



A Health Diagnostic Tool for Public Development Banks

Diana Smallridge
Fernando de Olloqui

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1300 New York Ave. NW, Washington, D.C., U.S.A.

Contact: Fernando de Olloqui (FDEOLLOQUI@iadb.org)

Abstract*

This study introduces a diagnostic tool for determining the health of a public development bank. It defines in normative terms what good health looks like across various dimensions, which allows the PDB to delineate how it can improve its overall performance and achieve its financial and developmental goals. Due to the variety of mandates and business models used by PDBs, there is no one definition of what constitutes perfect health for a PDB; nonetheless there are common parameters and features to their overall systems that can be compared against under a flexible and comprehensive framework. The three common parameters of performance identified in the Health Diagnostic Tool are public policy and corporate governance, development impact and financial and operational performance.

JEL Codes: G2

Keywords: development banks, governance, development impact, market gaps

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Introduction

The objective of this study is to develop a conceptual framework to assess the health and performance of public development banks (PDB). A healthy PDB is one that finds a financially sustainable way to effectively balance the needs of its stakeholders—shareholders (governments), clients, private sector intermediaries and taxpayers—while accomplishing its ultimate goal, which is meeting its public policy objective. Due to the variety of mandates and business models used by PDBs, there is no one definition of what constitutes perfect health for a PDB. All of these institutions operate within unique political, social and economic national contexts. Nonetheless, there are common parameters and features to their overall systems that can be compared against a common but flexible and comprehensive framework, which is what the Health Diagnostic Tool offers. The diagnostic tool defines in normative terms what good health looks like across various dimensions, which allows the PDB to delineate how it can improve its overall performance. Accordingly, this instrument differs from a “best practices” framework that allows PDBs to benchmark against an “ideal” PDB, because there is no such thing as an “ideal” PDB. Each PDB faces local and national circumstances with distinct and specific market gap, governance structure, operating model and sector focus, among other factors. Therefore, what might be good practice for a PDB in one context could be damaging in another context. In this sense, this tool is useful for defining a strategy for the PDB to achieve its financial and developmental goals, and not as a vehicle to qualify different banks as an index might.

This document is structured in two main sections. Section 1 provides a review of the rationale for and evolution of PDBs, the current state of PDBs, and their shortcomings and issues. Section 2 describes the theory and concepts behind a Health Diagnostic Tool for PDBs. In addition, there are three appendices. Appendix A summarizes the shortcomings addressed by the Health Diagnostic Tool. Appendix B outlines an assessment framework for evaluating a PDB’s performance against each of the key dimensions of health defined in Section 2. In Appendix C, the relevance of the Health Diagnostic Tool is validated by Banco de Comercio Exterior de Colombia (Bancóldex) of Colombia, which provided its feedback and experience under the tool’s concept and assessment framework. This exercise is complemented by a review of two other Latin American institutions to demonstrate some of the current practices in the region.

Section 1: Background to Public Development Banks

There is no single definition for public development banks, nor is there commonly applied terminology.¹ For the purpose of this report, the term PDB is used according to the definition applied by the United Nations (UN, 2009) during a recent cycle of consultations on “Rethinking the Role of National Development Banks”:

“Financial institutions set up (by the government) 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.”

This is consistent with the definition applied in Inter-American Development Bank (IDB) publications and addresses two key elements: 1) government intermediation in the financial system and 2) the PDB’s purpose of providing financing for projects to achieve socioeconomic objectives.² A recent policy paper by the World Bank differentiates between 1) deposit-taking PDBs and those that are non-deposit-taking and 2) between state financial institutions with a development or public and social policy mandate and those without such explicit mandates (Scott, 2007). One can also consider the distinction between Tier 1 and Tier 2 state-owned financial institutions, on both the asset (lending) and liability (funding) sides of their operations (Yeyat, Micco, and Panizza, 2004).

The core of the issue is whether a state-owned financial institution has a development or public and social policy mandate. The other dimensions, such as whether the institution is deposit-taking and whether it is Tier 1 or Tier 2, describe different options for how the institution funds and delivers on its mandate. The primary focus of this study is on those non-deposit-taking PDBs with a public policy mandate, which 1) are funded either by the government directly, by access to the bond market or by loans from multilateral or regional financial institutions, and 2) operate as either Tier 1 institutions (institutions delivering financial services directly to their clients, whether those clients are individuals, corporations or projects) or Tier 2 institutions (institutions channeling financial services to their clients via commercial banks or other financial intermediaries). This group represents the most narrowly defined PDBs and the most globally representative model.

¹ Other terms commonly used include development financial institutions (Scott, 2007), state-owned development finance institutions (Yaron, 2004) and national PDB (UN, 2005).

² “Although there is no universally accepted definition of PDBs, they are primarily concerned with offering long-term capital finance to projects that are deemed to generate positive externalities and hence would be underfinanced by private creditors.” (Inter-American Development Bank, 2005).

Rationales for PDBs

The intervention logic for PDBs has evolved and expanded over time, although in essence it remains based on the government playing a direct role in the financial sector to achieve public policy objectives. This may involve responding to perceived shortfalls in the provision of private sector financial services, or it may involve taking the lead in stimulating demand through the provision of additional resources. There is also a third category of intervention, which involves using the PDB as a proxy for financial regulation and monetary policy. The rationales among the three categories are not mutually exclusive, and boundaries between them can be blurred.³ Over time, governments have cited different rationales (alone or in combination) to justify intervention by the broader universe of PDBs, reflecting evolving political economic and development philosophies (as discussed in “Evolution of PDBs” below).

PDBs to Fill a Market Gap

The classic rationale for PDBs is based on the existence of market gaps (i.e., the existence of projects or sectors of the economy that are underserved by private sector sources of financial services) and the belief that state intermediation in the financial sector can make up for this private sector shortfall and lead to economic and social benefit for the country. Market gaps arise for two main reasons:

- 1) The private sector’s **unwillingness** to accept certain risks that they deem too high or that have relatively high transactions costs, or
- 2) The private sector’s **inability** to accept certain risks or to fund certain tenors because of their own internal limitations (access to funding, credit limits, etc.).

These reasons may be structural or temporal; that is, they may be a reaction to market cycles or to economic crises. Generally, the gaps occur on the supply side and exist because there is a lack of financial services being provided by private sector sources in an area the government deems to be an important public sector priority. Examples of PDB activity and underlying market gap rationale include providing financing to:

³ This study focuses on existing PDBs. In the case of a startup bank, a careful analysis of the rationale for the bank and a detailed assessment of the related market gap would be required before deciding on institutional arrangements. One option might be establishing a new bank. Alternative options might be for the government to decide to offer a financial product via an existing mechanism or outsourcing to a commercial bank.

- 1) Long-term infrastructure projects, due to a funding gap. This could happen if the commercial banks have access to short-term borrowing only, rendering them unable to lend the necessary long-term funds (even if they find the credit risk acceptable).
- 2) A strategically important company, such as a major exporter, because of a credit gap. This could result from the company having reached the commercial banks' lending limits.
- 3) Under-served sectors, such as small and medium-sized enterprises (SMEs) or rural activities in geographically isolated areas.

While the existence of a market gap or failure is **necessary** to justify state intervention, it is not a sufficient justification unless it can be shown that the direct and indirect benefits of such intervention exceed the costs. In other words, simply because a market gap exists does not justify the involvement of a PDB. There may be very good and valid reasons why the private sector is avoiding providing financial services to a particular market segment, and these reasons exist whether a private commercial bank or a government-owned PDB is involved. Similarly, the deemed social value of a financially nonviable project does not justify involvement by the PDB; in cases of “national interest,” where costs exceed direct benefits, the government should turn to the national budget for funding. The PDB is only one of a variety of instruments available to the government, and it is important that the government assigns to the PDB the most suitable public policy mandate and not make inappropriate demands on the PDB.

Indeed, there are dangers in the tendency to use indiscriminately all instruments, including PDBs, in response to crises or market imperfections (Rudolph, 2010). Careful analysis of the context of the market gap is required to identify its root cause and distinguish between the root cause and any symptoms. Furthermore, the nature of a market gap also bears analysis since it may be structural or cyclical, and it may be the result of supply-side issues or of demand-side issues. It is crucial to clearly and precisely define the market gap and its root cause to determine:

- Whether there is really a gap between demand for and supply of financial services for a particular public policy or social mandate,
- What the gap is,
- Why it exists,

- Whether filling any perceived gaps will result in the desired public policy outcomes,
- If so, what the best and most appropriate instrument is to fill any gaps, which may or may not be the PDB.

Market gaps also are not static; they change over time and require regular review and testing. Incomplete or incorrect analysis of the market gap and its causes can result in inefficient or even detrimental state intervention.

PDBs to Catalyze Supply and Stimulate Demand

The objective under this rationale is to: 1) stimulate demand for financing in sectors and projects that will contribute to economic development and 2) catalyze supply. The intention of PDB intermediation under this rationale—whether through risk sharing or backup guarantee—is to mobilize other financial institutions and investors with their financial resources, standard setting and knowledge of local market conditions. Done correctly, with PDBs having a “demonstration effect” and working in complement with the private sector, this approach can lead to the further growth of private financing resources, allowing gradual withdrawal of the PDBs. Done incorrectly, state intervention could lead to the private sector being crowded out, and could even delay structural adjustment by artificially boosting production (Rudolph, 2010). An additional issue is the degree to which the government subsidizes the credit that is channeled through the PDB, since the government may elect to offer subsidies as a way to create demand.

Catalyzing supply is particularly relevant during a crisis in which a previous supply of capital from private intermediaries has been withdrawn temporarily. In this situation, a PDB would be stepping in to play a counter-cyclical role, bearing in mind that commercial banks will need to be drawn back in as the recovery takes place. The challenge for PDBs in these circumstances has been referred to as the “Sleeping Beauty Syndrome” (Stephens, 1999). During normal economic times, the PDB will find that it no longer needs to intervene in a particular sector or with a particular facility, and therefore the expertise and knowledge that it developed will be “put to sleep.” However, should a crisis hit that opens up a market gap, the PDB will need this competency to quickly “spring back to life.” If PDBs are to have and maintain the technical expertise and experience that is essential to operating in current market conditions, and if they are to be regarded as serious and value-adding players by others involved in structuring and financing projects, there is a challenge for them to disengage or withdraw and later be brought back to an active and viable operation.

In addition, a valid role is for PDBs to stimulate demand for financial services by addressing nonfinancial gaps. For example, SMEs may need business advisory support, as well as capital, to grow. A PDB that offers training and advisory services to strengthen and build SME capacity could help improve the creditworthiness of the SME and make it more eligible for commercial bank financing.

PDBs as Proxies for Bank Regulators

A third rationale used by governments to justify state intervention in the banking sector is to ensure “the safety and soundness of the banking system.” This has been termed the “political rationale” since its aim is to “counter the substantial economic and political power of large private banks” (Hanson, 2004). In this capacity, public banks would serve not only as a backup (and counter-cyclical) source of liquidity—smoothing out credit cycles—but also in a more comprehensive role as a transmission belt for monetary policy and a regulator of market interest rates. The government therefore uses PDB essentially to avoid oligopolistic behavior on the part of commercial banks and keep interest rates in line with appropriate market levels and improve or increase competition. This is a very sensitive area, as it requires the PDB to have a strong sense of the market dynamics so that it avoids undercutting commercial banks to a level that would cause them to withdraw. Intervention also may involve the establishment of new public commercial banks from the nationalization of weak private sector banks.

Conclusion

The most relevant and up-to-date rationale for intervention by PDBs is to address the existence of market gaps. It is also the safest rationale and should always remain at the foundation of a PDB’s mandate and activity. Only when it has successfully operated under a restrictive market gap mandate should a PDB consider adding intervention based on the rationale of market regulator. A particularly relevant case is that of a PDB taking on a counter-cyclical role; in this situation, it is essential that the PDB have previous experience in the Tier 1 market and extensive knowledge of potential clients, since without this it will not be able to operate effectively. The PDB operates within a narrow band of acceptable activity; without the discipline of market gap analysis to guide its scope of activity, it may bring on any number of nonproductive results and unintended consequences including crowding out commercial banks, financial losses, low- to no-development returns, distorting markets and fiscal contingencies.

