reach out to every household but at least a serious effort was made to spread banking services: geographically, socially and functionally.

Some Recent Initiatives

Since the early 2000s, financial inclusion has become a key policy priority with intending to achieve inclusive growth and development in India. In 2005, the RBI launched a scheme of "no-frills" account under which all public and private sector banks were advised to provide a basic banking "no-frills" savings account either with nil or very low minimum balance to provide access to basic banking services to the financially excluded sections of the society. According to the RBI statistics, close to 139 million "no-frills" bank accounts were opened between 2005 and 2012 by the banking system. The bank group-wise analysis indicates that state-owned banks opened nearly 90 percent of "no-frills" accounts.

In 2013, the central government launched Bharatiya Mahila Bank Ltd. in 2013 to promote gender equality and economic empowerment of women. This was India's first Women's bank (state-owned) to lend money to women-run businesses and SHGs (self-help groups). The bank was later merged with State Bank of India.

In August 2014, the Indian government launched an ambitious Pradhan Mantri Jan Dhan Yojana (Prime Minister's People Money Scheme) to ensure access to affordable essential financial services throughout the country. The government claims that on an inaugural day, a record 15 million bank accounts were opened across the country under this initiative. Nowhere else in the world, such a large number of bank accounts have been opened on a single day. According to the RBI, 307 million bank accounts were opened, and about 231 million Rupay debit cards were issued until December 2017 under this nation-wide initiative. What is important to note is that state-owned banks played the pivotal role in achieving ambitious targets of opening bank accounts set under this national mission as more than 96 percent of accounts were opened by the state-owned commercial and regional rural banks while private banks opened the remaining 4 percent. Importantly, there was no participation of foreign banks operating in India under this scheme. In the absence of state-owned banks and regional rural banks, the government could not have executed such a massive bank account opening drive in India. Nevertheless, an important challenge is to make these accounts operational otherwise very little meaningful financial inclusion will be accomplished on the ground.

Based on Kavaljit Singh, *India-EU Free Trade Agreement: Should India Open Up Banking Sector?*, Special Report, Madhyam, 2009.

inclusion is vital to achieving inclusive growth as it generates positive economic externalities.

Secondly, State-owned banks are direct policy instrument in any government's toolbox to implement development initiatives, including the delivery of affordable banking services to poor people and encouraging economic development in underdeveloped areas.

In a country like India with its federal structure, for instance, state-owned banks can enable the central government to implement country-wide development programs in case there is a lack of enthusiasm to implement such programs among state governments and local bodies. Over the past four decades, the successive central governments in India have used state-owned banks to implement a wide range of social, economic and developmental programs throughout the country. Without state-owned banks, it would have been challenging to implement country-wide development initiatives launched by the central government.

By directly owning banks, a government can collect savings from the general public and direct those savings toward strategic projects and development initiatives, thereby generating aggregate demand and other positive externalities fostering social and economic development.

Without the existence of DFIs, the process of structural transformation and sustained economic growth in East Asian economies would not have taken place in the post-World War II period.

The issue of financial sector fulfilling the developmental needs becomes even more critical in the poor and developing countries where bank-based financial system plays a leading role in mobilizing savings and allocating capital. Banks are the key financial intermediaries in the poor and developing world. In contrast, the market-based financial system plays a more significant role relative to banks in some developed countries like the US.

State-owned commercial and development banks can directly promote industrial growth and the development of infant industry in the early stages of development. Many state-owned commercial and development banks a have a specific public policy mandate to promote economic development (especially in underserved areas, sectors, and segments), build social and physical infrastructure and create employment opportunities.

Through providing long-term credit financing, the DFIs played a salutary role in industrialization and overall economic development in many developing countries including South Korea, China, India, Malaysia, Brazil, Mexico, and Turkey. In East Asian countries, the DFIs were instrumental in supporting the financing needs of targeted industries or sectors. Without the existence of DFIs, the process of structural transformation and sustained economic growth in East Asian economies would not have taken place in the post-World War II period.

Thirdly, there is growing evidence that lending by state-owned tends to be less procyclical than lending by private (domestic and foreign) banks. As witnessed during the global financial crisis, some state-owned commercial and development banks played a countercyclical role by stabilizing aggregate credit in Latin America and Europe. As private banks (domestic and foreign) curtailed their lending activities during the crisis, the state-owned banks stepped up lending to offset the contraction of credit from private banks. Many countries including Germany, Brazil, Mexico, Poland, and China used their state-owned banks and development finance institutions to expand credit during the crisis thereby mitigating the sharp reduction in the private bank lending.

Using a large worldwide sample of banks for the recent period from 1999 to 2010, a World Bank research paper found that "lending by state banks is less procyclical than the lending by private banks, especially if the bank is located in a country with good governance, as proxied by indicators of government effectiveness. Moreover, lending by state banks in high-income countries is even countercyclical. Among private banks, we find that foreign-owned banks' lending is especially procyclical, perhaps because these banks have ready access to funding from their international parent firms to take advantage of local lending opportunities during economic upswings. State banks also expand their credit relatively more during banking crises, which suggests a stabilizing influence of state banks at a time of financial instability."[13]

Since the financial crisis, there has been a greater appreciation of the potential countercyclical role of state-owned banks and FIs in stabilizing credit flows during crises. There is a growing recognition that state-owned banks can be used as an additional policy tool for crisis management during downturns. Indeed, the global financial crisis has provided a new justification for these institutions.

> Since the financial crisis, there has been a greater appreciation of the potential countercyclical role of state-owned banks and development banks in stabilizing credit flows during financial crises.

