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GOVERNMENT-OWNED BANKS: THEIR ROLE IN PACIFIC FINANCIAL SYSTEMS

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This Pacific Finance Sector Policy Paper is the first of a series covering topical issues in Pacific finance, with the combined aim of assisting Pacific policymakers to alleviate the constraints faced by Pacific businesses when trying to access finance.

The series is prepared by the Asian Development Bank's (ADB's) Pacific Private Sector Development Initiative (PSDI). PSDI's finance sector expert, Dr Peter Dirou, is the series' principal author and Erin Harris is the series editor. This paper draws on an earlier PSDI publication, *Finding Balance 2019: Benchmarking the Performance of State-owned Banks in the Pacific,* co-authored by PSDI state-owned enterprise expert, Laure Darcy, and Dr Peter Dirou. PSDI is a regional technical assistance facility cofinanced by ADB, the Government of Australia, and the Government of New Zealand. The views expressed in this publication are those of the authors and do not necessarily reflect the views and policies of ADB, its Board of Governors, or the governments of Australia and New Zealand.

Front cover photo: National Bank of Tuvalu. Tuvalu has two banks, both are government-owned.

GOVERNMENT-OWNED BANKS: THEIR ROLE IN PACIFIC FINANCIAL SYSTEMS

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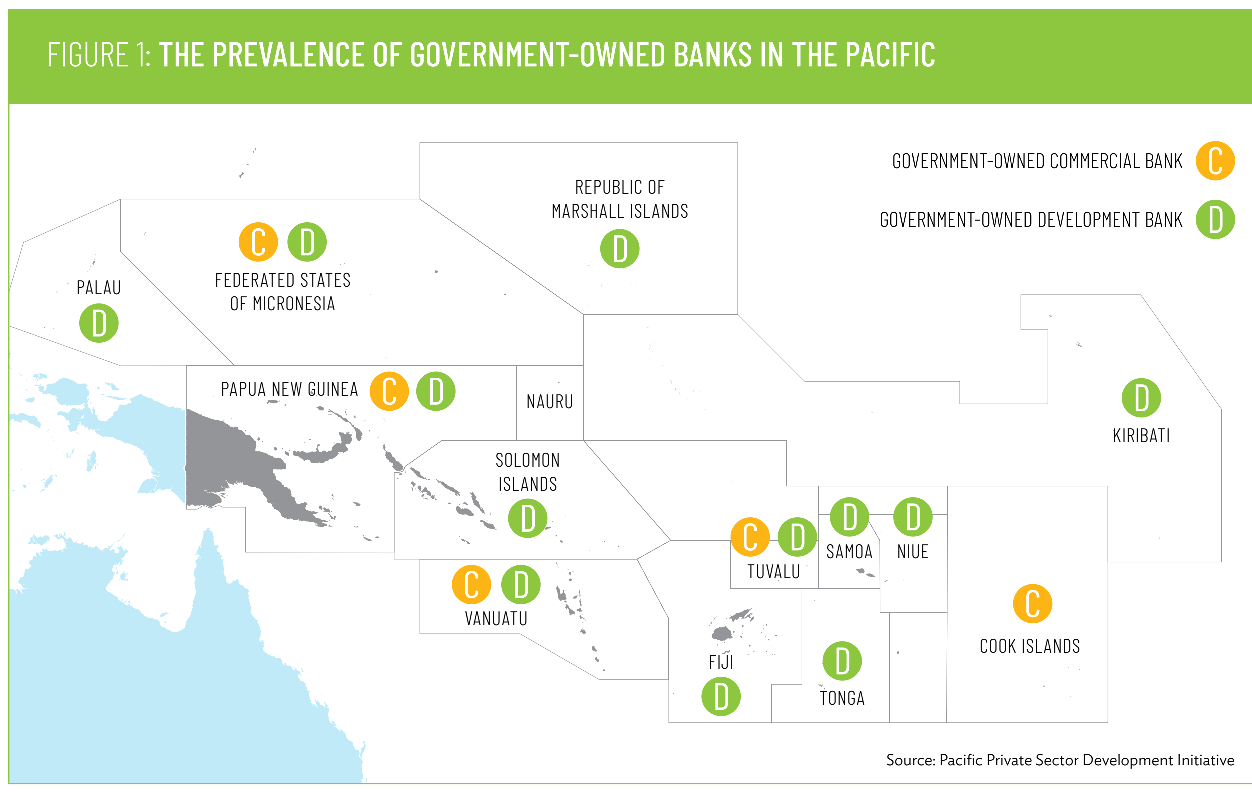
1 SECTION ONE INTRODUCTION