Evolution of PDBs

The history of PDBs extends back to the 19th century Industrial Revolution. Three distinct phases in the evolution of PDB global activity can be identified over the past half-century or more, each associated with the changing theory of development economics prevailing at the time. This evolution is useful in understanding the current state of PDBs and their challenges. Mid-twentieth century development theory identified capital investment as a catalyst for economic growth, with PDBs as the main tool for addressing the shortage of development financing.⁴ Based on a belief of the inadequacy of markets, especially in developing countries, this was part of a broader approach advocating direct government involvement in key economic sectors, which resulted in a range of government interventions. Characterized as the development (La Porta, Lopez-de-Silanes, and Shleifer, 2000) or interventionist (De la Torre, Gozzi, and Schmukler, 2007) view, it led to a proliferation of PDBs around the world, especially in South Asia and Latin America. Over time, these PDBs expanded beyond an initial mandate to alleviate a shortage in long-term financing for key infrastructure and industrial projects, and became active in areas such as rural credit, SMEs and housing.

By the late 1980s, the lack of evidence that PDBs were fulfilling their social mandate coupled with their poor financial performance led to questions about their role.⁵ Over the next decade many institutions, especially those operating under a Tier 1 model, required massive infusions of capital to survive. At a global level, it is estimated that at least 250 institutions were privatized between 1987 and 2003 (Francisco et al., 2008). Other banks were restructured, and even closed down altogether, which was in line with the then-prevailing Washington Consensus policy view that was aimed at liberalizing markets and restricting the role of government in the economy. This phase of PDB evolution, characterized as the laissez-faire (De la Torre, Gozzi and Schmukler, 2007) or political (La Porta, Lopez-de-Silanes and Shleifer, 2000) view, argued against government ownership of financial institutions on the belief that it leads to the politicization of decision-making and lowers economic efficiency through the misallocation of resources.

More recently, the pendulum has begun shifting to a midpoint, with the acknowledgement that government intervention can be constructive, provided it is based on an analysis of the market failure and its primary cause, and that it can be provided in a cost-effective way. It is believed that government intervention should be used to complement

⁴ Especially associated with Gerschenkron (1962), Myrdal (1960) and Lewis (1955).

⁵ Various empirical studies on the impact of government owned banks—not only PDBs—have pointed to negative or neutral results. These include La Porta, Lopez-de-Silanes and Shleifer, 2000; Beck and Levine, 2002; and Micco, Panizza and Yañez, 2007.

private sector activity or to facilitate market development and, on this basis, should be relatively short term and should include an exit strategy. This latest approach, characterized as the pro-market activism view (De la Torre, Gozzi and Schmukler, 2007), has gained ground as countries grapple with the fallout from recent financial crises. It suggests that limited and targeted involvement for PDBs directed at addressing market gaps or failures and with stringent disciplines to ensure efficiency may be effective, although this view still cautions about the potential long-term costs.

The situation in Latin America and the Caribbean has followed essentially the pattern described above: there was a surge in PDB activity through the late 1980s, followed by a wave of liquidations and restructurings in the 1990s.⁶ This is reflected in ALIDE's records, which indicate a drop in membership from 171 in 1988 to only 73 in 2003. Notwithstanding this contraction, it has been estimated that by 2005 the broader category of state financial institutions (including PDBs as well as public commercial banks) still represented 23 percent of banking assets in Latin America and the Caribbean, although this share varies widely from country to country (Rudolph, 2010).

Over the past decade, there has been renewed interest in the PDB as an instrument to achieve financial deepening and development objectives, at a time when private credit to socially important sectors has remained elusive. Indeed, PDB assets in Latin America doubled between 2004 and 2008. The objectives of PDBs are increasingly not just access to finance, but promotion of public policy objectives. Thus, in recent years they have expanded their role and been used for designing, financing and implementing climate change-related and infrastructure projects, and for delivering nonfinancial services such as business development. Many PDBs also have increased their intermediation channels to include non-bank entities to have better access to unattended or geographically dispersed economic agents and have looked to diversify the sectors in which they intervene.

Indeed, during the most recent international financial crisis, some Latin American governments turned to PDBs, using them in a counter-cyclical function to sustain financing as a means to stimulate the economy. The PDBs were allocated state funds to extend lines of credit in a range of sectors, including agriculture, industry, housing, infrastructure, international trade and SMEs, additionally providing preferential credits to specific segments, such as social housing and urban and rural small enterprises. They were also used to set up

⁶ Examples of liquidation include Minero, Industrial, Agrario y de Vivienda de Perú, Bancorural de México, Instituto de Fomento de Colombia, Bandagro de Venezuela, Banco de Crédito Popular de Nicaragua, *inter alia*. Examples of restructuring from Tier 1 to Tier 2 include COFIDE in Peru, NAFIN in Mexico, CFN in Ecuador, *inter alia*.

infrastructure funds, to funnel resources to financial intermediaries and to guarantee company share issues.

ALIDE, in its 2009 Statement of Curaçao,⁷ reaffirmed the major role to be played by PDBs in creating financial markets, correcting market failures and, during times of crisis, providing a counter-cyclical balance to the market.⁸ In fact, according to current statistics, ALIDE's membership has now risen to 101; of this number, 82 are wholly or partly-owned by the state. The banks tend not to specialize and, whether considering total membership or the population of 82 banks with state ownership, over 60 percent claim a broad multisector focus, something that has been identified as a common problem. Based on ALIDE data, the total assets of banks identified as public increased by 50 percent between 2007 and 2009 alone.

As is evident, PDBs in Latin America and the Caribbean once again have assumed a more prominent profile, and the discussion is now about what role they should play in the future. Governments in the region are seeking to reinvigorate these institutions with the goal of resolving the major economic and social challenges facing Latin America and the Caribbean (ALIDE, 2010). Priorities for PDB intervention cover a range of public policy interests, including tackling poverty and inequality, over-concentration on natural resource exports, low quality of education, climate change, technological development and infrastructure needs. While these are valid and important policy issues for governments to focus on, it does not follow that PDBs are the optimal public policy instrument to be used to address all of them. Indeed, the indiscriminate use of PDBs has been identified as a common problem (see "Shortcomings of PDBs" below). It is crucial to first analyze whether the PDB is the appropriate delivery mechanism for a government's policy objective and, if so, to define a targeted, narrow and logical mandate for it.

A further trend evident in Latin America and the Caribbean in the last couple of years that merits careful attention is the move to transform established and successful Tier 2 institutions into Tier 1 institutions. As mentioned above, if not accompanied by disciplined identification and evaluation of the assumed market gaps, and of the financial and market distortion risks involved, this trend may result in failures similar to those of the past.

Given this context of governments assigning increased roles and funding to PDBs, it becomes essential to analyze the factors and institutional settings that are conducive to having successful PDBs. Arriving at an accurate analysis of the aspects in which a PDB is performing well, and those in which it is not, is possible only through a comprehensive

⁷ ALIDE Statement of Curaçao. 2009: 1.

⁸ ALIDE Statement of Curaçao. 2009: 16.

diagnostic carried out institution by institution, as each PDB is the unique result of the particular political, legal and economic environment within which it operates.

Shortcomings of PDBs

It is useful to review the major problems and shortcomings of PDBs, as analyzing the causes of past failures may help governments avoid repeating them. The state of PDBs has been the subject of numerous studies and reports,⁹ especially since their fiscal failings of the 1990s led to questions about their future role. Recent literature covers listings of the problems and shortcomings of these institutions. Notwithstanding some successes, the performance of PDBs has been disappointing on a macro level: their fiscal failures have been evident, leading to substantial losses for their national treasuries, while their record in fulfilling public policy mandates has been questionable. The following table summarizes the problems with PDBs, as identified by the literature, under three broad categories.

⁹ These include Yaron, 2004; Rudolph, 2010; Hanson, 2004; Almendáriz de Anghion, 1999; UN, 2005 and 2006; Titelman, 2003; Ratnovski and Narain, 2007.

Table 1. PDB Issues and Shortcomings¹⁰

| A. Public Policy and Corporate Governance | |
|--|---|
| <i>Government policies and strategy</i> | <ul style="list-style-type: none"> • Inadequate government policies (i.e., macroeconomic, industrial, financial, agricultural and development policies) that hamper private financial intermediation to resolve credit needs),^A • Policymakers that do not distinguish root cause from symptoms of credit shortage, resulting in ill-designed solutions,^A • Attempting to resolve all situations with a PDB when it actually has a limited but important role to play,^B • Intervening in sectors that are not crucial for economic takeoff, or sectors where PDBs do not have competencies,^C • Lack of understanding by the state of the need to create an enabling environment (regulation, legal, judicial, enforcement systems, institutional arrangements), and^A • Government insistence on operating Tier 1 institutions, ignoring potential of using private agents.^A |
| <i>PDB mandate</i> | <ul style="list-style-type: none"> • Lack of a clear mandate,^{E, F} • Mandates that are rigid and often inappropriate,^G • Multiple objectives,^D • Difficulty in reconciling dual mandates: financial sustainability and policy,^G • “Pendulum shift” in hard times (i.e., shutting down low-value loans) resulting in mission drift.^A • Engaging in business practices that displace the provision of commercial financial services by the private sector, impeding new market entry and undermining competition,^L • Entrenchment, reluctance to downsize, reform or liquidate once market is able to take over,^H • Programs that grossly outlive their usefulness, and^A • Inadequate targeting of clients.^A |
| <i>PDB corporate governance</i> | <ul style="list-style-type: none"> • Political interference,^{D,E,F,G,H,I} • Government officials acting in capacity of owners who directly intervene in day-to-day operational decisions,^L • Government conflicts of interest in its multiple roles (shareholder, regulator, supervisor and defender of taxpayer interests),^D • Pressure groups, capture from unintended borrowers,^{A,D} • Weak boards of directors,^E • Inadequate prudential regulation and ineffective supervision,^{G,I} • Low accountability to shareholders,^{D,I} • Evidence of mismanagement and corruption,^J • Lack of transparency or information,^{F,H,I} • Internal and external financial and nonfinancial reporting that is incomplete and inaccurate; that does not provide an adequate basis for decision-making by boards and executive managers; and that misleads government owners, legislatures and the public,^L |

¹⁰ Sources: A—Yaron, 2004; B—UN, 2006; C—UN, 2005; D—Hanson, 2004; E—Rudolph, 2009; F—Titelman, 2003; G—Thorne & du Toit, 2009; H—Ratnovski & Narain, 2007; I—Rudolph, 2010; J—Armendariz de Aghion, 1996; K—IDB, 2005; L—Scott, 2007.

| | |
|-----------|---|
| | <ul style="list-style-type: none"> • Lack of transparency regarding costs versus benefits of PDB to deliberately obscure knowledge of real costs,^A • Unknown annual costs of maintaining PDB, leading to lack of public debate on desirability of supporting it,^A • Intervening in unsustainable, politicized or poorly managed ways^C • Weak management,^{A,E,K} • Executive managers who act with near autonomy, pursue unintended objectives, and operate in a manner contrary to sound commercial business and public financial management principles,^L • Limited managerial, financial and operational skills and lack of proper incentives,^{E,G,I} • Lack of appropriate hiring policies, and^A • Overstaffing (government employment vehicle).^H |
| B. | Development Impact |
| | <ul style="list-style-type: none"> • Poor development outcomes and impact measurement.^{E,G} <p>(The literature generally acknowledges that this is an underexplored area.)</p> |
| C. | PDB Financial and Operational Performance |
| | <ul style="list-style-type: none"> • High losses,^{A,G,I} • Persistent needs for recapitalization or subsidies,^{A,I} • High subsidies and lack of transparency,^A • Lax financial discipline,^A • Poor credit risk management and cost-benefit evaluations,^{F,J} • Credit misallocation and politically motivated lending,^{A,I,K} • Inadequate loan pricing,^A • Risk of underpricing,^L • Political difficulty in lending at market rates, collecting loans and executing collateral,^D • Culture of nonpayment,^D • Large labor contingencies, including underfunded pensions, and^A • Weak debt recovery policy, high arrears ratios.^{A,F,J} |

While their shortcomings and problems have been evident, the underlying causes have been less so. Some of the issues identified are “symptoms” and others are “root causes.” Usually, only a small number of root causes exist, and these few root causes give rise—directly or indirectly—to all (or most) of the other issues (or symptoms) identified. For example, the root cause of a number of shortcomings is the lack of a clear mandate: without a clear mandate, a PDB runs the risk of attempting to address all situations, such as intervening in areas or sectors not crucial for economic takeoff, or in sectors where it does not have competency or where there is no market gap. Another root cause is the blurring of a government’s multiple roles and responsibilities as shareholder, supervisor and regulator, and defender of taxpayer interests, which can result in symptoms such as political interference, low accountability, inadequate prudential regulation and supervision, and credit misallocation. If the root causes are addressed and resolved effectively, most of the other

issues (or symptoms) tend to fall away over time. This approach therefore offers a powerful and useful diagnostic concept for assessing the state of health of PDBs.