Fourthly, it has been widely observed that state-owned banks are perceived to be safer during financial crises for various reasons including the existence of implicit government guarantees. Depositors prefer to keep their money in state-owned banks during financial crises. Deposit runs are more frequent on private banks, especially during crises. In India, for instance, depositors shifted money out of private banks (e.g., ICICI Bank) and moved it to state-owned banks (e.g., State Bank of India) during 2008-09. Similar trends were also noticed in other countries during the crisis. Compared to private banks, the relatively more stable funding base of state-owned banks enables them to provide stable lending during crises (Micco and Panizza, 2006).

Fifthly, state-owned banks are well positioned to channelize financial resources to productive sectors of the economy and thereby sustaining long-run financial and economic development. Whereas private banks could potentially pose a threat to financial stability and overall economic prosperity by diverting resources from essential developmental activities to excessive risk-taking speculative activities in search for quick profits, as demonstrated during the global financial crisis.

The "casino banking" in many developed countries led to a widespread misallocation of financial and human resources towards unproductive speculative activities in the run-up to the financial crisis. Instead of channeling savings into productive investments, big private banks engaged in risky financial instruments knowing that the taxpayers will foot the bill if their speculative bets go wrong. Further, the irresponsible compensation

13. Bertay, Demirgüc-Kunt, and Huizinga (2012, p. 15).

packages incentivized private bankers to take excessive risks which, in turn, increased systemic risk in the financial system. The risky business models coupled with weak internal governance structures led to the failure of large private banks engaged in "casino banking," some of which were subsequently nationalized.

Sixthly, state-owned banks can spur competition in the banking sector by charging lower interest rates than privately owned banks, thereby pushing private banks to reduce interest rates to remain competitive.

Lastly, state-owned banks can potentially counter the power and influence of private sector banks in determining regulatory policies. In many countries, private sector banks lobby is influential in shaping the regulatory and supervisory processes that protect their private interests at the expense of the broader public interest. Regulatory capture is alive and well in the banking sector. Regulatory capture by big private banks has weakened banking regulations over the years and, therefore, there are growing calls for reducing the excessive lobbying power of private banks.

While arguing in favor of state-owned financial institutions, it needs to be clarified that full ownership of the entire banking system by the state is not the answer to the myriad problems posed by private commercial banks and recurring financial crises. Instead the need of the hour is a greater diversity in the banking system with different ownership structures, competing for business models and wider geographic focus so that customers have more choice and assets are less concentrated in a particular market or institution. A diversified system consisting of private, public and cooperatives banks and other forms of financial institutions have worked well in the past in Europe and elsewhere. Besides, there is growing evidence to suggest that a well-diversified banking system is more resilient to financial crises besides better equipped to channelize long-term financial resources to productive sectors of the economy, in particular, SMEs.

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Do State-owned Commercial Banks Perform Poorly?: Evidence from India

Are private commercial banks (domestic and foreign) more profitable than state-owned banks? Do private banks perform better than state-owned banks on efficiency? Much of the recent criticism of state-owned banks centers around their relatively poor performance compared to their private sector peers. There is a widespread perception that state-owned banks perform poorly, particularly in the developing countries. By and large, the performance of state-owned banks in the developing countries has been a mixed bag: some state-owned banks perform poorly, others do not.

Some cross-country studies support the theoretical arguments against state-owned banks by highlighting that state-owned banks are endemically inefficient vis-à-vis their private sector counterparts as they misallocate resources by serving political interests (Sapienza, 2004; Khwaja and Mian, 2005; Carvalho, 2014). However, these studies suffer from an endogeneity problem. Further, institutional factors such as the rule of law, governance mechanisms, and regulatory framework play an important role in a bank's performance, and these factors can vary from country to country. Put simply, context matters.

More importantly, the relationship between ownership and efficiency can be more clearly assessed at an individual bank level because heterogeneity exists within a country and bank group.

The efficiency of banks can be measured in two ways:

1. Accounting Indicators: Some of the commonly used accounting indicators to assess the soundness, profitability, and efficiency of banks are capital adequacy ratio[14], cost-to-income ratio (CI), net interest margin (NIM), and return on assets (RoA), and return on equity (RoE).

2. Data Envelopment Analysis (DEA): The DEA is a non-parametric methodology and has become recently popular in measuring bank efficiency in many European countries. The DEA method calculates efficiency by incorporating numerous factors affecting banks' performance. The DEA measures the efficiency of a bank relative to the constructed benchmark. Closer the rank to the benchmark (with rank = 1), the more efficient is the bank.

In the Indian context, Reserve Bank of India, country's central bank, regularly evaluates the efficiency of different bank groups using both accounting and DEA methodologies. The analysis carried out by RBI during 2006-07 suggests that state-owned commercial banks do not perform poorly on several bank efficiency indicators.[15] On several parameters, state-owned banks have outperformed both foreign and private banks during 2006-07 even though state-owned banks run a vast branch network in the rural and semi-urban areas and undertake substantial social and developmental banking activities.

Based on its rigorous analysis for the fiscal year 2006-07, the RBI's Report on Currency and Finance (2006-08) observed that "ownership has no definite relationship with efficiency. During 2006-07, the State Bank group in the public sector was the most efficient, followed by new private sector banks, nationalized banks (in the public sector), foreign banks and old private sector banks."[16] Based on the DEA efficiency analysis (2006-07), the RBI noted that "most efficient banks are found both in the public and private sectors. In all, there are seventeen most efficient banks, which belong to the public, private as well as foreign bank groups. In fact, all the 28 least efficient banks are in the private sector (old private or foreign)."[17]

Based on its rigorous analysis for the fiscal year 2006-07, the RBI's Report on Currency and Finance (2006-08) observed that "ownership has no definite relationship with efficiency."