As governments throughout the Pacific islands grapple with the financial and economic impacts of the global coronavirus pandemic (COVID-19), the ability to finance any recovery, alongside severe fiscal constraints, has become a critical policy issue. Government-owned banks[1] are a pervasive feature of the Pacific financial landscape, so it is understandable that the role they can play in financing recovery, the extent of that role, and the terms of any financing they provide are being intensively debated. Each of the Asian Development Bank's (ADB's) 14 Pacific Developing Member Countries (DMCs),[2] except Nauru, has either a government-owned commercial or development bank, and in some cases, both (Figure 1).

The financial performance of government-owned banks and their importance to individual Pacific financial systems therefore warrant continued analysis. *Finding Balance 2019*—the most recent iteration of PSDI's flagship publication on state-owned enterprises (SOEs)—was devoted to this. In earlier *Finding Balance* reports, attention to the financial performance of these banks was obscured

FIGURE 1: **THE PREVALENCE OF GOVERNMENT-OWNED BANKS IN THE PACIFIC**



Source: Pacific Private Sector Development Initiative

1 The term "government-owned bank", rather than "state-owned bank", is used throughout this paper because the Cook Islands and Niue are not independent states under international law: they are self-governing countries operating in free association with New Zealand.

2 Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

within a broader analysis of each country's complete SOE portfolios. *Finding Balance 2019*, on the other hand, highlighted the financial performance of government-owned banks and showed that it could be assessed in a similar way to the financial performance of other SOEs, allowing for the distinct nature of financial services. It also discussed ways this performance could be improved.

Even before the onset of COVID-19, policymakers in most Pacific DMCs were concerned by low levels of private sector credit, reflective of an unwillingness to finance small and medium-sized enterprises—the dominant business form in the Pacific—and a broader aversion to taking on Pacific risk. They were also searching for ways to reduce the exposure Pacific DMCs have to the loss of bigger banks, a concern heightened by Westpac's retreat from the region. Government-owned banks are often seen as a solution—at least partially—to both these issues. Other partial solutions, such as online banking, movable assets financing, and alternative capital raising platforms, will be addressed in subsequent PSDI policy papers.

This paper aims to:

(i) **assist policymakers address questions regarding the retention or divestment of individual government-owned banks**, and

(ii) **highlight the need to increase private participation in most Pacific financial systems,** if these systems are to meet the financing needs of businesses effectively.