Section 2: Assessing Public Development Bank Health

Recent literature on PDB, although limited, does include analysis on both best practices and performance appraisal frameworks for PDBs. Scott (2007) and Rudolph (2010) provide valuable benchmarks for best practices in the areas of mandate and governance. Scott's paper addresses corporate governance practices in wholly state-owned financial institutions (SFIs), consisting of state-owned commercial institutions and state-owned development institutions. Rudolph analyzes the importance of having a clear and sustainable mandate, as well as an institutional framework that can mitigate political interference. Rudolph's paper analyzes good practices for building, implementing, financing and evaluating the mandates of SFIs. It also examines ownership by and nomination of board members. Rudolph stresses two things: 1) the importance of market failure as a key variable in the definition of a mandate and 2) the need for rules of cooperation with the private sector to ensure the SFI plays a complementary role to that provided by the privately owned commercial banks. He also discusses governance issues, with particular emphasis on ownership policies, the process of nominating board members and ensuring the professional qualification of management, and safeguards to deal with political intervention.

Francisco et al. (2008) use two indices to conceptualize the economic and social profitability of PDBs, while ALIDE and Saldaña developed indices with a more holistic approach to assessing the performance of PDBs. Each of these performance models offer interesting insights into how a PDB can be assessed.

One important issue that has been commonly raised is the need to balance two basic performance criteria: 1) achieving a social or policy objective and 2) remaining financial sustainable. It also is generally acknowledged that PDBs have particular characteristics that differentiate them from private intermediaries and which must be taken into account in analyzing financial indicators. For example, PDBs do not maximize profit; they can have different returns on capital requirements; and they are by definition engaged in riskier activities than private intermediaries. Nonetheless, some fundamental perspectives are (partially or fully) absent from these performance models:

- A PDB always has to work within the parameters set by its government shareholder, and therefore its evaluation should be situated in the broader

context of the economic policy set by government. Even if the PDB's "stand-alone" operational performance could be considered excellent, its overall assessment may be suboptimal if the goals pursued by the PDB are contradictory, or at the very least not complementary, to the overall objectives set by the government. It is also possible that the government's strategy is incorrect; that its market gap analysis is correct, but the PDB is not the correct public policy tool to use to address it; or that the cost of trying to fill the gap is too high to justify the benefits, and therefore not worth it.

- A PDB that has access to cheap government funding, explicit credit support and a range of financial subsidies, and that is not "burdened" by capital adequacy rules, should perform in all respects much better than a PDB that does not benefit from these advantages.
- Fundamentally, PDBs have been created to address various market gaps (geographic, industry, segment, product demand and supply). Therefore, it is expected that a strong-performing PDB will: 1) define exactly what the market gap is (bankable or viable project), 2) determine whether it makes economic sense to fill the market gap, 3) develop a strategy based on this analysis and 4) regularly update this exercise and integrate the results of this update, in conjunction with "development lessons learned," in an updated strategic framework.

Both the public policy and market gap perspectives on PDB performance are concepts that are hard to quantify in absolute terms. This is why the quantitative approach, while interesting in establishing operational and development return concepts, cannot offer a complete solution to measuring the performance of PDBs.

Current literature offers some very strong components of what is wrong with PDBs and what constitutes best practices across some important areas. However, no single paper addresses the problems in an all-encompassing way, as shown in the section "Shortcomings of PDBs," which summarizes the literature on PDB shortcomings; nor does any single paper offer a comprehensive approach to best practices or an approach to measure the health of an organization against such best practices. The diagnosis and important elements are largely in place, but the definition of good health remains to be fully developed and established. This study proposes a new methodology, one that is a comprehensive framework for measuring the health of a PDB.

The Health Diagnostic Tool for PDBs offers a flexible and comprehensive framework to compare the common parameters and features to their overall systems, regardless of type, form and function. This tool is not a “best practices” framework that allows PDBs to benchmark against an “ideal” PDB, because there is no such thing as an “ideal” PDB; all PDBs operate within unique political, social and economic national contexts. Moreover, what might be good practice for a PDB in one context could be damaging in another context. For example, a PDB that has a mandate to stimulate demand and is operating within a financial sector that is very mature and deep, and where the markets gaps are therefore limited and quite precise, runs the serious risk of crowding out the commercial financial players, if not careful. In one context, it might be preferable for a PDB to have government officials on its board of directors, but for another PDB in a different country and within a different system of government bureaucracy and policy-making, a more autonomous relationship with government may be more appropriate. This tool therefore does not advocate “cutting and pasting” an exact replica of one PDB into another country or context, as a well-performing bank in one context could risk failure in another.

The framework is balanced and comprehensive and combines elements of both developmental and financial returns, while also integrating more abstract concepts such as business model, market gap analysis, and degree of policy, regulatory and financial autonomy. Because of the variety of business models and mandates of PDBs, there is no one definition of what constitutes perfect health for a PDB (just as there is no one healthy weight for people, as a healthy weight depends on a person’s height, bone structure and other factors).

A healthy PDB is one that finds a financially sustainable way to balance the needs of its stakeholder—shareholders (governments), clients, private sector intermediaries and taxpayers—while accomplishing its ultimate goal, which is meeting its public policy objective. Three common parameters of performance can be identified: 1) public policy and corporate governance, 2) development impact and 3) financial and operational performance. Each of these three parameters is further explored using four key dimensions, with each key dimension being a value statement intended to define—in absolute terms—what “health” means for that particular element in the PDB’s organization and operations. The 12 key dimensions are “normative statements” depicting what good health would look like, and they were developed to ensure that: 1) taken **individually**, each key dimension captures the critical aspects of best practice within that element, and 2) taken in **aggregate**, the 12 key dimensions serve as a diagnostic system for determining the overall health of the PDB.

The parameters for a healthy PDB described below tend to delineate those practices that are particular to PDBs and are not intended as an exhaustive list of issues since they exclude basic elements that are obvious for any successful (i) public entity and (ii) financial intermediary. In the next section, each of the three parameters and associated key dimensions will be described in turn, with an explanation of what it covers and why it is important.

Public Policy and Corporate Governance

PDBs exist to meet a public policy need. It is therefore critical to ensure that a PDB's mandate and resources are properly framed relative to the government's strategy within that public policy domain and the PDB's own legal foundation. It is also critical that the PDB is supported by an appropriate system of corporate governance, and that the analysis of the market gap—the extent to which the private sector sources of finance and risk capital are unable to meet the needs—is undertaken and feeds into the PDB's vision and strategy. The four key dimensions of health in this area are described below.

1. The government has a clear strategy for developing and promoting a target area, and this strategy has been a key input in drafting the PDB's vision, strategic plans and budget.

If the government fails to develop a multiyear strategy outlining how to achieve maximum development (or financial) value, it will jeopardize the policy's chance of success. It is therefore critical for the PDB's government shareholder to develop a long-term government strategy that is transmitted, in writing, to the various agents of the government, including the PDB. The strategy should: 1) set out why one approach is more suitable than alternatives, 2) determine whether the PDB is the best and most appropriate instrument to meet the objective, 3) outline the respective responsibilities for each agent and 4) describe the resources needed to achieve success in reaching the objective. It is then the PDB's responsibility to implement the strategy that has been outlined for it by the government. The PDB must integrate the government's economic strategy, the philosophy behind the strategy, and the role that has been assigned to it as a key input in its own strategic plan and operational budgets.

Although evaluating whether a government's strategy is right or wrong falls outside the scope of this health framework—which has been designed to assess whether a PDB is performing well or not—it is important to highlight that a government-owned PDB is only one of many available instruments of public policy. Choosing the “wrong” instrument, or failing to take a global and comprehensive government approach, will result in suboptimal

development results, even if the PDB's performance is excellent on a stand-alone basis. Furthermore, the government's strategy itself may be faulty, in that it may have miscalculated the importance of a market segment to economic or social development, leading it to intervene in areas with little or no public policy benefit.

2. The PDB's mission statement and resources are clearly defined by law, act or company bylaws.

PDBs do not operate in a legal or strategic vacuum. They are created to address socioeconomic policy objectives in response to market failures or gaps, and their legal existence is set out in a law or act or in the bylaws of the PDB. The extent to which the bank's mandate and available instruments and resources are clearly described in the PDB's legal framework will affect its ability to operate efficiently and productively. It will establish the boundaries of the bank's playing field and should act as a benchmark against which a PDB's performance will be rated. Among other things, the legal framework should:

- Clearly define the PDB's legal form and the applicability of other laws related to similar public organizations (such as budget processes, auditing and acquisitions) and to financial institutions (such as supervision and prudential norms);
- Clearly define the PDB's public policy mandate or purpose;
- Set out its relationship with the government, particularly the role of the government's shareholder representative;
- Position the PDB as a complement to the private sector;
- Lay out the financial context for the PDB's operations, including any constraints on its activities (such as a requirement to be self-sustainable), the resources to be made available to it and any government obligations for guaranteeing its debt or recapitalization;
- Define the products the PDB can offer (loans, guarantees, equity capital, etc.) and Tier 1 or Tier 2 funding, although broad statements with some flexibility to meet market needs are required;
- Outline the governance system, especially requirements for an independent board of directors and for transparency and disclosure through regular reporting.

The PDB has little or no direct influence over the quality of its legislative framework, since it is an external input from the government shareholder. Nevertheless, while

recognizing that there is no ideal model for a PDB, it is in the bank's own interest to validate the coherence of its action against the mandate and that resources have been provided to fulfilling it, and to ensure that it benefits from the strongest possible legislative basis.

3. The PDB has a solid code of corporate governance.¹¹

Corporate governance is the system by which institutions are directed and controlled. The corporate governance framework for a public financial institution sets out the rules of engagement and the respective roles and responsibilities of the government shareholder, the board of directors, auditors and management. The shareholder's role is to appoint the directors and the auditors, and to satisfy itself that an appropriate governance structure is in place. The board of directors is responsible for the governance of the institution, including setting its strategic aims and providing leadership toward its achievement, supervising management, and reporting to the shareholder. This role is to be distinguished from the day-to-day operational management by its full-time executives.

The purpose of corporate governance is to facilitate effective and prudent management that can deliver the long-term success of a PDB and help it achieve its mandate and objectives efficiently. Good governance is based on the principles of accountability, transparency, probity and focus on the sustainable success of an entity over the long term. Specifically, transparency in the form of published corporate plans and annual reports that detail subsidy levels and set out performance targets and results is essential. Good governance must also include tools for effective monitoring, as well as high levels of internal controls.

The corporate governance code can be imposed by law, or the PDB may institute a code on its own initiative. The PDB faces a challenge in that it may be subject to the norms that govern all state-owned enterprises and to the policies of other public institutions, which may result in obstacles to achieving its mandate. Also, being a public entity, the lines that limit the roles of the shareholder, board of directors and management can become blurry. Thus, to the extent possible, the framework must assure that conflicts of interest and political interference are avoided.

¹¹ For a more complete analysis on corporate governance best practices for PDBs, refer to Scott (2007) and Ibarguen (2010).

4. The PDB has clearly defined the market gap and plays a complementary role to private sources of capital.

While an assessment of the quality of a PDB's public policy strategy is essential (as already noted), that is something assigned to it by the government, leaving the PDB only to integrate the strategy into its own planning. As stated earlier, the most relevant and up-to-date rationale for intervention by PDBs is the existence of market gaps. As such, the fundamental role of the PDB is to contribute to economic and/or social development by supporting economic agents and segments that are underserved by the private sector, but are nevertheless deemed to be of critical importance to the government's economic policy. In other words, PDBs should address market failures and play a complementary role to commercial banks and other sources of finance and risk capital, instead of crowding them out. Identifying and defining the market gap, and using this analysis to develop the PDB's vision and strategy, is therefore critical.

The bank should carefully define the market gap and determine whether or not it is sensible to fill the gap; it may not make economic sense to fill all gaps, and the bank's activities must fit its resources. At the same time, it may not be desirable to dedicate public resources to an activity that will have minimal impact or whose marginal benefits are outweighed by the costs. Thus, the nature of the gap needs to be understood:

- 1) Is the gap structural or temporal (i.e., is it crisis-based)?
- 2) Is the gap narrowly defined by a specific region, industry, product or segment, or is it more widespread?
- 3) Is the gap due to excess demand or insufficient supply?
- 4) If supply-based (i.e., private commercial banks and other intermediaries are unwilling or unable to provide the products and services the clients need), is it because:
 - a. There is a lack of information to make credit decisions?
 - b. There is information, but the private financial intermediaries are unwilling to take the risks because of their own financial positions?
 - c. The administrative costs are too high relative to the returns?
 - d. There are high opportunity costs for the intermediaries entering those segments (i.e., there are more profitable areas in which to invest or offer credit)?