14. Capital Adequacy Ratio, also known as Capital to Risk Weighted Assets Ratio (CRAR), is the ratio of a bank's capital in relation to its risk-weighted assets. The minimum capital adequacy ratios are imposed by bank regulators to ensure that banks have big enough cushions to absorb unexpected losses before they fall into insolvency.

15. It must be noted here that such comparisons may not present clear evidence of efficiency and profitability of banks given the wide diversity of size and business activity that exists in each bank group.

16. Reserve Bank of India (2008, p. 425).

17. Ibid.

Table 3: Some Efficiency Parameters (2006-07) (in Percent)

Bank Group	Operating Cost to Total Assets	Net Interest Margin	Intermediation Costs	Return on Equity
State Bank Group	1.98	2.79	2.97	15.30
Nationalized Banks	1.67	2.58	3.32	14.65
Old Private Banks	1.88	2.74	3.63	10.32
New Private Banks	2.11	2.36	3.61	13.57
Foreign Banks	2.78	3.74	5.51	13.86

Source: Reserve Bank of India, 2008.

From 2013 onwards, state-owned banks showed a substantial decline in RoA and RoE as compared to previous years.

The intermediation cost is the standard benchmark of bank efficiency. The intermediation costs refer to administration and operational costs incurred by banks while offering services. The higher the intermediation cost, the lower is the efficiency of a bank. In contrast to domestic private banks and foreign banks operating in India, intermediation costs of state-owned banks were lowest during 2006-07 (Table 3). The RBI further observed that "high intermediation cost in the case of foreign banks was partly due to their ability to raise low-cost deposits."[18] During 2006-07, the RBI found that state-owned banks also performed better than private sector banks and foreign banks concerning parameters such as operating cost to total assets and non-labor cost per unit of earning assets.

The net interest margins (the difference between interest earned on investments and interest paid out to depositors) captures the operational efficiency of the banks. Lower the NIM ratio, the more efficient is the banking system. State-owned banks performed slightly better than private sector banks with lower NIMs during 2006-07. In contrast, the NIMs of foreign banks were considerably higher than other bank groups, primarily due to a large proportion of current accounts which has allowed foreign banks to access low-cost funds in India. As pointed out by the RBI, the low cost is not being passed on to the borrowers.[19]

What about profits per-branch and profits per-employee? There is no denying that the average business done in a branch of a state-owned bank is much lower in comparison with private banks. However, this is mainly because state-owned banks maintain close to 60 percent branches in the rural and semi-urban areas where the transaction size is small. Consequently, profits per-branch and profits per-employee of state-owned banks are lower than their private counterparts. Whereas foreign banks perform better on these two indicators since they mostly operate in metropolitan and urban areas and usually serve high-net-worth individuals (HNWIs) and large corporations.

18. Ibid., p. 405.
19. Ibid., p. 444.
20. Reserve Bank of India (2017, p. 71).

Over the years, the CRAR of all bank groups in India has improved. Since 2000, all state-owned banks in India have maintained a higher capital adequacy ratio than the stipulated 9 percent. India is implementing Basel III norms in phases between April 2013 and March 2019. In 2017, the CRAR of state-owned banks under Basel III norms was higher than the minimum regulatory requirement of 10.25 percent (including Capital Conservation Buffer of 1.25 percent) and 11.5 percent for end-March 2019 when Basel III norms will be fully operational.[20]

Two other important accounting indicators – return on assets (RoA) and return on equity (RoE) – measure the overall profitability of banks. RoA indicates how much profit a bank earns for every unit of its assets. RoE indicates how efficiently a bank is using shareholder equity to generate profits. The higher the ratios, the better the profitability and productivity of banks. During 2006-07, state-owned banks recorded a higher average RoE compared to private and foreign banks (Table 3). During 2008-09, RoA and RoE of all the bank groups, except the foreign banks, increased.

From 2013 onwards, however, state-owned banks showed a substantial decline in RoA and RoE as compared to previous years. The foreign banks' RoA and RoE dipped marginally in the post-2013 period. Whereas private banks recorded a modest increase in both ratios, indicating their relatively better financial performance and increased profitability in the post-2012 period (Table 4 and 5).

Table 4: Return on Assets - Bank Group-wise in India (2008-15) (Percent)

Bank Group	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Public Sector Banks	1.02	0.97	0.96	0.88	0.78	0.50	0.46
Private Sector Banks	1.13	1.28	1.43	1.53	1.63	1.65	1.68
Foreign Banks	1.99	1.26	1.74	1.76	1.94	1.54	1.87
All SCBs	1.13	1.05	1.10	1.08	1.03	0.81	0.81

SCBs: Scheduled Commercial Banks.
Source: Reserve Bank of India.

From 2013 onwards, a sharp deterioration in the asset quality of state-owned banks has been witnessed with the rise of bad loans thereby affecting their overall profitability. State-owned banks reported net losses during 2016-17 while private sector banks posted a small increase in profits. The gross nonperforming assets (GNPA) ratio of state-owned banks increased from 9.3 percent in 2016 to 11.7 percent in 2017 of total advances (Table 6).