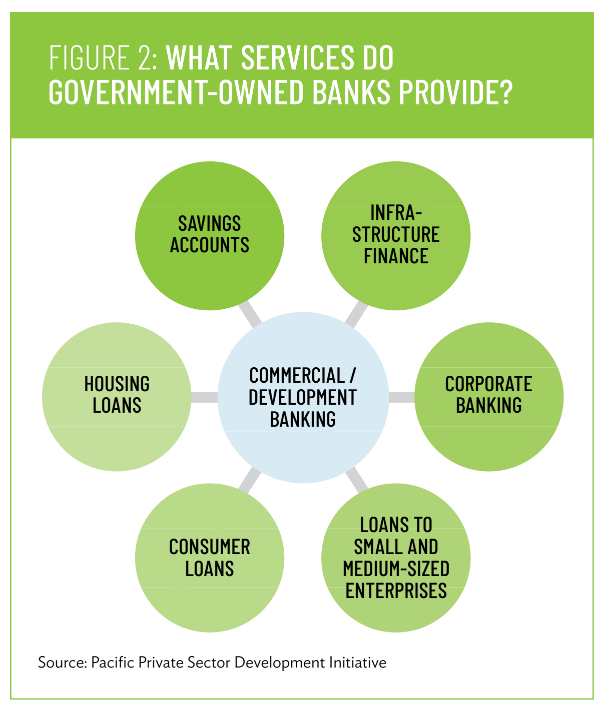
Section two provides a broad overview of government-owned banks in the Pacific and outlines a conceptual framework that can guide policymakers in Pacific DMCs, bearing in mind the significant differences across countries and banks. It also stresses the importance of applying principles of good finance to any consideration of the role of government-owned banks. Section three extends the discussion to the contribution government-owned financial institutions, alongside privately-owned financial institutions, can make towards finance sector development. Section four provides concluding remarks and offers indicative content guidance for policymakers looking to develop clear government-owned bank policy.

BOX 1: WHY DO GOVERNMENTS OWN BANKS?

- **Facilitate financing** of government policy priorities.
- **Increase competition** and guard against the possible retreat of international banks.
- **Address financing gaps** in the market.

Source: Pacific Private Sector Development Initiative

FIGURE 2: WHAT SERVICES DO GOVERNMENT-OWNED BANKS PROVIDE?



Source: Pacific Private Sector Development Initiative

SECTION TWO

2 THE CONTEXT AND ROLE OF PACIFIC GOVERNMENT-OWNED BANKS

KEY MESSAGES

- **Government-owned banks are prevalent across the Pacific** and could make a greater contribution to alleviating some of the constraints felt by Pacific businesses when attempting to access finance.
- **A clearly defined role for government-owned banks is essential if they are to make a positive economic contribution,** but in the Pacific these roles are not always clear.
- **A government-owned bank must offer additionality,** either by profitably providing financial services that would not otherwise be provided or by making the banking system more competitive.
- **Discussion of a development bank's role should be reoriented from "development" to "risk"** to emphasize the distinction between the type of finance a development bank provides and the type of finance provided by other lenders in that financial system.

The first step in improving the policy framework for government-owned banks is to understand their prevalence across the Pacific and the role they are currently playing within individual countries.

PACIFIC CONTEXT

Across the Pacific, some general observations can be made:

- **Development banks are the dominant government-owned bank structure.** Of the 13 Pacific DMCs with government-owned banks only one, the Cook Islands, does not have a development bank.[3]
- **There is no general development banking model through the Pacific, just as there is not internationally.** Mandates, business models, funding structures, and the composition of loans all vary.
- **Several Pacific DMCs have more than one government-owned bank.** Federated States of Micronesia,[4] Tuvalu, and Vanuatu have both a government-owned development bank and

[3] The Bank of the Cook Islands is a licensed commercial bank but it has a development bank legacy—it was established in 2001 through the vesting of assets in the former Cook Islands Savings Bank and the Cook Islands Development Bank.

[4] Although Federated States of Micronesia (FSM) has two government-owned banks, they each have different ownership structures. The Bank of the FSM has a diverse shareholding which includes 24% private ownership, 24% ownership by FSM Development Bank, and the balance of 52% split between the Government of the FSM (27%) and the FSM's four state governments (25%). FSM Development Bank, on the other hand, has the government as its principal shareholder with 98.8% of the shares, and the states of Chuuk and Kosrae owning 0.9% and 0.3% respectively.

a government-owned commercial bank, and Papua New Guinea has a government-owned development bank and two majority-government-owned, licensed micro banks. Tuvalu is an extreme case: it has only two banks and both are government-owned.

- **In almost all Pacific countries, government-owned banks play an important role in providing private sector credit to businesses and households.** This role is particularly pronounced in the North Pacific and among the smallest DMCs of the South Pacific.