The gap then needs to be precisely defined through detailed interviews with the commercial banks and other private financial intermediaries. This is then validated on the demand side by clients in the domain area to ascertain what types of transactions are currently not being supported and in which specific instances these transactions have been rejected by the commercial banks.

The PDB must also decide what types of projects to address: bankable, nonbankable but viable (for example, because of a lack of capital or collateral), social projects that are neither bankable nor viable, or any combination of these. Table 2 summarizes the types of quantitative data that must be collected to undertake a market gap assessment. The table uses an SME-focused PDB for illustrative purposes. In this case, the SME population must be clearly defined and segmented (micro, small enterprises, medium-sized enterprises, etc.).

Table 2. Definition and Measures of Types of Gaps for an SME Development Bank

| Definition | Measures |
|---|---|
| Market gap at a macro level | <ul style="list-style-type: none"> • All loans/GDP, • Corporate loans/GDP, • All SME loans/GDP, • Small enterprise loans/GDP, • Medium-sized enterprise loans/GDP, • Micro loans/GDP, • Large enterprise loans/GDP, • Risk capital/GDP, and • Venture capital/GDP. |
| Analysis of the supply side of the market gap for all subsegments | <ul style="list-style-type: none"> • Number of commercial banks (privately owned and state owned), • Number of loans from commercial banks per segment, • Market share of the development bank in terms of volume, and • Market share of the development bank in terms of number of customers. |
| Analysis of product supply for all SME subsegments | <ul style="list-style-type: none"> • Total working capital loans/GDP, • Total long-term loans/GDP, • Total trade finance loans/GDP, • Total risk capital exposure/GDP, and • Market share for the development bank in all product niches. |
| Analysis of supply per industry and per region | <p>On a per-industry/per-region basis:</p> <ul style="list-style-type: none"> • Contribution to GDP, • Total available financing, and • Total available financing /contribution to GDP. |
| Analysis of the demand side of market gap on a segmented basis | <ul style="list-style-type: none"> • Total number of companies by segment, product, region and industry, and • Surveys identifying: <ul style="list-style-type: none"> ○ Number of loan applications, ○ Percentage of loan applications/total number of companies, ○ Number of loan applications rejected, ○ Percentage of loan applications rejected, and ○ Reasons for rejection (risk profile, capital adequacy, strategy for specific segments, unavailability of funding, etc.). |

The PDB must have a clear strategy and rules of engagement for catalyzing private sources of capital to take more risk. It is crucial that the bank takes on a complementary role to the role of the private sector and actively promotes its involvement through risk sharing (such as co-financing and guarantees). Where it is appropriate for a PDB to be involved in Tier 1 direct lending to the client, the bank must avoid crowding out the private sector by

following proper market segmentation and recognizing that different segments of the market may be more attractive to commercial players.

Market gap analysis should be repeated periodically because market gaps change as market conditions and economic policy shift. As a consequence, a gap analysis performed in the past may no longer be valid, and failing to address the new “gap environment” could lead to a suboptimal strategy. A gap analysis should be done for each new segment identified as a potential market.

During economic or financial crises, PDBs have a counter-cyclical role, and they may be called on to help smooth out the effects of credit contraction as Tier 1 capital providers. During these crises, market gaps can open up in many areas that, under normal market conditions, can be served by private financial intermediaries. For example, as a result of the current risk-driven capital framework (Basel II), many commercial banks will reduce their loan exposure during economic downturns, and thereby aggravate the consequences of crises. This market gap need not only apply for SMEs and more typical areas where market gaps exist, but could also hit large corporations (such as General Motors in 2008–09), and the PDB might be required to provide direct loans to these clients. Or, commercial banks might find their own access to funding limited, and therefore be unable to fund the transaction, even if the credit risk they are being asked to take is acceptable.

This so-called procyclicality of commercial banks could be addressed by government policy and by providing liquidity through PDBs in their counter-cyclical role. However, once the crisis has subsided, the PDB must be able to withdraw so that the commercial banks can re-enter certain parts of the market.

Development Impact

The goal of PDBs is to contribute to socioeconomic development. Therefore, measuring the development impact of a PDB’s activities is central to assessing its performance. To do so, the bank must clearly articulate its development objectives as key performance indicators (KPIs), reflect these development objectives in its lending criteria, monitor its development results and draw on an independent unit to verify performance. There are four key dimensions for health in this area:

5. The PDB has clearly defined development objectives.

In addition to developing clear financial objectives, the PDB requires clearly defined development objectives. If it does not have these, the PDB risks not linking its development

objective and strategy with its day-to-day operations, and as a consequence, it could end up not pursuing the right objective or not even pursuing a real objective at all.

For example, the objectives for an SME-focused development bank may include: 1) a development effect, or the extent to which intervention by the PDB has resulted in the ultimate developmental goal (such as more productive SMEs) and created more economic value, 2) relevance and additionality, or the extent to which the activity is incremental to that provided by private intermediaries, 3) demonstration effect, or the extent to which private intermediaries have increased their market share in the segment where the PDB is active, 4) transfer of skills, or the extent to which the PDB has organized training or other technical assistance activities to improve business and professional skills, and 5) changing business conduct, such as improved environmental and social awareness.

6. The PDB has clearly defined development criteria incorporated in its lending/investment policies and processes.

Development criteria are defined not only at the macro level; they also need to be incorporated at the micro level through the PDB's lending policies. The articulation of these development-related KPIs is reflected in how the bank frames its lending criteria and how it measures results. Coherence between these two levels is achieved by ensuring that the themes of the bank's KPIs or development objectives and criteria are translated into complementary lending criteria.

Furthermore, the PDB's internal decision-making processes should be organized to specifically take development considerations into account when credit decisions are being made. An effective way of achieving this is to have a separate department in the bank responsible for representing the development perspective, thereby ensuring a balance between financial return and development return.

7. The PDB regularly monitors its development impact, and the lessons learned are integrated into subsequent strategic plans.

A PDB cannot rely on an assessment of its financial performance only, as this would ignore its public policy development mandate. It is this development mandate that distinguishes the PDB from a commercial bank. Measuring and analyzing the bank's development impact verifies the effectiveness of its actions. It can also help the bank understand what has worked and what has not, so that the bank can incorporate these "lessons learned" into its next strategic plan and budget. The main challenge of an impact-evaluation study is to determine

what would have happened to the beneficiaries if the program had not existed. That is, the evaluation tries to determine the (expected) outcome of a firm that received a financial service in the absence of the intervention. This requires the PDB to construct the necessary data from the beginning of the program and analyze the data using, among other things, econometric techniques capable of eliminating or reducing potential selection bias. This selection-bias problem has been widely analyzed in the literature on policy evaluation, and the same analysis can be adapted to the evaluations.

8. An independent evaluation unit carries out a review of the PDB's development impact.

The principle of internal control is entrenched in well-performing commercial banks through the segregation of duties (front office versus risk management) and through having an independent department of internal audit to evaluate the overall internal control system. In the same way, PDBs also require an independent evaluation department. However, in the case of PDBs, the department is responsible for evaluating *ex-post facto* the bank's "development return" and making recommendations for improvements to the bank's best practices for "development management." This department should have no relationship with the bank's front-office operations.

Financial and Operational Performance

As with any institution, it is necessary to consider whether the PDB is being viably and sustainably managed, respecting its nature as a state-owned financial institution with a dual mandate of addressing public policy objectives while being financially self-sustaining. The following are the final four key dimensions to financial and operational health:

9. The PDB has a comprehensive marketing strategy that is consistent with its mandate.

The PDB needs a marketing strategy that:

- Is efficient in terms of distribution of products and services (place),
- Is consistent with its mission statement in terms of pricing (price),
- Provides the right products to the right customers (product).

The analysis of **distribution** (place) is particularly important to PDBs because, like any other bank, they need efficient distribution channels, but they also need to have sufficient

leverage over their distribution channels to achieve their strategic development objectives. PDBs operate through two different distribution models: Tier 1 PDBs provide direct lending, quite often (but not exclusively) via their own network of branches, whereas Tier 2 PDBs sell their loan products via the distribution network of commercial banks. Virtual and mobile distribution networks have also been developing rapidly.

In this context, the Tier 1 PDB has the advantage of carefully selecting its customers according to its desired financial and development profile. However, the Tier 1 PDB will have less-efficient penetration potential, as (in the majority of cases) it will not have a broad branch network to bring customers on board, and will be less cost-efficient. The Tier 2 PDB, on the other hand, uses the distribution capacity of the commercial banks but also leaves the lending decision in the hands of the commercial bank. This approach is optimal for maximizing lending volume, but it may not achieve the intended development outcome because a commercial bank's lending criteria (collateral, capitalization, pricing, etc.) may be completely different from the PDB's strategic mandate. In this case, the PDBs must have well-defined policies for funding banks under certain programs (such as rediscounting) and an auditing system of the banks' portfolios.

A third theoretical hybrid model could consist of outsourcing parts of the process to a commercial bank, using its distribution platform and analysis capacity (based on PDB lending policy guidelines), while still directly funding the end-customer and giving a fee to the commercial bank for sourcing, documenting, disbursing, monitoring and collecting the loan. The commercial bank could also be invited to take risk participation in the loans, or competition could be organized among the commercial banks to encourage risk appetite.

The **pricing** policy for a PDB is complex since potentially contradictory targets need to be met: optimizing both financial return and development return, which may result in not selecting the best risk-return scenario. Other considerations also come into play when analyzing pricing policy, including the degree of subsidy (coverage of risks and costs) provided by the public shareholder, which should also be transparent, and assumptions for the cost of capital and capital adequacy rules. Indeed, PDBs may be guided by a different set of regulatory requirements or economic capital requirements. These economic capital considerations are ultimately driven by the PDB's risk profile and the return a shareholder is entitled to expect on the economic capital its activities require.

Table 3 describes what could be a coherent pricing strategy depending on a PDB's financial and institutional constraints. It shows pricing as a function of a PDB's mandate and its capital and financial framework; as such, there is no optimal pricing strategy for the entire

population of PDBs. Moreover, there is no definitive pricing methodology that can be applied to the spectrum of PDBs. Therefore, it is preferable to verify the consistency of a PDB’s pricing policy, taking into account its institutional, legal and capital adequacy framework.

Table 3. Pricing Consistency Matrix

| Pricing policy/institutional framework and mandate | Fully subsidized bank, no capital adequacy rules, social lending | Hybrid bank (some level of subsidies, soft capital adequacy rules) | Stand-alone bank with tight capital adequacy framework, no obligation for “social” lending |
|--|--|--|--|
| No cost coverage | X | | |
| Cost coverage ¹² | | X | |
| Cost + risk coverage | | X | |
| Cost + risk coverage + economic profit | | | X |

Table 3 illustrates the most consistent approach taking into account PDBs’ institutional framework and mandate. For example, it would be inconsistent for a PDB, which would be heavily subsidized and unconstrained by a tight capital adequacy framework, to have the same pricing approach as commercial banks, as this would imply the subsidies have been awarded to make the PDB more profitable and not to foster economic development by providing SMEs or other target clients with lower-cost financing. The PDB’s development subsidies should lead to a higher level of risk-taking without: 1) increasing pricing to prohibitively high levels and 2) crowding out the commercial banks. At the other extreme, it would be equally inconsistent for a fully autonomous PDB, which is not benefiting from any support and is facing the same regulatory framework as its commercial peers, to have a pricing strategy in place that would not even cover cost, as this would create heavy financial imbalances.

Product management should be in line with the market gap analysis. For example, a financial industry with plenty of short-term liquidity but not enough long-term funding is probably unwilling to take unreasonable liquidity and interest rate mismatch positions, which would result in underserving the corporate sector’s long-term financial requirements. It therefore would make sense for the PDB to address the long-term financing gap by offering long-term funding, either directly or indirectly. A PDB with good product management has defined the facilities offered so that they address the identified gap. For example, if the market gap is that the credit risk of corporate customers is no longer acceptable to the commercial banks, a Tier 2 loan that is on-lent to the end-customer does not solve the

¹² Costs included are operational and administrative costs, and cost of funding.

problem. In this case, the PDB may need to argue that either a guarantee of the commercial bank or a direct loan (Tier 1) is the more appropriate instrument.

