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Regulating, Supervising, and Handling Distress in Public Banks

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

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Executive Summary

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

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

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

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

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

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

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

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