20. Reserve Bank of India (2017, p. 71).

Table 5: Return on Equity - Bank Group-wise in India (2008-15) (Percent)

Bank Group	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Public Sector Banks	17.94	17.47	16.90	15.33	13.24	8.47	7.76
Private Sector Banks	11.38	11.94	13.70	15.25	16.46	16.22	15.74
Foreign Banks	13.75	7.35	10.28	10.79	11.52	9.03	10.24
All SCBs*	15.44	14.31	14.96	14.60	13.84	10.68	10.42

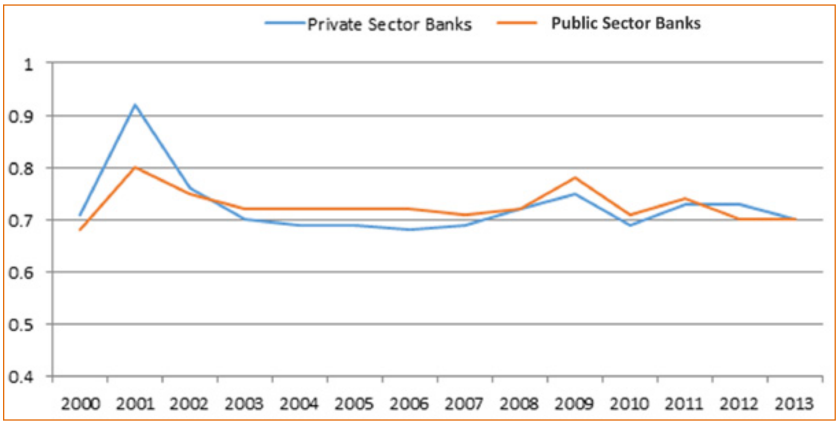
*SCBs: Scheduled Commercial Banks.
Source: Reserve Bank of India.

Table 6: Trends in NPAs: Bank Group-wise in India (Amount in Rupees billion)

Item	Public Sector Banks	Private Sector Banks	Foreign Banks	All Banks
Gross NPAs				
Closing Balance for 2015-16	5,400	562	158	6,119
Opening Balance for 2016-17	5,400	562	158	6,120*
Addition during the year 2016-17	3,275	814	66	4,157
Recovered during the year 2016-17	1,000	237	36	1,274
Written-off during the year 2016-17	827	207	51	1,085
Closing Balance for 2016-17	6,847	932	136	7,918
Gross NPAs as a percent of Gross Advances				
2015-16	9.3	2.8	4.2	7.5
2016-17	11.7	4.1	4.0	9.3
Net NPAs				
Closing Balance for 2015-16	3,204	267	28	3,498
Closing Balance for 2016-17	3,831	478	21	4,331
Net NPAs as a percent of Net Advances				
2015-16	5.7	1.4	0.8	4.4
2016-17	6.9	2.2	0.6	5.3

Notes: * Opening balance for 2016-17 is different from closing balance for 2015-16 due to the inclusion of two small finance banks in 2016-17.
Source: Reserve Bank of India, 2017.

Graph 1: Bank Group-wise Trends in Efficiency using DEA (2000-13)



Source: Reserve Bank of India.

Although the GNPA ratio was lower in the case of private banks, it also witnessed a jump from 2.8 percent to 4.1 percent during 2016-17. While the GNPA ratio of foreign banks showed a marginal improvement from 4.2 percent to 4 percent during the same period.

These bank group-wise statistics reveal that the rise in nonperforming assets (NPAs) in recent years is not only restricted to state-owned banks as private sector banks and foreign banks have also witnessed a deterioration in their asset quality.

It is worth mentioning here that the sharp rise in NPAs in non-priority sectors[21] is reflective of the general slowdown in the Indian economy resulting from domestic and global factors. Sector-wise, 76 percent of NPAs were concentrated in the non-priority sector in 2017 with industries and infrastructure sector recording the highest levels of NPAs.[22] In 2017, the non-priority sector NPAs accounted for 75.9 percent of total NPAs of state-owned banks, 82 percent in the case of private banks and 82.2 percent of total NPAs of foreign banks.[23] What is increasingly worrisome is that large borrowers with an exposure of Rs. 50 million or more accounted for about 86.5 percent of all NPAs in 2017.[24]

The RBI has analyzed the bank group-wise trends in efficiency levels using DEA from 2000 to 2013 (see Graph 1). Based on its analysis, the RBI stated that "for public sector banks (PSBs), the average efficiency scores were above that of private sector banks over a major part of the period under consideration. However, they lagged slightly behind the scores of private sector banks after 2010, a period that witnessed a slowdown in the growth and profitability of public sector banks. Importantly, there was much less variation across public sector banks in terms of efficiency levels as compared to private sector banks."[25]

The rise in nonperforming assets (NPAs) in recent years is not only restricted to state-owned banks as private sector banks and foreign banks have also witnessed a deterioration in their asset quality.

Development Banks: A Potential Game Changer

Although development banks are financial institutions with a substantial part of their equity owned by the state, there is no precise definition of a development bank. According to the World Bank, a development bank is defined "as a bank or financial institution with at least 30 percent state-owned equity that has been given an explicit legal mandate to reach socioeconomic goals in a region, sector or particular market segment."[26] While the UN defines them as "financial institutions set up to foster economic development, often taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities."[27]

21. The Reserve Bank of India has identified specific sectors (such as agriculture, micro, small and medium enterprises, export credit, education, housing, social infrastructure, renewable energy and others) as "priority sectors" which will receive a specified portion of bank lending. The rest of the sectors are categorized as non-priority sectors. The priority sector lending is aimed at promoting social and developmental banking in India.

22. Reserve Bank of India (2017, p. 77).

23. Ibid.

24. Ibid.

25. Reserve Bank of India (2013, p. 64).

26. de Luna-Martinez and Vicente (2012, p. 4).