ROLE OF GOVERNMENT-OWNED BANKS IN THE PACIFIC

Clarifying the role of government-owned banks is an essential part of ensuring they make a positive economic contribution. Yet the diversity of Pacific government-owned banks suggests a general lack of such clarity, particularly for development banks.

In order to clarify a bank's role, policymakers must determine whether or not the bank is filling an otherwise unmet need. Making that determination rests on a bank being able to demonstrate additionality. This could be demonstrated by providing financial services that would not otherwise be provided—for example, to underserved segments of the population such as women or the agriculture sector—and providing these services profitably. Additionality could also be demonstrated by making the banking system more competitive, thereby lowering the cost of financial services to consumers. Both cases imply that these outcomes would not be achieved solely through privately-owned banks.

Discussion of the role of government-owned banks must also sit within the broader context of finance sector development. An assessment of the need for a government-owned bank requires an evaluation of the associated risks and the bank's strategic direction needs to be periodically reviewed against the unmet financing needs of that country—including non-bank finance.

RATIONALIZING GOVERNMENT-OWNED BANKS

The initial priority for policymakers is to rationalize the need for a government-owned bank. Doing this requires several fundamental assessments:

(i) should governments be in the business of banking?

(ii) if so, should that business cover finance for personal consumption, business, or both? and

(iii) how should these banking services be provided—through a commercial bank, a development bank, or perhaps some other type of structure?

Many governments make a distinction between a government-owned commercial bank and a government-owned development bank when deciding how to deliver financial services, with development banks often viewed as better suited to some types of lending than commercial banks. But the distinction is commonly also linked to a broader "development agenda," where governments want to ensure that particular segments of the population, or specific business sectors, can access credit on cheaper terms than those offered by commercial banks.

While the use of government-owned banks to further a country's development agenda is often well-intentioned, it becomes problematic if decoupled from principles of good finance. Often, the development objective is conflated with cheaper credit, but cheaper credit is advocated without considering the funding costs a lender incurs in providing that credit. If funding costs cannot be recovered by a government-owned bank, then the costs are ultimately absorbed by the government as reduced profits or budget transfers. The initial question that should concern a government is not whether a development bank is a better option than a commercial bank, but whether a government's use of its financial institutions to deliver its development agenda is the right approach. There is a big difference between financing social assistance and development transfers from the government budget and providing finance through a financial institution operating off its own balance sheet with its own board and management. All financial institutions, regardless of whether they are government-owned, must do the "job of finance" and use their credit

assessment and risk management skills to convert a pool of savings into loans profitably. In doing so, they improve resource allocation within an economy.

It is not necessary for policymakers to push a distinction between government-owned development and commercial banks. There are already instances in the Pacific of banks that blur these distinctions. The National Bank of Vanuatu is a licensed commercial bank, but in recent years has deliberately de-emphasized non-agriculture credit in favor of lending to financially underserved rural communities. Tonga Development Bank is a licensed commercial bank that has a development mandate. Similarly, the Bank of the Cook Islands, another licensed commercial bank, has traditionally seen itself as an instrument to advance the well-being of Cook Islanders. The experiences of these banks highlight that there is no inherent incompatibility between development finance and commercial finance.

FROM “DEVELOPMENT” TO “RISK”

To better assess the lending role of a government-owned bank, it is useful to reorient the discussion away from “development” to “risk” (Box 2). “Development” is a loose term that can be used in a number of subjective ways, including to justify the continued use of unsustainable lending practices. Additionally, given all financial institutions contribute to economic development in some way through their financing activities, it is not helpful to perpetuate the notion that development banks are essential to economic development.

A focus on “risk” forces policymakers to consider whether there is a distinction between the type of finance a development bank provides—or could provide—and the type of finance provided by other lenders in that financial system. This distinction is based on differing risk appetites: development banks are willing to finance activities that have important economic impacts, but that other financial institutions are reluctant or unwilling to finance. The details of this lending are country-specific and depend on each country’s economic and business structures, the sectors that are most important, and the type of businesses that need financing.