10. The PDB has an independent risk management function in place that covers all types of risk (credit, market and liquidity, and operational).

Like a commercial bank, a PDB has a risk management function independent from the front office. It covers the entire risk domain, both from a strategic/policy and an operational perspective, and as such, it plays a key role in all the PDB's strategic decision-making processes. However, a PDB by its nature assumes more risk than commercial banks, and therefore it is crucially important that the PDB has good risk management practices to ensure adequate pricing and financial sustainability in the long run.

Managing all categories of risk brings a double benefit to the PDB: not only does sound risk management protect the PDB's financial sustainability, but it is also taken into consideration by external rating agencies during credit assessments. An external credit rating is paramount to the PDB and its government shareholder, because a weak rating would preclude the PDB's ability to access international capital markets; without this access, less funding will be available to the PDB, which will result in reduced activity and lower development returns. Strong risk and capital management are therefore a prerequisite for enhancing development return.

In the **credit risk** domain, the following best practices are covered:

- Issuing an independent credit opinion on submitted transactions and participating as a key member in credit committee deliberations,
- Drafting loan documentation in accordance with decisions taken by the credit committee,
- Monitoring and reporting credit risk,
- Undergoing intensive care and recovery,
- Analyzing credit risk (Basel II modeling and economic capital requirements).

The risk management framework will be different if the PDB is engaged only in Tier 2 lending, as Tier 1 banks take direct customer risk or project risk. The Tier 1 PDB will always have the political challenge of collecting loans and executing collateral when operating under a context of a deeply imbedded culture of nonpayment, particularly if the government has written off loans in the past. One way to mitigate this problem is to operate as a Tier 2 institution or development agency; in this situation, the PDB needs good risk

evaluation of private intermediaries and assurance that these intermediaries, in turn, have good risk practices as well as regulatory compliance—which is obligatory.

Credit risk is the main risk faced by PDBs in terms of economic capital measurement and the assignment of external ratings. It is good corporate governance to divide responsibilities inside a PDB between staff who negotiate directly with the customer and staff who are responsible for objectively assessing the risks of the business. Strong banks manage to keep a healthy balance between business and risk by introducing the “four-eyes principle,” meaning that at least two individuals are involved in risk assessment. A PDB, as stated earlier, needs to consider another dimension in its lending policy and processes: the development return. The functions assigned to the credit risk department help the PDB maintain a high level of internal control, since it is unwise to assign responsibility for the entire credit cycle (from negotiation over documentation to recovery and collection) to one department.

In the **market risk** domain, risk management covers measurement/modeling, policy and implementation of:

- Liquidity risk management,
- Interest rate risk management,
- Currency risk management,
- Equity risk management.

In general, the second most important risk faced by PDBs is **liquidity risk**. This is because PDBs in developing and emerging markets often face liquidity mismatches. PDBs will normally have a high local credit rating due to an implicit or explicit government guarantee. Due to this guarantee, many PDBs decide to “carry” the liquidity risk because they can refinance in the market without any problems; however, this carries a risk in time of crisis. This liquidity mismatch needs to be carefully measured and managed for the PDB to remain financially sustainable.

Liquidity mismatches create interest rate mismatches for the simple reason that liquidity events lead to interest rate risk events, assuming that: 1) the PDB’s lending book is based on fixed interest rates and 2) few or no hedging options are available (which is usually the case in developing and emerging markets). A rise in interest rates would immediately lead to a loss in the PDB’s earnings and value. For this reason, the open interest rate position should be correctly measured and managed.

Currency mismatches can have an equally negative impact on a PDB's capital position or profit and loss (P&L) position. End-customers may opt for foreign currency-denominated loans, even when they only have sales income in foreign currency. This may be driven by the lower nominal interest rates for foreign currency loans, a practice accepted by the majority of commercial banks because they prefer to have more assets than liabilities in the stronger foreign currency, which is likely to appreciate and deliver foreign exchange gains to the balance sheet. There are two types of risks associated with this practice: 1) the foreign currency may depreciate instead of appreciate, and therefore generate foreign exchange losses, and 2) the appreciation of the foreign currency will put an additional burden on the loan customers, since their debt servicing capacity will grow because more local currency will have to be generated to repay the same level of financial indebtedness. Currency risk models and policy guidelines only address the foreign exchange exposure of the PDB; they do not cover the indirect credit exposure driven by market events. The latter risk is addressed by bank policy prescribing more stringent lending guidelines for borrowers wishing to receive funding in foreign currency.

The PDB will experience equity risk if it decides to provide risk capital funding to its customer base. This often means providing equity capital to companies still in their start-up phase. The absence of liquidity, in conjunction with a high-risk profile, means the bank needs to have in place the appropriate metrics as the basis for portfolio allocation of capital funding support.

In the **operational risk** domain, the following topics are covered:

- Measuring operational risks (internal and external fraud, quality of processes, quality of staff, quality of systems), and
- Defining an operational risk strategy.

Operational risks have been neglected for some time, but they are gaining attention due to the Basel II capital adequacy rules that specifically refer to them. Operational risk events may have a “low frequency, high severity” profile, but information technology (IT) system breakdowns, for example, can cause customers to lose confidence, while fraud can result in serious damage to a bank's reputation as well as to its financial health. The better-performing PDBs have supportive operational risk measurement systems, including operational risk event databases, self-assessment processes and related KPIs for core departments, as well as operational risk strategies ranging from improving internal controls to buying insurance.

11. The PDB has a clearly defined risk strategy, supported by a risk- and development-adjusted financial reporting system, and a capital management framework.

As shown by the review of the various methodologies used to evaluate development finance institutions, there have been attempts to adjust the accounting of their profitability by considering the effect of the subsidies they receive. The adjustment, while appropriate, tells only part of the profitability story, since it treats only the revenue part of the P&L picture.

PDBs, however, take more credit and market risk than commercial banks because of their public policy mandate. To correctly understand the real profitability of a PDB, a second round of adjustments is necessary to take into account “risk and development” effects. This second adjustment will indicate to what extent the PDB has taken more risk than commercial banks by relating the corrected return number to the “excess risk” taken. If the final profitability number is much higher than what commercial banks are making, this may mean the interest rates the PDB is charging to its customers are too high. Conceptually, there are three types of financial reporting for a PDB: accounting-based, risk adjusted, and risk and development adjusted.

Accounting-based financial reporting is based on the accounting standards imposed by the legislator. These are the statutory accounts consisting of balance sheet, P&L and (often) cash flow statements. This type of financial information provides general information on the PDB’s financial health based on an accepted set of accounting rules.

Risk-adjusted financial reporting basically replaces the loan loss reserve number calculated on the basis of accounting standards with an expected loss number. This enhances the accounting-based financial reporting by adding a credit risk dimension.

Risk- and development-adjusted financial reporting is the ideal reporting philosophy for a PDB as it integrates the costs of both risk and development. It is ideal because the PDB needs to understand its real profitability to correctly interpret whether it has performed well financially. Therefore, a first round of adjustment consists of adapting the accounting-based financial reporting numbers based on the expected loss to arrive at a risk-adjusted return. A second adjustment consists of adjusting the PDB’s performance to take into account all development costs and income.

Development costs and income consist of incremental costs/revenues associated with a PDB’s development focus that would not be generated by a commercial bank. This concept should also be used as a key input for the PDB’s strategic and financial planning processes in

order to understand the size of the “development cost budget” and its impact on the financial profitability and sustainability of the PDB. For example:

- Development income could consist of subsidized interest rates against which the PDB was able to borrow money, either directly from its government shareholder or by benefiting from an explicit or implicit sovereign guarantee, or other forms of operational subsidies that would not be provided to commercial banks. This development income would need to be identified and measured.¹³
- Development costs could result from a PDB (in pursuit of its development mandate) having a more flexible credit policy (such as credit risk and pricing) than a commercial bank; the difference in expected loss between the commercial bank and the PDB could be quantified as a development cost. A PDB (often the sole provider of long-term funding in developing and emerging markets) could also be driven to take a higher liquidity risk exposure than a commercial bank; to the extent that this liquidity risk is not re-invoiced to the end-customer via loan pricing, and that no commercial bank would be prepared to take this risk, this too could be quantified as a development cost.

In addition to adequately managing its capital base and reporting and managing identified risks, the PDB also needs a **capital management framework**. This capital management framework may be internally developed or based on the BIS framework, even if there is no regulatory requirement to do so; it applies economic, regulatory capital and rating agency constraints to the PDB’s strategic and financial planning process.

Managing their capital base is essential to all banks, whether development or commercial. Regulators have imposed a set of rules on commercial banks to protect the main stakeholders, primarily the depositors. These rules vary from country to country: in their most elementary form, they are expressed as a minimum capitalization requirement in absolute terms, while at the other extreme, regulators have called on banks to develop their own internal models to calculate capital requirements. In addition to these rules, some banks have also developed an internal capital management framework to measure requirements for

¹³ An implicit guarantee improves the rating of the PDB, and the rating differential causes the funding cost to be lower. This can be translated as development income.

“economic capital,” defined as the capital a bank needs to hold, taking into account its risk profile within a certain time period and confidence interval.

A PDB has particular reasons to carefully manage its capital base:

- Capital is held by the PDB as a cushion against unexpected losses. In its strategic planning process, a PDB needs to take into account how far it can go with its risk exposure. Not quantifying its risk exposure, and not translating this quantification into risk policies and limits, may expose the PDB to financial stress. In extreme situations, this could even lead to the PDB losing its financial viability, thereby jeopardizing its development mandate.
- Not all PDBs can rely on the injection of substantial government funding. In developing and emerging markets, fiscal constraints turn PDBs into financially autonomous institutions, which must survive on the capital that was injected at their inception. As a result, these PDBs often have to rely on external funding. International capital markets, however, will only make funds available provided they receive reasonable assurance that they will be repaid. The quality of the PDB’s rating will depend, among other things, on its risk profile and the sophistication of its risk measurement systems. As such, more-developed risk management practices foster stronger credit ratings.
- As a publicly funded institution, the PDB is responsible to the taxpayers who deserve assurance that their money is being well spent. Taking inconsiderate risks because of the absence of good risk management practices amounts to bad governance on the part of the government.

12. The PDB Is Cost-Efficient and Productive and Remains Financially Sustainable.

Financial sustainability is the capacity to keep operating in the long term; in other words, delivering products and services in accordance with one’s mandate. It is another important indicator of success for a PDB because filling market gaps usually requires: 1) adopting an above-average risk-taking profile and 2) sustaining a relatively long period of systematic effort. The combination of these two elements puts relatively high pressure on the “economics” of the PDB, implying the quality of risk management and cost management should be better than average.

PDBs incur various costs while carrying out their mandate and, like any other institution, they need to optimize the balance between inputs and outputs. The agreed level of outputs should be generated with a minimal, yet acceptable and appropriate, level of resources—such as human resources and technology—to ensure that the PDB remains financially sustainable. A challenge often faced by PDBs is ensuring appropriate and skilled staff can be attracted and retained with adequate compensation, including incentive schemes. Therefore, it is important to have adequate budget flexibility; PDBs often are constrained because they are public institutions subject to budgetary laws. Similarly, IT costs must reflect the specific needs and structure of the PDB to balance productivity and cost-efficiency.

Due to the long-term nature of these institutions, careful analysis must be made of the labor contingencies generated and the proper funding of these contingencies, as the lack of proper actuarial calculations and reserves has led to the financial nonviability of many PDBs.

Summary and Application of Tool

Table 4 summarizes the three parameters of the Health Diagnostic Tool and the 12 dimensions which, taken together, constitute a healthy PDB operating at full potential.