27. United Nations (2005, p. 11).

Box 4

Some Prominent Development Banks

- KfW (Germany)
- Banco Nacional de Desenvolvimento Econômico e Social (Brazil)
- Norwegian Industrial and Regional Development Fund
- Green Investment Bank (UK)
- Industrial Development Bank of Turkey
- Agricultural Development Bank of China
- China Development Bank
- Development Bank of Japan
- Development Bank of Singapore
- Development Bank of the Philippines
- Industrial Finance Corporation of India
- Japan Bank for International Cooperation
- Korea Development Bank

Their creditworthiness is ensured due to their backing by government funds and guarantees that also enable them to raise capital from national and international markets.

Developments banks are quite different in size, ownership, funding and business activities across the world. The national development banks usually operate within a country. Most national development banks are relatively small in relation to other financial players. They focus on the promotion of domestic economy and offer loans, equity, and other financing instruments. The Small Industries Development Bank of India, the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil, and the British Business Bank are some prime examples of national development banks.

On the other hand, bilateral development banks finance development projects and activities in the poor and developing countries. They provide a wide range of assistance including grants, loans, structured funds, and technical advice. Examples of bilateral DBs are the Japan International Cooperation Agency and Germany's Kreditanstalt für Wiederaufbfau (KfW). In addition, there are regional development banks (such as the African Development Bank) and multilateral development banks (such as the World Bank) performing similar functions as that of bilateral development banks.

In addition, there are development finance institutions (DFIs) that make investments or lend money to private sector companies in sectors or countries that are unable to attract capital.

Some of the key characteristic features of a development bank are the following bank:

- It does not operate with the primary objective of maximizing profits. A development bank believes that profitability can go hand in hand with meeting development objectives. Different development banks pursue different developmental objectives. Some development banks focus on infrastructure and industrial development while others pursue social development and inclusive growth.

- It is backed by government funds and guarantees ensuring its credit-worthiness.
- Due to public ownership, the government determines its mandate and strategic direction.
- Unlike a commercial bank which usually provides short-term working capital financing, a development bank can offer medium and long-term loans for projects that require 15-25 years of funding.
- It has in-house technical expertise to understand business dynamics of a particular sector. By building partnerships and imparting specialized skills, a development bank can provide business support services and advice when it is needed.
- A development bank has an explicit public policy mandate to enhance economic development and to achieve other socio-economic goals such as the development of backward areas and structural transformation of the rural economy.
- A development bank provides a high level of "additionality", financing investments and activities that would not otherwise have happened.
- Apart from correcting market failures, a development bank can also support new initiatives aimed at tackling urgent societal challenges (such as climate change, food security, financial crises, inequality and inclusive growth), thereby contributing to social value creation.
- It can invest in setting up new greenfield projects or at the beginning of new sectors (such as IT and clean energy technology) with an objective of nurturing innovations. It can provide first time funds to businesses that may struggle to attract commercial investors for a variety of reasons.

Unlike a commercial bank which usually provides short-term working capital financing, a development bank can offer medium and long-term loans for projects that require 15-25 years of funding.

The Revival of Interest in Development Banks

The global financial crisis of 2008 has brought the role of development banks (DBs) and development finance institutions (DFIs) back in the policy spotlight. Post-crisis, governments across the world are considering these institutions as a part of the countercyclical policy toolkit besides recognizing their role in supporting economic development and structural transformation.

Post-crisis, one is witnessing the formation of new DBs and DFIs in both developing and developed countries. Most of the recently established institutions in developed countries put greater emphasis on promoting green finance, new technologies, SME development, and startups. The UK, for instance, established Green Investment Bank in 2012 to finance specifically green projects. In 2013, British Business Bank (BBB) was launched to meet the financing needs of SMEs. In 2012, France created a new institution, Banque Publique d'investissement (BPI), by bringing together Oséo, CDC Entreprises, the FSI and FSI Régions. BIP aims to support small businesses and create local jobs. In 2014, Portugal established a development bank, Instituição Financeira de Desenvolvimento (IFD), to support SMEs. Similarly, the Strategic Banking Corporation of Ireland (SBCI) was established in 2015 to support Irish SMEs.

In many developed countries, industrial policy is back in fashion. The revival of discussions on industrial policy may encourage governments to explore the potential role of DBs in financing long-term strategic industrial projects or sectors.

The recent positive experience of many development banks in Asian and Latin American countries during the financial crisis may also encourage other developing countries to create new or revive existing institutions to pursue economic growth and structural transformation. In all likelihood, DBs and DFIs are bound to play an important role in the arena of development finance in the coming years.

This is in contrast to the 1980s and 1990s when the development banks almost disappeared in many countries in the wake of market-oriented financial reforms.

A development bank provides a high level of "additionality", financing investments and activities that would not otherwise have happened.

For instance, in India where development banks were seen as key actors in providing long-term funding for industrial and infrastructure projects in the post-Independence period, their role in financing long-term projects drastically diminished with the withdrawal of low-cost funds from the government in the early 1990s. Consequently, Industrial Investment Bank of India was folded up while ICICI and IDBI were converted into full-fledged commercial banks in India. The sharp decline in long-term credit in the post-reform period has revived the demands for creating a new state-funded DFI in India that can provide medium and long-term credit to manufacturing and infrastructure sectors.

The Countercyclical Role of Development Banks

The recent attraction in DBs and DFIs is primarily due to the countercyclical role played by such institutions during the global financial crisis. In many Latin American and European countries, the state-owned development banks played a countercyclical role by stepping up lending when private sector loans dried up.

Below are some examples of development banks playing a countercyclical role, especially during the early years of the global financial crisis.