BOX 2: REORIENTING GOVERNMENT-OWNED BANK DISCUSSION: FROM “DEVELOPMENT” TO “RISK”

MOVING AWAY FROM CONSIDERING A GOVERNMENT-OWNED BANK’S FINANCING ROLE IN TERMS OF “DEVELOPMENT”

- **“Development” is a loose term:** it can be (and is often) applied subjectively.
- **“Development” fails to emphasize the need to apply principles of good finance** to decision making.
- **Focusing on “development” helps perpetuate a false impression that only development banks contribute to economic development.**

REORIENTING TO CONSIDER THE ROLE IN TERMS OF “RISK”

- **A focus on “risk” foregrounds risk management** as part of lending decision making.
- **“Risk” encourages the application of principles of good finance.**
- **“Risk” helps clarify a bank’s role within each country’s individual finance sector and the (country-specific) additionality that each bank can sustainably provide**—thus improving commercial performance.

Source: Pacific Private Sector Development Initiative

SECTION THREE

3 GOVERNMENT-OWNED BANKS AS AN INSTRUMENT OF FINANCE SECTOR DEVELOPMENT

KEY MESSAGES

- **Strengthening individual banks strengthens the financial system as a whole.**
- **A well-performing government-owned bank reinforces the importance of locally-owned financial institutions** by demonstrating how lenders committed to financing the needs of a community can have a positive economic impact.
- **A government-owned bank must have the financial capability to perform its role profitably.**
- **Single-purpose government-owned banks have a greater concentration of risk, requiring stronger risk management skills** than banks with a diversified loan mix. The development of these skills benefits the entire finance sector.
- **Strengthening the performance of a government-owned bank increases its value,** making it easier to attract private investors.
- **Private investment can strengthen a bank's operations and provide access to capital for continued growth,** in addition to reducing the burden on a government's financial resources.
- **Retirement funds are an obvious source of private equity** for government-owned banks in the Pacific.
- **The role of a government-owned bank can evolve to fill other financing gaps,** but they must continue to provide additionality.
- **Regulatory frameworks should encourage the emergence of locally-owned institutions** that can fill financing gaps and guide the growth of these institutions from small to large.

The reorientation of government-owned bank discussion from "development" to "risk" can be extended to broader finance sector development, since describing the architecture of a financial system is essentially an exercise in mapping structures that provide financial services onto different classes of risk. This section focuses on two channels through which government-owned banks can be an instrument of finance sector development. The first channel focuses on the financial strength of government-owned banks as a determinant of the financial system's overall strength. The second stresses the important role government-owned financial institutions could play in financing other classes of risk that are not usually financed through bank credit. It is also important that any discussion on the role of government-owned institutions take place alongside a discussion on the need to increase private sector participation in the finance sector.

STRENGTHENING A BANKING SYSTEM

The stronger individual banks are, the stronger the banking system as a whole. The starting point to this is ensuring that a government-owned bank is—and can remain—relevant. Without this, the bank's business case is weak, which usually translates into poor financial performance.

Profitable government-owned banks strengthen a government's balance sheet. They help protect the government's fiscal position, as the bank would be relying on its own balance sheet and not on government transfers or regular injections of equity. They would then be in a position to pay dividends—where this was consistent with prudent capital management—and the business's value would increase over time. Where government-owned banks are not profitable, they are a drain on government finances, with the consequent lost opportunity to finance other important social objectives, such as health and education.

Even where there is a valid business case, government-owned banks need to operate commercially. Otherwise, they are unsustainable and undermine a government's overall financial position and the strength of the financial system.

The financial sustainability of any government-owned bank will be achieved through improving each bank's financial performance, improving each bank's financial strength in order to match its risk-taking profile, and strengthening the structural foundations of the broader financial system, including regulating government-owned banks.