Table 4. Summary of Health Diagnostic Tool

| Parameters | Dimensions |
|---|---|
| Public policy and corporate governance | <ol style="list-style-type: none"> 1. The government has a clear strategy for developing and promoting a target area, and this strategy has been a key input in drafting the PDB’s vision, strategic plans and budget. 2. The PDB’s mission statement and resources are clearly defined by law, act or company bylaws. 3. The PDB has a solid code of corporate governance. 4. The PDB has clearly defined the market gap and plays a complementary role to private sources of capital. |
| Development impact | <ol style="list-style-type: none"> 5. The PDB has clearly defined development objectives. 6. The PDB has clearly defined development criteria incorporated in its lending/investment policies and processes. 7. The PDB regularly monitors its development impact, and the lessons learned are integrated into subsequent strategic plans. 8. An independent evaluation unit carries out a review of the PDB’s development impact. |
| Financial and operational performance | <ol style="list-style-type: none"> 9. The PDB has a comprehensive marketing strategy that is consistent with its mandate. 10. The PDB has an independent risk management function in place that covers all types of risk (credit, market and liquidity, and operational risk). 11. The PDB has a clearly defined risk strategy, supported by a risk- and |

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| | <p>development-adjusted financial reporting system, and a capital management framework.</p> <p>12. The PDB is cost-efficient and productive and remains financially sustainable.</p> |
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Section 2 has described the theory and concepts behind the PDB Health Diagnostic Tool. Appendix B outlines an assessment framework for evaluating a PDB’s performance against each of the 12 key dimensions of health. In Appendix C, the relevance of the Health Diagnostic Tool is validated by Banco de Comercio Exterior de Colombia (Bancóldex) of Colombia, which provided its feedback and experience under the tool’s concept and assessment framework. This exercise is complemented by a review of two other Latin American institutions, Banco Multisectorial de Inversiones (BMI) of El Salvador and Corporación Financiera de Desarrollo (Cofide) of Peru, through a questionnaire. The objective is to examine the relevance of the tool and exemplify some of the current practices in the region; it does not constitute a full analysis of the banks using the Health Diagnostic Tool. A full analysis would have required an in-depth due diligence, engaging senior management and the board of directors and reviewing in detail the processes and practices of the banks, which falls outside the scope of this study.

From this exercise, one can see that the PDBs reviewed have experienced overall improvements in dimensions related to policy mandate, corporate governance and financial performance. However, efforts in evaluating development impact have been weak, although there has been increased awareness of this issue, as seen in recent Bancóldex actions.

Conclusion

This study introduces a diagnostic tool for determining the health of a PDB. It is designed to provide a comprehensive framework against which to judge an individual PDB’s health and performance. This tool offers a holistic approach and addresses the typical root causes for past failures with the intention of helping PDBs avoid repeating past failures. The tool defines in normative terms what good health looks like across the various dimensions, which allows the PDB to determine how it can improve its overall performance. The tool is not a statement of best practices, as these will vary depending on the type of PDB and the special context in which it operates.

Regardless of the target focus (such as SMEs or infrastructure), a PDB that scores well against all 12 key dimensions should achieve good performance for its major stakeholders, including: 1) its shareholder, by ensuring the public policy mandate is achieved;

2) its clients, by ensuring the PDB is meeting their needs and having a development impact; 3) private sector sources of capital, by ensuring complementarity; and 4) the taxpayer, by ensuring financial performance is optimized. This is equally true in developed and in developing countries, as the framework takes unique national circumstances into account. The market gap—and the reason for its existence—will be different in a high-income developed country with a mature financial and banking sector than it will be in a country with a relatively underdeveloped financial system.

Where performance in one dimension is poor, PDB's must take to apply remedial measures to improve health in this dimension in order to avoid the unintended consequence of worsening performance in other areas. For example, if a PDB performs poorly in dimension 4 (operating within the market gap and playing a complementary role to private commercial banks), there is a danger that financial sustainability will be affected if the bank then only does business that the private commercial banks consider too risky.

This diagnostic tool could be transformed into a rating tool, similar in concept to those used by credit rating agencies. This study provides the “black box” of analysis that would be used to score individual PDBs. Future work could be done to develop the rating system and validate it against particular PDBs. Work also could be done to provide individual PDBs with the tools to improve their health, including detailed questionnaires to determine the market gaps, development reporting systems and training.

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Appendix A: Shortcomings Addressed by Health Diagnostic Tool

| PDB Shortcomings | Health Diagnostic Tool Dimension |
|---|----------------------------------|
| Inadequate government policies (i.e., macroeconomic, industrial, financial, agricultural and development policies) hamper private financial intermediation to resolve credit needs. | 1 |
| Policy makers do not distinguish root cause from symptom of credit shortage, resulting in ill-designed solutions. | 1 |
| A government attempts to resolve all situations with a PDB, when actually it has a limited but important role to play. | 2 |
| A government intervenes in sectors that are not crucial for economic takeoff, or sectors where PDBs do not have competencies. | 1 |
| The state does not understand the need to create an enabling environment (regulation, legal, judicial, enforcement systems and institutional arrangements). | 1 |
| The government's multiple roles (shareholder, regulator and defender of taxpayer interests) result in conflicts of interest. | 3 |
| Governments insist on operating Tier 1 institutions, ignoring the potential of using private agents. | 1 |
| The PDB lacks a clear mandate. | 2 |
| Mandates are rigid and often inappropriate. | 2 |
| The PDB has multiple objectives. | 1 |
| The PDB has difficulty reconciling its dual mandate: financial sustainability and policy mandate. | 1 |
| There is a "pendulum shift" in hard times (i.e., shutting down low-value loans), resulting in mission drift. | 4 |
| The PDB engages in business practices that displace commercial financial services provided by the private sector, impede new market entry and undermine competition. | 4 |
| The PDB becomes entrenched and is reluctant to downsize/reform/liquidate once the market can take over. | 4 |
| Programs outlive their useful life. | 4 |
| Clients are inadequately targeted. | 9 |
| The PDB struggles with political interference. | 3 |
| Government officials, acting in the capacity of owners, directly intervene in day-to-day operational decisions. | 3 |
| The PDB deals with pressure groups and capture from unintended borrowers. | 3 |

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| The PDB has a weak board of directors. | 3 |
| The PDB has inadequate prudential regulation and ineffective supervision. | 3 |
| The PDB is not accountable enough to shareholders. | 3 |
| There is evidence of mismanagement and corruption. | 3 |
| There is a lack of transparency/information. | 3 |
| Internal and external financial and nonfinancial reporting is incomplete and inaccurate, does not provide an adequate basis for decision-making by boards and executive managers, and misleads government owners, legislatures and the public. | 11 |
| Knowledge of real costs is obscured by an intentional lack of transparency regarding the PDBs cost versus its benefit. | 11 |
| The annual costs of maintaining the PDB are not known, so there is no public debate on the desirability of supporting it. | 12 |
| The PDB intervenes in an unsustainable, politicized or poorly managed way. | 10 |
| The PDB has weak management. | 12 |
| Executive managers act with near autonomy, pursue unintended objectives, and do not use sound commercial business and public financial management principles. | 3 |
| There are limited managerial, financial and operational skills, and a lack of proper incentives. | 12 |
| Appropriate hiring practices are lacking. | 12 |
| The PDB is overstaffed (government-employment vehicle). | 12 |
| The PDB has poor development outcomes and impact measurement. | 5, 6, 7, 8 |
| The PDB's losses are high. | 10, 11, 12 |
| The PDB persistently needs recapitalization/subsidies. | 3, 10, 11, 12 |
| Subsidies are high and there is a lack of transparency. | 11 |
| Financial discipline is lax. | 10, 11, 12 |
| Credit risk management and cost/benefit evaluations are poor. | 10, 11, 12 |
| Credit is misallocated and lending is politically motivated. | 3, 10, 11, 12 |
| Loan pricing is inadequate. | 6 |
| Risks are underpriced. | 10 |
| The PDB has political difficulty lending at market rates, collecting loans and executing capital. | 11, 12 |
| The PDB operates in a culture of nonpayment. | 11, 12 |
| There are large labor contingencies, including underfunded pensions. | 12 |
| The PDB has a weak debt recovery policy and high arrears ratios. | 11, 12 |

Appendix B: Measurement Framework for Health Diagnostic Tool

For illustrative purposes, the following sets out suggested measurements for assessing the performance of an SME PDB against the 12 key dimensions described in the Health Diagnostic Tool. However, the assessment structure and process may be applied to any PDB.

Public Policy and Corporate Governance

1. The government has a clear strategy for developing and promoting a target area, and this strategy has been a key input in drafting the PDB's vision, strategic plans and budget.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Has the government designed a long-term strategy for developing the SME sector?
 - Does the strategy include a justification for government intervention based on correctly identifying a market segment important to achieving economic/social development and needing government intermediation?
 - Does the strategy identify and outline specific roles for each of the different government agents, including the PDB, as part of a comprehensive strategy?
 - Does the strategy describe the resources committed to each government agent, including the PDB?
- Has the government clearly communicated this strategy to the PDB?
 - Does the government provide the PDB with a copy of its strategy?
 - Does the government make the PDB aware of the roles to be played by other government agents in its strategy to ensure the PDB is aware of the broader context for its actions and interactions with relevant stakeholders?
 - Does the government update its strategy regularly (e.g., annually) and ensure the PDB is informed of these updates?
- Has the PDB integrated this government strategy when defining its own vision, mission statement, strategy and budget?

- Does the PDB place the government's strategy at the center of its planning process?
- Is timing of the PDB's planning process synchronized with the government's strategic planning cycle?
- Does the PDB specifically reference the government's strategy in its annual plans and link its plans and targets with that strategy?

2. The PDB's mission statement and resources are clearly defined by law, act or company bylaws.

The quality and the transparency of the legislative framework should be adequately analyzed, as this will give insight into: 1) how the law, act or company bylaws prescribe what the PDB should or should not do (mandate), and 2) what resources, in the broadest possible sense of the concept, have been given to the PDB to fulfill its mandate.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Are the following high-level factors covered in legislation?
 - Primary objectives/mandate for the PDB,
 - PDB's legal form and applicability of other laws related to similar public organizations (e.g., budget processes, auditing and acquisitions) and to financial institutions (e.g., supervision and prudential norms),
 - Role to be played by government, including how it will exercise ownership and its relationship with other state bodies,
 - Identification of government's shareholder representative,
 - Criteria defined for when authorization/approval by legislature is required,
 - Resources to be made available to the PDB and any constraints on its operations (whether the PDB is authorized to raise external funding, and if so, how much, maximum total exposure, etc.),
 - How costs incurred by the PDB in delivering its mandate (e.g., providing concessionary credit) are to be covered, nature and extent of state's obligation to cover losses and/or recapitalize the PDB,
 - Requirement for self-sustainability,

- Principle of PDB's complementary role based on level playing field, with expectation of cooperation with private commercial banks,
- Requirement for independent board of directors,
- Requirement for mandate reviews, at minimum once every 10 years, and
- Requirement for regular (annual) reporting on strategy and plans, and on results.

Other specific related issues are reviewed under corporate governance, the next key indicator.

3. The PDB has a solid code of corporate governance.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Does the PDB have a code of corporate governance consistent with its legislative basis? If yes, does the code of corporate governance cover the following domains?
 - Conflict of interest rules at all levels, including clear separation of responsibilities between government as shareholder and government as regulator and supervisor,
 - Checks and balances at all levels,
 - Transparent procedures for nominating and electing CEO/board members based on qualifications against explicit criteria,
 - Finite and staggered terms for board members,
 - Clear definition of roles, responsibilities and authorities (i.e., board of directors, management board, CEO, government shareholder), including clear indication that the board is responsible for defining strategy.
 - Composition of board of directors (e.g., mixture of public and independent, based on expertise) and assurance of its independence,
 - Self-assessment by board of directors,
 - Main committees of the board (e.g., audit, human resources, risk management, nomination),
 - Market-reflective remuneration of board members and CEO,

- Processes to ensure qualified bank management and staffing, using transparent hiring practices based on qualifications and training regime (normally requires budget flexibility that would not apply to other state-owned entities),
- Requirement for regular independent external financial audit following agreed-to accounting standards,
- Requirement for financial and nonfinancial objectives set by shareholder and communicated to PDB and its board,
- Requirement for preparation of regular and transparent reporting on plans/strategies and results against agreed-to financial, operational and development/policy performance targets, and
- Requirement for publication of annual report, submitted to legislature and publicly available, covering financial and nonfinancial results for the year, management and board composition, performance against objectives (reporting standards should be comparable to publicly listed firms).

4. The PDB has clearly defined the market gap and plays a complementary role to private sources of capital.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Does the PDB’s mandate clearly indicate which types of projects are to be addressed (e.g., only bankable projects, only viable but nonbankable projects, only social projects, or any combination of the above)?
- Does the PDB have precise criteria to describe the various subsegments of the SME target population (micro/small/medium/large, based on criteria such as turnover, number of employees, total assets, etc.)?
- Does the PDB regularly undertake a market gap analysis to reflect changing market conditions?
 - Does the PDB examine at the macro level the overall level of financial intermediation? The most appropriate metric is a financial ratio comparing the volume of loan or investment product to GDP.