In Brazil, BNDES was the most critical policy tool used by the government as a countercyclical response to mitigate the adverse effects of financial crisis on the Brazilian economy. BNDES received a big capital injection of R$100 billion in 2009 from the government and used it to disburse credit to domestic firms. Loans from BNDES were given at subsidized rates – considerably lower than the prevailing market rates. Credit by BNDES surged from R$160 billion (at 2005 prices) in September 2008 to R$277 billion in December 2010.[28] BNDES played a crucial role in stabilizing the level of

28. World Bank (2012, p. 106).

domestic investment by ensuring the flow of funds to long-term projects. Without the support of subsidized loans offered by BNDES, many Brazilian companies may not have undertaken long-term investments in adverse times. The countercyclical role played by BNDES helped Brazil face the crisis much better than many other developing countries although concerns have been raised about the bulk of the subsidized credit going to large firms.

In Mexico, development banks played a countercyclical role by expanding credit when risk-averse commercial banks curtailed credit growth in 2009. The domestic demand experienced a severe decline in 2009 when Mexico's GDP contracted by 6 percent. The Mexican development banks supported the housing and commercial paper markets through public guarantee credit schemes. Specialized development banks such as Nafin and Bancomext rapidly expanded their credit and guarantee programs to ensure that firms involved in manufacturing and exports do not face a credit crunch. The DBs played a crucial role in economic recovery in 2010-2011, supported by strong manufacturing exports and domestic demand.

Established in 1948, Germany's KfW has played an essential role in financing the reconstruction of its economy in the post-war period. KfW is a state-owned DFI and is active in the financing of infrastructure, SMEs, housing, environmental and development projects in Germany and abroad. Composed of five primary units, the objective of KfW is to overcome market failures and promote socially-beneficial projects that are underfunded. During the global financial crisis, KfW played a countercyclical role by launching a special programme in 2009 which issued €13.3 bn of credit to SMEs. Besides, KfW implemented a multi-year economic stimulus plan for German enterprises (€40 bn) and energy efficiency and infrastructure measures (€10 bn).[29] According to KfW, its financial activities saved around 360,000 jobs at suppliers and roughly 370,000 jobs at the ultimate borrowers by 2012.[30]

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In Poland, PKO Bank Polski (PKI BP) came to the rescue of the domestic economy by increasing lending to households and firms when Polish subsidiaries of foreign banks drastically cut credit supply during the crisis. In Poland, foreign banks control nearly three-fourths of the total assets of the banking system.

In many other European countries including Spain, Italy, Austria, and Bulgaria, development banks increased lending and guarantee support during the 2008 crisis. In some instances, they took on additional activities to revive investments in a stuttering economy. In Europe, it has recently been observed that some national DBs and DFIs supported each other by providing loans and policy advice.

Of late, some national development banks (such as KfW) have enlarged their international presence, particularly in the poor and developing world.

29. Ulf Moslener, Matthias Thiemann and Peter Volberding, National Promotional Banks as Active Financiers: The Case of KfW, Washington, DC, April 2017. Available at http://policydialogue.org/files/events/Future_of_National_Development_Banks-_Presentation_-KfW.pdf.

30. KfW, Sustainability Report, Facts and Figures Update, November 2014, Available at: https://www.kfw.de/PDF/Download-Center/Konzernthemen/Nachhaltigkeit/englisch/KfW_NH-Fakten-Update-2014_en.pdf.

Besides, one is witnessing the emergence of new regional and South-led development banks such as the New Development Bank (NDB) established by the BRICS states; the Asian Infrastructure Investment Bank (AIIB) – China-led multilateral development bank aiming to finance the building of infrastructure in the Asia-Pacific region; and the Bank of the South Bank (BancoSur) – a monetary fund and lending institution established by Argentina, Brazil, Paraguay, Uruguay, Ecuador, Bolivia, and Venezuela. The motivations behind establishing these new institutions are myriad, but the under-representation of developing countries in the governance structures of existing international financial institutions and regional development banks also added momentum to these initiatives.

In addition to fulfilling their traditional mandate of addressing market failures, successful development banks in many countries have provided financing and other support to initiatives aimed at tackling urgent societal challenges such as climate change, food security, women's empowerment, poverty elimination, and human development. There is no gainsaying that such public financial institutions are well positioned to address broader social and economic challenges.

Traditionally, the impact assessments of development finance institutions have been focused on micro-level impacts but given their important role in tackling global challenges, the time has come to measure impacts in terms of their contribution towards tackling global challenges.

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By scaling up lending operations of development banks and DFIs, their importance as major players in sustainable development will get recognized.

Leveraging Development Banks for SDGs

Adopted by all member-states of the United Nations in 2015, Agenda 2030 for Sustainable Development provides a shared global framework for building a fairer, more prosperous, peaceful and sustainable world. With a commitment to "leave no one behind," it consists of 17 Sustainable Development Goals (SDGs) – also known as the Global Goals – and 169 targets, indicators, and means of implementation. The SDGs came into effect in January 2016 and are supposed to be met by 2030.

The Agenda 2030 is universal in nature, and therefore it applies to all countries irrespective of the level of development. The SDGs build on the successes of the Millennium Development Goals and cover a wide range of issues including poverty, hunger, climate change, gender inequality, peace and justice, among others. The Agenda 2030 calls for partnerships among governments, business, and civil society to realize the SDGs.

To meet the investment needs of the SDGs, a considerable amount of financial resources from a variety of sources are required. The UNCTAD has estimated that achieving the SDGs will require the global investment between \$5 trillion to \$7 trillion per year, with an investment gap of \$2.5 trillion in developing countries.[31] Even if one may question the basis of investment

31. UNCTAD (2014, p.xi).

estimates made by UNCTAD, the fact remains that the SDGs require substantial financial resources from all sources: public and private, domestic and international.