A government-owned bank must have the financial capability to perform its role profitably. A number of Pacific DMCs require SOEs—including government financial enterprises—to operate profitably, but it has not been always easy for government-owned banks to meet this requirement. To finance risks that other lenders are unwilling to finance, development banks have to put capital at risk and be able to absorb losses from bad loans. To do so, while remaining profitable, they need adequate capital, allowing for their risk appetite and tolerance. For this reason, some Pacific government-owned banks need additional funding sources, such as higher-value term deposits, and more diversified loan portfolios to manage their risk exposure better.

Given the nature of the risks they finance, government-owned banks need strong credit assessment and risk management skillsets. They must operate to the standard expected of a commercial bank—arguably to a higher standard if commercial banks are not financing these risks.

FINANCIAL TARGETS AND BENCHMARKS

Government-owned banks, both commercial and development, should be required to adopt financial performance targets, such as return on assets (ROA) or return on equity (ROE), as top-line indicators of their performance. These targets would underpin the commercial transformation of a bank and direct the board and management towards the business's ongoing profitability.

Financial performance targets should be supplemented with the adoption of benchmarks, for example an efficiency ratio such as operating expenses/revenues. Establishing these benchmarks is relatively straightforward for state-owned commercial banks, as there are usually private

comparators available, either regionally or in a single country. It is a less straightforward exercise for development banks, given the absence of a general development bank model. The suggested interim approach is for development banks to develop an “adjusted commercial bank benchmark.” This benchmark would account for differences in population size, the cost of servicing remote locations, the type of businesses financed, and the sectors in which these businesses operate.

REGULATION AND SUPERVISION

Regulation and supervision of development banks would strengthen the financial system. While most development banks in the Pacific are regulated—as is the case internationally—the requirement should be extended to all. Regulation would strengthen both individual banks and the banking system, reduce the direct fiscal costs and contingent liabilities governments carry, and lower the cost of capital in the economy. Additionally, it would increase confidence in the government’s broader economic management and give assurance to other banks that they can participate in that market on equal terms.

An additional argument for requiring regulation of development banks is the nature of the risks they finance. Development bank lending is inherently riskier than the financing undertaken by other credit providers and there should be some regulatory adjustment for this risk. Capital adequacy standards need to be higher than for commercial banks, and other forms of capital reserves might be justified, as might more stringent provisioning requirements. The critical point is not that development banks are poorly run and therefore need to operate under a relatively higher capital adequacy ratio, but that the nature of the risks taken should be accepted and regulated accordingly.

BROADENING A FINANCIAL SYSTEM

There is current discussion in the Pacific on the merits of a government:

(i) owning more than one bank;

(ii) divesting or diluting its equity stake in a bank;

(iii) establishing new single-purpose banks, such as for small and medium-sized enterprises; and

(iv) establishing vehicles such as venture capital funds to finance high-risk/high-return projects.

These, often contentious, discussions can be guided by an overarching policy consistent with principles of good finance. Assuming that a case

BOX 3: GOVERNMENT-OWNED BANKS AND BANKING SYSTEM STRENGTHENING

CLARIFY THE ROLE OF GOVERNMENT-OWNED BANKS

A government-owned bank must offer **additionality**–by offering services that would not otherwise be provided or by making the finance sector more competitive.

Whatever its role, a government-owned bank must be able to perform that role **profitably.**

ADOPT TARGETS AND BENCHMARKS

Such as: ROA, ROE, efficiency ratios.

Underpin a bank’s commercial transformation by providing board and management with ongoing profitability indicators.

Protect the government’s fiscal position by reducing a bank’s reliance on government transfers and equity injections.

REQUIRE REGULATION AND SUPERVISION

Strengthens both individual banks and the banking system.

Reduces government burden: fiscal costs and contingent liabilities are reduced.

Increases confidence in government economic management, and for other banks to enter market on equal terms.