- Does the PDB interview or survey private financial intermediaries to determine what financing resources are currently available? While this approach is far from perfect, it is an acceptable proxy, especially in emerging markets with a less-developed financial sector, which face more constraints on its available liquidity and capital than do developed markets. This will be analyzed by market segments and products and by industry and region.
- Does the PDB interview or survey private financial intermediaries to determine the total population of potential clients (further segmented by industry, region and product) and calculate the rejection rate of loan applications filed by this population?
- Does the PDB validate these findings through demand analysis of the potential customer base?
- Does the PDB use the outcome of market gap definition and analysis in its strategic planning process and regularly update this exercise to rebalance its strategy if necessary?

Development Impact

5. The PDB has clearly defined development objectives.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Does the PDB have clearly defined and articulated development objectives?
- Have these development objectives been translated into specific high-level macro KPIs or criteria that can be used to focus PDB activity and ensure it remains focused on achieving development impact?

6. The PDB has clearly defined development criteria incorporated in its lending/investment policies and processes.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Has the PDB meaningfully translated its high-level development criteria into loan eligibility criteria?
- Has the PDB set up the necessary internal organization, processes and procedures to ensure a balanced approach with respect to lending decisions and loan policy?
- Has the PDB rejected perfectly bankable or viable projects based on their perceived insufficient development potential?
- Does the PDB have a clearly defined asset allocation plan expressed in terms of segments, products, industries and geographies?

7. The PDB regularly monitors its development, and the lessons learned are integrated into subsequent strategic plans.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Does the PDB have a proper process in place that: 1) measures and evaluates the ex-post facto development return and 2) integrates the lessons learned from this evaluation into its subsequent strategic planning?

8. An independent evaluation unit carries out a review of the PDB's development impact.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Does the PDB have an independent evaluation unit whose principal mission consists of assessing the PDB's development results?

Financial and Operational Performance

9. The PDB has a comprehensive marketing strategy that is consistent with its mandate.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- Is the PDB's pricing policy consistent with its mandate and its institutional and financial framework/constraints?
- Is the cost of capital incorporated in the pricing analysis, and are the government subsidies (direct and indirect) identified and transparent?
- Does the PDB optimize its potential reach in terms of distribution capacity?
- How many different types of distribution channels are used by the PDB (physical, online, mobile and other), and are they appropriate for the PDB's strategy?
- Does the PDB have strong and effective control over its development eligibility criteria, if any?
- Does the PDB generate a high percentage of deals on a risk-sharing basis?
- Does the PDB establish its products in-line with the market gap analysis?
- Does the PDB have a promotion policy to create awareness among its potential clients?

10. The PDB has an independent risk management function in place that covers all types of risk (credit, market and liquidity and operational risk).

This dimension has both qualitative and quantitative measures.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

Credit Risk

- Does the PDB have an independent credit risk function responsible for credit risk analysis, documentation, monitoring, resolution and recovery, and credit risk modeling? Are credit risk staff key players in making lending decisions?
- Does the PDB have well-documented lending policies and processes aligned with its mandate?

- Are the credit limits set to ensure they safeguard the PDB's financial sustainability and maintain an overall risk profile consistent with the target external credit rating?
- Does the PDB measure credit risk based on the latest available credit risk methodology (e.g., Basel II, economic capital)?

Market and ALM Risk

- Does the PDB have an independent department to calculate exposure to market risk (currency, equity, interest rate and liquidity), design risk policies and actively participate in decision-making in these domains? Is the same department in charge of ALM policy?
- Are these policies, processes and methodologies well documented?
- Are the limits set to ensure they safeguard the PDB's financial sustainability and maintain an overall risk profile consistent with the target external credit rating?
- Does the PDB calculate its exposure to market risk based on the latest available methodologies (e.g., Basel II, economic capital)?

Operational Risk

- Does the PDB have an independent department to calculate exposure to operational risks using: 1) an operational risks database, 2) KPIs per department and 3) a self-assessment procedure managed by the operational risk department and instituted throughout all the PDB's departments?
- Is the operational risk department in charge of formulating policy proposals, and does it participate in the decision-making process?
- Does the PDB have an independent internal audit department and plan? Is the audit plan risk-based and approved by the audit committee, a subcommittee to the board of directors?

Quantitative: Targets are developed for the following areas.

Table 5. Quantitative Measures for Risk

| | |
|-----------------------------------|---|
| <p>Credit risk</p> | <ul style="list-style-type: none"> • Nonperforming loans/total loans, • Loan loss reserves/total loans, • Loan loss reserves/open risk (gross risk minus value of collateral), • Cost of risk (burn rate/average gross loan exposure), • Distribution of credit ratings across various rating categories, • Calculation of probability of default, loss given default, expected loss, • Expected loss/average gross loan exposure, • Top 10 concentration risk/gross loans, • Industry concentration risk, and • Regulatory/economic capital calculation of credit risk. |
| <p>Market risk and ALM</p> | <p><i>Quantitative metrics (to be translated into limits)</i></p> <p>Liquidity risk (on a per-currency and global basis):</p> <ul style="list-style-type: none"> • Liquid assets/total assets, • Static gap analysis, • Dynamic gap analysis based on input business lines, • Cumulative gap in critical short-term buckets/total deposits, • Stress scenarios applied to dynamic gap analysis, and • Liquidity contingency plan and waterfall. <p>Currency risk (to be translated into limits):</p> <ul style="list-style-type: none"> • Open position per currency/capital (on a per-currency and global basis), • Value at risk based on an acceptable confidence interval (shock to be applied against the position) and acceptable methodology (historical, parametrical VAR), and • Earnings at risk based an acceptable confidence interval (shock to be applied against the position) and acceptable methodology (historical, parametrical VAR). <p>Interest rate risk (to be translated into limits):</p> <ul style="list-style-type: none"> • Gap analysis + calculation of shock against position resulting in maximum acceptable loss/capital or P&L, • Duration analysis + calculation of shock against position resulting in maximum acceptable loss/capital or P&L, and • Interest rate VAR. <p>Equity risk:</p> <ul style="list-style-type: none"> • Equity VAR + calculation of shock against position resulting in maximum acceptable loss/capital or P&L. |

| | |
|-------------------------|--|
| | <p>Global:</p> <ul style="list-style-type: none"> • Calculation of economic capital/regulatory capital requirements |
| Operational risk | <ul style="list-style-type: none"> • Level of operational losses (gross, insurance, net)/category and bank's business-line: <ul style="list-style-type: none"> ○ Systems and processes, ○ Internal fraud, ○ External fraud, and ○ Staff • Economic/regulatory capital for operational risks, • Operational KPIs for PDB's main business lines, tailor-made for each department, • Processes for self-assessment scores, and • Scores assigned to PDB and departments by internal audit department. |

11. The PDB has a clearly defined risk strategy, supported by a risk- and development-adjusted financial reporting system, and a capital management framework.

Qualitative: A positive answer to the following questions will justify a high score in this dimension.

- How different are the PDB's operations in terms of risk appetite from its commercial peers (i.e., the development cost)?
- Is support received from government shareholders at a cost lower than market (i.e., subsidy income)?
- Overall (i.e., the net of development cost and subsidy income), does the PDB calculate the development cost and budget of operating as a PDB?
- Does the PDB have a capital management framework to steer its overall business and risk strategy (either externally imposed by a regulator or through an appropriate and sophisticated internal capital management framework)?
- Is maintaining or improving its external credit rating/regulatory/economic capital base one of the PDB's KPIs?
- Are the risk constraints attached to this KPI an important input in the PDB's strategic and financial planning process?

12. The PDB is cost-efficient and productive and remains financially sustainable.

Quantitative: Targets are developed for the following areas, among others.

Table 6. Financial Sustainability Metrics

| Item | Metric (to be benchmarked against commercial banks) |
|---------------------------------|--|
| Cost management | <ul style="list-style-type: none"> • Cost/income ratio, • Average number of loans per employee, and • Number of loans disbursed per employee in year t, t-1, t-2. |
| Financial sustainability | <ul style="list-style-type: none"> • Return of equity, • Return on assets, and • Risk-adjusted return on risk-adjusted capital (RARORAC). |

Appendix C: Application of Health Diagnostic Tool

The following describes specific Latin America/Caribbean illustrative examples of good practice for the 12 key dimensions, with a particular focus on Bancóldex as a case study.

Public Policy and Corporate Governance

1. The government has a clear strategy for developing and promoting a target area, and this strategy has been a key input in drafting the PDB's vision, strategic plans and budget.

Bancóldex reflects the vision of its supervisory ministry (Ministry of Trade, Industry and Tourism) in its planning, and uses the Ministry's overall economic targets (listed below) to develop its strategic plan and objectives.

The Ministry has developed the following targets: 1) to be an economic growth engine and a driving force in transforming productive assets, 2) to double exports, 3) to triple the number of foreign tourists, 4) to reduce the informal enterprise segment by 50 percent, 5) to increase the level of banking and 6) to increase social insertion.

As a result of basing its own strategic plan on the specific targets set by its direct government shareholder, Bancóldex scores very well on this first key dimension.

2. The PDB's mission statement and resources are clearly defined by law, act or company bylaws.

For Bancóldex, the law and bylaws clearly define the PDB's mandate. For illustration purposes, some of the main features include:

- **Mission:** Bancóldex's corporate mission is to finance primarily but not exclusively activities related to exports and the domestic industry, acting as a discounting or rediscounting bank rather than as a direct intermediary.
- **Operating model:** Bancóldex shall not incur any form of direct risk except in those cases where the nation, a financial intermediary or legal entities of international public law are participating, or in the event it is benefiting from risk coverage via guarantees or similar products that transfer the direct risk incurred by Bancóldex.
- **Financial sustainability:** In case Bancóldex, because of law, other rules or at the specific request of the national government, is obliged to engage in

operations that would yield below-market profitability or that would not guarantee the financial health of the institution, Bancóldex should conduct such operations solely if: 1) there are specific budgetary resources and 2) these budgetary resources have been made available before the loans to be provided at below-market conditions are to be disbursed. The budgetary resources/transfers shall cover at the very least the difference between the yields obtained on the loans and the PDB's funding cost.

Similarly, Cofide's mandate is clearly defined by its legal framework, which establishes: 1) the hierarchy of economic action (referring to the policies and plans of the state), 2) the preferred target segments, 3) the importance of its infrastructure mission and 4) the Tier 2 character of the institution. The following outlines the different legislative decrees and laws governing Cofide:

- Contribute to the country's overall development by capturing savings and financial intermediation to promote projects and to finance companies in accordance with the policies and plans determined by the state. In this capacity, Cofide is mandated to carry out operations as allowed by law and its bylaws to realize its objectives.
- Promote and execute medium- and long-term pre-investment financing operations related to launching productive investment projects and public-private partnerships at the country level, including areas with lower levels of economic development, which, because of their physical location and size, are not target zones for the private sector.
- Channel foreign resources not targeted at financing studies or executing public national infrastructure projects preferably through domestic financial intermediaries.
- Set up a financing business to serve small entrepreneurs and farmers at the country level, preferably in distressed areas, by operating through financial intermediaries or other development entities capable of supporting rural economic activity and small entrepreneurs in general. In this context, Cofide is mandated to channel financial resources from both domestic and international sources, including funds assigned by the government, donations and funds from similar sources. By its very nature, Cofide is precluded from capturing

public deposits and providing credit facilities for its own account to persons or companies that do not qualify as financial intermediaries or development entities active in the agricultural sector or the small business environment.

3. The PDB has a solid code of corporate governance.

Bancóldex has a Code of Corporate Governance embedded in its regulatory framework: based on requirements from the regulator (Superintendencia Financiera), the Code of Corporate Governance lists the specific measures to be taken by the PDB with respect to: 1) its management process and conduct, and 2) information to be provided, aiming to protect shareholders' legal rights, observe the legal and regulatory framework and insure adequate management. Moreover, its Code of Corporate Governance contains specific rules to inform the public. Furthermore, Bancóldex is required to observe the rules contained in the Code of Corporate Governance in order to attract any funds to be invested by pension funds in securities to be issued.

Bancóldex's Code of Corporate Governance covers the main topics one expects to be ruled by such a document:

- Clear definition of responsibilities for all governing bodies (supervisory board, management board and senior staff),
- Clear rules about the organization of internal and external control, the bodies through which this control is to be carried out, and the degree of independence of this control,
- Clear rules about preventing and managing various conflicts of interest at all levels,
- Clear rules about the criteria and processes for selecting and compensating main governing bodies and their members,
- Composition of the board of directors,
- Procurement policy, and
- Minimum information standards to be observed by the institution.

An index/scoring system exists, and Bancóldex is one of the top performers in the country.