To bridge the investment gap, OECD and some experts emphasize on mobilizing commercial finance for SDGs by adopting new financing mechanisms such as blended finance.[32] It is often argued that blended finance can be a useful tool to mobilize commercial finance for development-related investments linked to SDGs.

Blended finance may appear attractive in concept but can be problematic in practice. The evidence base on blended finance is limited so far. Much of its focus has been on middle-income countries, thereby raising questions about its effectiveness in the poor countries. There is very little cross-country evidence to show how blended finance enabled projects with high development impact. Besides, there are significant shortcomings in monitoring systems that make it difficult to assess the performance and impact of blended finance in any meaningful way.

There is no denying that the private sector has an important contribution in the realization of the SDGs but the role of the public sector is fundamental to the delivery of public goods and services. There is a need to scale up public investment to meet SDG-implied demands for financing.

Given private investment (both domestic and foreign) has remained muted in the aftermath of the global financial crisis, the demand for public funds has increased in the poor and developing countries. In this context, development banks can act as catalysts in mobilizing development finance and help in bridging financing gaps to achieve the SDGs.

The role of development banks becomes even more critical as the development finance landscape has rapidly changed in recent years with the official development assistance (ODA) remaining far short of the UN target of 0.7 percent of the gross national income of DAC countries. The prospects of achieving a target of 0.7 percent remain bleak, at least in the near future.

The unique characteristics of development banks enable them to deliver on the SDGs with their ability to raise financial resources through various sources; provide funding to projects that would not have otherwise have received it; and provide technical expertise to undertake long-term development projects. Besides, their willingness and experience to incorporate the environmental, social, and governance (ESG) in business activities place them in a strong position to play a leading role in meeting the SDGs.

The unique characteristics of development banks enable them to deliver on the SDGs with their ability to raise financial resources through various sources; provide funding to projects that would not have otherwise have received it; and provide technical expertise to undertake long-term development projects.

In India and elsewhere, many development banks emphasize different developmental challenges such as housing, agriculture, women's empowerment, and small-scale industries. Some of them have successfully shown

32. Blended finance is a mix of public and private capital to fund a particular development project or program. The OECD defines blended finance as "the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries. Additional finance is commercial finance that does not have an explicit development purpose, and that has not primarily targeted development outcomes in developing countries. Development finance is public and private finance that is being deployed with a development mandate."

Box 5

Transparency and Participation: Closing the Gap

As public institutions, development banks and other state-owned financial entities should follow key principles of good governance – transparency, participation, inclusion, and accountability – in the conduct of their business.

Transparency in business conduct and decision-making processes can enable citizens and other stakeholders to scrutinize projects supported by development banks and hold management to account for its decisions and actions. The citizens deserve to know how development banks are conducting their business. Transparency is also central to the concept of ethical business practice. Therefore, it is imperative that all relevant information related to project lending and other activities should be publicly shared through a user-friendly interface. The banks should also disclose development impact data and analysis on the ex-ante projections and ex-post impact assessments.

By combining transparency with participation, state-owned financial institutions can increase engagements with the stakeholders and the broader public beyond the narrow world of banking professionals. It can enable new partnerships and flow of ideas and information between the state-owned financial institutions and stakeholders to achieve continuous improvements in accountability and overall performance.

that developmental success can go hand in hand with financial success. Such success stories can be replicated across the world.

The poor and developing countries can set up new development banks to undertake this challenging task. A development bank should not necessarily be wholly government-owned although some level of government ownership is desirable for achieving broader social and economic objectives. Development banks can mobilize finance required for development-oriented projects by borrowing from both domestic and international capital markets. To ensure that they raise funds at reasonably low costs, development banks can be offered direct financial support by the national governments or allowed to issue tax-free bonds. Another option is to raise concessional funds from international development banks such as KfW.

Governance Matters

As many more governments are taking a fresh look at various types of state-owned financial institutions, it is essential that greater attention should be paid to their governance, performance, and public accountability, given their mandate to serve the public interest.

As development banking is inherently risky, state-owned banks and financial institutions face a peculiar challenge – how to remain financially viable while pursuing broader socio-economic objectives. Some well-managed development banks often find it difficult to reconcile these conflicting objectives. However, they can face this challenging task under the right circumstances, with appropriate governance and policy frameworks.

Studies on the performance of state-owned financial institutions show mixed results. Some poorly managed state-owned financial institutions failed, leading to substantial fiscal costs and poor development outcomes while some have performed spectacularly in terms of their economic sustainability as well as the fulfillment of broader development objectives. Needless to add, policymakers can learn from both past failures and past successes of state-owned institutions.

There is no "one-size-fits-all" model for the governance of state-owned banks and FIs as it is influenced by a wide range of factors including a country's institutional environment and regulatory regime. As pointed out by Janine Thorne and Charlotte du Toit, a state-owned financial institution is unlikely to achieve its desired objectives if the institutional environment in a country is weak coupled with weak regulation and supervision; its mandate is not clearly defined; its staff lacks critical skills in the management and operations; and there is interference by corrupt officials, board members and politicians in its business activities.[33]

To begin with, a development bank needs an enabling environment to accomplish its desired objectives. The prospects of a "successful" development bank tend to be bleak in countries with weak political institutions, high levels of corruption, the weak rule of law, and higher macroeconomic instability.

In addition, well-functioning legal and regulatory institutions are as much a prerequisite for public-owned development banks as for the private banks.