Accounts for the increased risk inherent in development bank lending: riskier lending should be accepted and regulated accordingly.

Source: Pacific Private Sector Development Initiative

for a bank based on additionality exists and that skilled people can be found—neither of which are trivial assumptions—then two key issues confront policymakers. The first is the government's ability to underwrite the bank's ongoing capital needs. The second is whether any decision that is made improves the way an individual bank or the government assesses and manages credit risk.

GOVERNMENT OWNERSHIP

For most Pacific DMCs, it will be difficult to make a case for more than one government-owned bank. This is primarily due to the relatively small size of any loan portfolio and fiscal and human resource constraints.

GOVERNMENT EQUITY

If Pacific DMCs aspire to broader financial systems, increased private participation is essential. Governments should look to the private sector for equity partners, even where the case for a government-owned bank rests on the private sector's unwillingness or inability to provide credit. Fiscal constraints make it difficult for many Pacific governments to contribute the additional capital government-owned banks need, whether to finance expansion or to replenish capital depleted by bad loans or general poor financial performance.

A government-owned bank's value should increase over time as a reflection of its ability to retain earnings from operating profits and build its capital base. Governments should aim to realize this increase in value, where possible, and be open to private minority shareholding partners at any stage, with a view to full privatization at some future point.

The relatively small size of Pacific banks means that foreign banks are unlikely to seek equity stakes. They are more likely to be interested in protecting their brand and looking for opportunities to expand their Pacific regional footprint, as BSP did when it purchased much of the former Westpac banking franchise in the Pacific. Opportunities such as this are limited, however, unless some way is found to aggregate government-owned banks, or small privately-owned banks, across the Pacific into a Pacific franchise with a scale to interest foreign investors. Any new investment in standalone Pacific banks, government or private, will most likely come from multilateral development banks or local investors.

The obvious source of domestic investment in Pacific government-owned banks is retirement funds. There are several precedents for this: NASFUND PNG wholly owns NASFUND Contributors Savings & Loan Society Ltd, and has stated its intention to pursue a banking license for it; Fiji National Provident Fund owns 75% of HFC Bank in Fiji; and the Vanuatu National Provident Fund owns 15% of the National Bank of Vanuatu, and is open to increasing its shareholding. In 2019, Tonga's Retirement Fund Board and the National Retirement Benefits Fund each acquired a 15% equity stake in Tonga Development Bank, and the Solomon Islands National Provident Fund received approval to apply for an interim license to establish a subsidiary finance company, Solomon Finance Limited.

New shareholders can improve capital strength by reducing a bank's reliance on the government as a shareholder. Reducing this reliance is important, given the financial limitations of government shareholdings. New shareholders can also strengthen a government-owned bank's board. Their additional skills will be important to developing risk management capability, insulating the bank from political pressures, and generally improving bank performance.

SMALL, LOCALLY-OWNED FINANCIAL INSTITUTIONS

A complementary strategy could be to encourage the establishment of small, locally-owned financial institutions. Nationwide Microbank (MiBank) in PNG is an example of such an institution, successfully financing domestic activity and growing its footprint and range of services while it gains experience. This kind of strategy would require a regulatory framework biased towards this objective, but since these kinds of institutions are not systemically important, this could be achieved without compromising a financial

system's safety. Similarly, a licensing framework could recognize different classes of credit providers and embed pathways for graduating between these classes, as PNG has done with its microbanks. Development banks would not be a separate class of credit institution under this proposal. If smaller institutions are to be encouraged, then licensing conditions would need to permit lower capital requirements and less restrictive conditions on prior finance sector experience or foreign banking partners, compared to the requirements for bigger banks.