Similarly, Cofide provides a very strong example of corporate governance. It has a Corporate Governance Charter embedded in its legislative framework. The charter comprises 33 principles, which are self-assessed; moreover, its results are made available to the public. Cofide has fully or partially implemented the most important principles, as follows:

- The role of all governing bodies (supervisory board and management board) is clearly defined. The supervisory board is in charge of determining strategy, plans and overall policies, while the management board is in charge of implementing the strategic guidelines.
- The supervisory board is composed of government representatives and independent experts, and there is a specific policy with respect to the independent status of directors.
- There is a specific process for designating members of the board of directors and senior executives.
- The board of directors has established the following subcommittees: risk, audit, and assets and liabilities.
- There are specific assessment mechanisms to evaluate the performance of both the board of directors and management board.
- There is a specific remuneration policy for members of the board of directors and the management board.
- There is a succession plan.
- A clear policy for dealing with conflicts of interest has been outlined.
- The role, reporting line and plan of the internal audit department are clearly defined, and there is a process to assess the performance of internal and external auditors.

4. The PDB has clearly defined the market gap and plays a complementary role to private sources of capital.

Bancóldex is very clear in defining what an SME is and how budget should be split over various segments, products and tenors. This is conducive to a policy driven by the existence of gaps, which governs the institution's corporate planning process.

SMEs, large-caps and micro-companies are clearly defined, with definitions given by law. Programs have been designed for all of the aforementioned segments. On the other hand, based on publicly available information, there has been no formal attempt to define and quantify macro, industry, product or demand/supply gaps, as it is understood that as a Tier 2 institution, the balancing act between promoting economic development and the gap-driven allocation of resources is much harder. Moreover, there is no clear definition of what a market gap is, as the PDB's website clearly indicates all companies are eligible to be financed

(barring some small exceptions) via the program, with it being understood commercial banks make the fundamental lending decisions.

As another example, BMI affirms the existence of market gaps as one of the key reasons for its existence, although it does not carry out quantitative gap analysis, but instead determines the nature and magnitude of various gaps by maintaining contact with the main economic actors in its target markets. BMI uses information obtained through these channels to identify market failures and to help it structure solutions in specific domains where private banks are not offering solutions.

- At the macro level, BMI periodically monitors the financial supply of its intermediaries and uses the results of this analysis to create, revise or update its product base to correct some of the existing imbalances. BMI, however, openly acknowledges that it is not in a position to help bridge all gaps in economic situations where commercial banks have sufficient liquidity and do not turn to BMI for additional funding support. In a way, this is tantamount to stating that as a Tier 2 institution, BMI can contribute to address liquidity issues, but is in no position to “force” the banks to on-lend.
- At the segment level, BMI does not systematically monitor the financing gap, but it infers segment information from its commercial banking partners. As a result, BMI has identified a segment of the SME community with hampered access to credit: those that are “too big” for the microfinance companies yet “too small or too unsophisticated” for the commercial banks.
- At the product level, BMI constantly monitors product requirements through discussions with various economic players such as government, enterprise associations or financial institutions, and it uses this information to update specific needs in terms of lending products. Good examples of new lending products developed on the basis of these discussions include “credito rural,” a product aimed at developing industry in rural zones, and reinforcement of the guarantee program.
- At the geographic level, BMI’s information system is capable of capturing the location of commercial bank borrowers, and it uses this information to identify gaps in geographic coverage, which, according to BMI, are concentrated in the rural areas and especially in very poor towns and villages.
- At the industry level, BMI’s information system also captures financing gaps.

- BMI does not measure demand gap on the basis of credit applications rejected by commercial banks, but instead monitors this gap through discussions with representatives of financial institutions and industry associations.

BMI offers a strong example of an institution that grounds its activities on ongoing market gap analysis and maintains close contact with its private sector counterparts.

Development Impact

5. The PDB has clearly defined development objectives.

Bancóldex has clearly defined development objectives at various levels. First, the government has introduced a Governability Management System (SIGOB). This system allows the government and every citizen to monitor the quality of the implementation of social and economic policies that are part of the country's development plan. As part of the SIGOB framework, Bancóldex has objectives in the following domains (among others) for the period covering 2006 to 2010:

- Total disbursements,
- Volume and number of disbursements to microenterprises,
- Volume and number of disbursements to SMEs,
- Number of entrepreneurs reached for training.

In its annual report, Bancóldex is tracking a complementary set of development parameters, each of which has the potential to cover specific gaps. The most important parameters are:

- Number of nonbanking correspondents (through which loans are sold),
- Increase in regional presence (geographic gaps),
- Introduction of new products (product gap),
- Promotion of industrial renewal (industry gap),
- Improving levels of capitalization of domestic companies.

BMI has placed development objectives at the forefront of its activities and translated them into the following KPIs that guide its day-to-day operations, ensuring the PDB remains focused on achieving its development objectives:

- Increase of loan portfolio and number of end-users,
- Number and volume of customers per size of company,
- Number and volume of loans per sector,

- Number and volume of loans per geographic area,
- Number and volume of loan guarantees via various types of guarantees,
- Growth in percentage of strategic sectors that were provided support by BMI,
- Number of financial intermediaries,
- Number of intermediaries that benefited from technical assistance,
- Number and volume of loans granted in poor areas,
- Number of enterprises that were provided technical assistance,
- Level of administrative expenses/total assets,
- Actual performance versus budget,
- Net worth/risk-weighted assets.

BMI defines success as the degree to which credits and other financial and nonfinancial instruments have reached end-users (ranging from large-caps to micro companies, students and productive industries), while complying with all legal and regulatory requirements. By integrating its development objectives into its KPIs, and thereby linking its public policy mandate to its daily operations, BMI scores well on this dimension.

6. The PDB has clearly defined development criteria incorporated in its lending/investment policies and processes.

None of the PDBs interviewed fully meets this criterion. This is, in part, a consequence of their Tier 2 operational models, wherein the responsibility for credit allocation has been left in the hands of their commercial bank intermediaries. For example, Bancóldex leaves credit decisions to the financial intermediaries, explicitly stating that it does not analyze the underlying credit applications, but only reviews whether the application is in-line with the formal requirement of the program.

It is clear, however, that Tier 2 PDBs require a balancing act. On the one hand, they would like commercial banks to maximize on-lending, which implies granting the commercial banks a certain degree of flexibility in terms of lending autonomy. Yet on the other hand, they need to channel financial resources to those entities that will achieve high development returns, in accordance with their public policy mandate as PDBs.

Cofide, to some extent, is trying to move in a more proactive direction. It has started shifting its business model from a pure Tier 2 bank toward an institution taking risk participation in individual projects structured by commercial banks. These projects include project finance infrastructure deals and credit insurance guarantees for SMEs. Cofide has

explicitly stated that this change of focus has been inspired mainly by a drive to meet its development objectives, and less by credit risk considerations.

7. The PDB regularly monitors its development impact, and the lessons learned are integrated into subsequent strategic plans.

Bancóldex is currently finalizing two studies to measure the impact of some of its major programs, which will result in important contributions not only to Bancóldex, but also to the rest of the region, as in general, impact-evaluation studies are not carried out. Bancóldex is also measuring the level of compliance with its development KPIs/development objectives at various levels.

At an industry level, BMI regularly analyzes the impact of lending activity on employment levels, new infrastructure, exports and environmentally friendly capital expenditures, among other things. Moreover, it measures investment by geographic area (poor versus rich), size of enterprises and industry.

8. An independent evaluation unit carries out a review of the PDB's development impact.

None of the PDB's interviewed presently has an independent unit or department to review the development impact or return on its activities at any level (whether individual loan, program, business unit, or PDB as a whole). However, the PDB's interviewed for this study have indicated a high level of interest in the concept and have attributed some of the activities to certain departments.

Financial and Operational Performance

9. The PDB has a comprehensive marketing strategy that is consistent with its mandate.

Bancóldex has set up a very efficient multi-layered distribution model capable of penetrating almost all geographic areas and reaching all targeted segments and subsegments:

- The main players of Colombia's bank markets allow Bancóldex to use their networks.
- Bancóldex also sells its financial services to nonregulated financial institutions.

- Bancóldex has business centers providing information and assistance in the main cities.
- Local shops (e.g., bakeries, supermarkets) in small municipalities are being used to increase the PDB's geographic coverage (through the Oportunidades program).
- Through investments in private equity funds, Bancóldex has opened an additional promotion and distribution channel.

Bancóldex's approach toward distribution and promotion is also highly professional:

- Commercial bankers are frequently made aware of Bancóldex's products.
- Conferences for entrepreneurs are organized.
- Business training sessions are generally free of charge.
- The PDB's website is extremely professional and is a powerful promotional tool.
- Various technical assistance programs aimed at strengthening micro-companies are set up in co-sponsorship with international entities.

As a Tier 2 institution, Bancóldex leaves pricing to the commercial banks, which has led to financial intermediaries sometimes charging hefty spreads on the back of the relatively low-cost funding provided to them.

10. The PDB has an independent risk management function in place that covers all types of risk (credit, market and liquidity, and operational).

Bancóldex has established an independent risk function that reports directly to the president of the board of directors. Its risk management department is in charge of defining policies, methodologies and processes for indentifying, measuring, monitoring and managing risk across the full taxonomy. The scope of risk management responsibilities at Bancóldex is very clearly defined and in-line with industry best practices.

11. The PDB has a clearly defined risk strategy, supported by a risk- and development-adjusted financial reporting system, and a capital management framework.

Bancóldex clearly understands a healthy risk management framework is essential for meeting its objectives. This is seen at various levels. In its 2009 annual report, Bancóldex states that global risk management is a strategic project, essential to preserving financial sustainability and meeting its overarching goals as a PDB. Bancóldex's management has concentrated its

efforts on strengthening the risk culture and on extending methodologies to measure and monitor risk across the risk taxonomy. On the other hand, Bancóldex understands the necessity of maintaining a strong credit rating and has therefore requested credit rating agencies Standard & Poor's, Fitch and BRC to assign local and international ratings. Cofide emphasizes best practices in risk management for a number of reasons:

- Cofide is ambitiously working toward Basel II compliance, as it is committed to qualifying for one of the more sophisticated versions of Basel II (the Internal Ratings Based approach). This philosophy is induced by Cofide's willingness to: 1) be in a better position to evaluate risks, 2) have a transparent decision-making process using risk analysis to make the decision-making process as objective as possible and minimize potential external interference and 3) obtain a strong external credit rating. Cofide's capital management framework consists of, among other things, rules with respect to the minimum capital to be held (higher than what is required by the regulator), on top of which additional calculations are made to quantify the level of required "shadow capital" that incorporates provisions for credit or foreign exchange risk.
- Cofide has an independent risk management organization and has developed clear policies, procedures and processes in the credit risk domain. Cofide also covers part of the market risk taxonomy by using interest rate and exchange rate risk models. An internal audit function controls operational risks, while a compliance department controls legal/reputational risks.
- Cofide wants to create financial value and acknowledges this is impossible without properly assessing the risk side of transactions.

Cofide ranks highly on this dimension, with a strong focus on its risk management system and capital management standards.

12. The PDB is cost-efficient and productive and remains financially sustainable.

As stated earlier, barring some specific exceptions that should be addressed by its budget, Bancóldex is precluded from operating at a loss. Moreover, Bancóldex has clearly indicated that the efficiency of the organization, next to financial sustainability, is one of its strategic "internal action blocks." The quality of financial results is such that financial sustainability is

protected, which is demonstrated by the solid ratings assigned by the various credit rating agencies. However, Bancóldex has not defined any specific cost targets, which is understandable as its operating structure is less heavy because of its Tier 2 status.

Cofide's KPIs are more volume-driven than profit-driven. In 2009, for example, there were two loan volume-driven parameters, one related to technical assistance and the other to internal parameters (productivity and diversification of revenues). Yet, the institution also attaches importance to maintaining a solid external credit rating. This rating is dependent not only on the rating of the sovereign (Republic of Peru), but is also a function of the financial sustainability of Cofide's own business model. Cofide is aware that it will be perceived as a more competitive borrower on international capital markets if it can maintain a high level of financial sustainability: the more solid its rating, the easier it becomes to raise longer-term and cheaper funding, which can be used for indirect on-lending to target players in the domestic real economy. It is common knowledge that external credit rating agencies analyze all elements of financial sustainability in their assessment process (such as business environment, liquidity, solvency, liquidity and funding, and operational performance), and Cofide takes this into account in its operations. Again, Cofide is well-positioned to ensure it operates in a cost-efficient way, and accepts the discipline brought to bear by external credit ratings.