Strong internal control structures should be embedded in a bank's governance system to ensure a high quality of transparency and accountability not only to the government but all stakeholders.

Second, the mandate of a development bank should be clearly articulated regardless of whether the mandate is narrow or broad. In particular, the board of directors and the executive team of a state-owned financial institution should have a clear understanding of its purpose and objectives and their role in achieving this. It is likely that the mandate of a state-owned bank may change over time, but it should be clearly articulated. Otherwise, a development bank may drift away from its stated objectives, leading to undesirable outcomes.

Third, under state ownership, the government is both the owner and the regulator of banks. Therefore, the government should establish clear ownership policy, ensuring that it will regulate state-owned financial institutions in a transparent and accountable manner, avoiding any potential conflict of interest.

Fourth, the quality of internal governance and management systems also play an essential role in the functioning of a development bank. The board of directors and the executive team of a development bank should have relevant expertise and experience to steer and manage the bank. This is a challenging task because not all countries have a deep pool of local expertise and talent to create and run a development bank.

It is essential that the board of directors should be independent of the highest standards of competence. Even though the ownership remains with the government, the senior executive team of a state-owned bank should have operational autonomy to run the day-to-day operations of the bank.

33. Janine Thorne and Charlotte du Toit (2009), A Macro-framework for Successful Development Banks, *Development Southern Africa*, 26:5, pp. 677-694.

Besides, strong internal control structures should be embedded in a bank's governance system to ensure a high quality of transparency and accountability not only to the government but all stakeholders.

Fifth, the board and senior management team should have a commitment to integrity and be held accountable for their actions by the government, regulatory agencies and the wider public.

Finally, alternative regulatory frameworks should be worked out specifically for development banks as the commercial banking regulations may not be appropriate for development banks that do not raise money from depositors.

An Agenda for Civil Society Groups

NGOs, citizens' groups, and labor unions can play a leading role in highlighting the potential role of state-owned financial institutions in public value creation. This may involve a wide range of public interventions (both nationally and internationally) - from dispelling the neoliberal claims that state-ownership is inherently bad, to arguing instead that state ownership of banks can be used to fund important development projects and to address wider societal challenges, to building united campaigns on creating effective, accountable and inclusive public-funded financial institutions that finance sustainable development and contribute to the stability of the financial system.

There are many examples of successful public banking with diverse ownership models that can be highlighted as alternative ways of conducting successful banking business.

Within the civil society groups, there exists a knowledge gap on development finance issues, but it can be addressed by reaching out to progressive economists, development experts, and think-tanks and seeking their technical support and advice.

The universal and integrated nature of the SDGs has provided an opportunity for NGOs to collaborate with other stakeholders from other sectors and countries. In this context, NGOs can play a crucial role in holding the governments and corporations to account for their promises. To do this, they need to develop new advocacy tools and cross-sectoral coalitions which can influence governments to recognize the importance of state-owned development banks and DFIs in achieving long-term sustainable development.

There are many examples of successful public banking with diverse ownership models (from the Bank of North Dakota – a state-owned bank in the US – to New India Co-Operative Bank Limited – established by trade union activists on the model of German Labour Bank) that can be highlighted as alternative ways of conducting successful banking business. Besides, NGOs can propose concrete policies and actions plans to ensure that state-owned commercial banks, DBs, DFIs, cooperative banks and other publicly-owned financial institutions are truly run in the pursuit of broader public interest and hold them accountable on their developmental goals.

Conclusion

In recent years, there is a growing recognition of critical role state-owned commercial banks, development banks, and DFIs can play through countercyclical lending as well as supporting economic development and structural transformation. Such institutions are well positioned to provide a stable and predictable financial support including long-term financing for key sectors such as SMEs, agriculture, housing, and infrastructure.

Apart from correcting market failures, state-owned DBs and DFIs can also support new initiatives aimed at tackling urgent societal challenges such as climate change, food security, inequality and inclusive growth. In the new mellinnium, the role of development banks goes beyond the traditional framework of correcting market failures and extends to addressing broader societal challenges. With the right policies and sufficient financial and political support to implement those policies, state-owned commercial banks and development banks can act as effective institutional mechanisms to deliver on the SDGs.

In order to effectively contribute to sustainable development, it is crucial that development banks should follow key principles of good governance in the conduct of their business and take all necessary measures to avoid adverse impacts on human rights and environment.

State-owned development banks and financial institutions are likely here to stay in many countries in the new millennium. Even if the motivations may diminish over time for political reasons, state-owned financial institutions will remain influential players in the financial system as long as they are soundly managed, and they adhere to their distinct goals and core values.

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The global financial crisis of 2008 has reignited an intense debate on the ownership structures of the banking sector and the desirability of direct state interventions in the financial sector. The crisis has challenged conventional thinking on state ownership of financial institutions and forced policymakers to reconsider the role of the state in the financial sector, especially state ownership of banks and other forms of financial institutions.

In recent years, there is a growing recognition of critical role state-owned commercial banks, development banks, and DFIs can play through countercyclical lending as well as supporting economic development and structural transformation.

The state-owned commercial banks, development banks and DFIs can directly finance investments needed for the realisation of the 2030 Agenda and the SDGs besides leveraging resources from the private sector.

In the new millennium, the role of development bank goes beyond the traditional framework of correcting market failures and extends to addressing broader societal challenges such as climate change, food security, inequality and inclusive growth.

In order to effectively contribute to sustainable development, it is crucial that development banks and other state-owned financial institutions should follow key principles of good governance in the conduct of their business and take all necessary measures to avoid adverse impacts on human rights and environment.