SINGLE PURPOSE GOVERNMENT-OWNED BANKS

Any case for a single-purpose bank—for example, to provide credit to small and medium-sized enterprises or the agriculture sector—would need to be based on additionality. It would also need to be reconciled with government ownership of other banks, where that exists, and address the risk implications of managing a concentrated, rather than diversified, loan portfolio. Diversification reduces a lender's overall risk exposure and is a standard risk management technique, yet this protection is denied to specialized lenders engaged in single focus lending. Accordingly, minimum capital requirements need to reflect this risk profile. Single-purpose lenders to small and medium-sized enterprises or the agriculture sector may require higher levels of capital than diversified banks or single-purpose banks focused on lower-risk lending, such as housing. Riskier lending also demands more robust credit assessment and risk management frameworks, and the development of these skills and frameworks would benefit a country's broader financial system.

HIGH RISK/HIGH RETURN FINANCING STRUCTURES

Policymakers must allow for a bank's role to change over time. For example, the market share of a development bank in specialized classes for risk, such as agriculture lending, may eventually erode, as other banks realize this lending can be undertaken profitably. Additionally, it is already common for development bank customers to graduate to other banks, where they can obtain cheaper finance, once they have established a stable credit history.

Rather than foreshadow a development bank's demise, these changes offer opportunities for evolution. A development bank can reposition to finance—in a disciplined way—risks that are not being addressed by private lenders, building on its experience profitably providing less risky

BOX 4: HOW GOVERNMENT-OWNED BANKS CONTRIBUTE TO FINANCE SECTOR DEVELOPMENT

INCREASE AVAILABILITY OF CREDIT

The availability of credit in a financial system is increased when government-owned banks provide additionality by filling otherwise **unmet financing needs.**

PROVIDE FOUNDATIONS FOR INCREASED PRIVATE PARTICIPATION

Governments can ensure government-owned banks build foundations for **increased private sector participation** by:

- limiting the **number of government-owned banks,**
- looking for ways to **divest or dilute** government equity in banks, and/or
- developing pathways to **encourage small, locally owned lenders.**

STRENGTHEN CREDIT ASSESSMENT AND RISK MANAGEMENT SKILLS IN THE FINANCE SYSTEM

Government-owned banks can bring **important credit assessment and risk management skills** to a financial system.

PROVIDE A PATHWAY TO FILLING GAPS IN PROVISION OF HIGHER RISK FINANCE

Government-owned banks can **encourage private banks to provide higher risk finance** by demonstrating that it is possible to do so profitably.

Source: Pacific Private Sector Development Initiative

types of finance. As demand for different types of financing emerges, there could be a transition to equity financing, hybrid credit-equity instruments, wholesale financing, venture capital financing, and possibly credit guarantee corporations[5]. The introduction of private shareholders could support this evolution, by reducing risk to the government and introducing additional capital, specialist skills, and experience.

[5] Most government guarantee schemes and risk-share facilities have not met their intended objectives. For more detail on the structure of these schemes and the reasons for this general lack of success, see ADB PSDI. 2016. Credit Guarantees: Challenging their role in improving access to finance in the Pacific region. *Occasional Paper.* Manila.

4 SECTION FOUR CONCLUSION

The prevalence of government-owned banks across the Pacific is an understandable response to the difficulties businesses in the region have in accessing finance—a significant constraint to economic development. However, this response is often formulated in the absence of a structured policy to guide the establishment, governance, operations, and retention of these banks.

This paper addresses that absence and concludes with an indicative outline of such a policy (Box 5). The policy should contextualize a bank's role within that country's broader financial system and specify the problem requiring policy intervention, thereby making a case for the bank's existence, including its potential contribution to finance sector development. Once that case is made, the policy should address the requirements of a well-run financial institution, including governance, funding, capital strength, the bank's financial relationship with the government, risk appetite, and financial performance. It should also situate a government-owned bank within that country's formal finance sector regulatory framework and provide an exit strategy from government ownership.

The paper emphasizes that, since the "job of finance" is to finance economic development, development finance and commercial finance are not incompatible. Therefore, it is useful to reorient any discussion on the merits of development finance to focus on the nature of the risks being financed. This reorientation will help ensure that government-owned bank policy adequately addresses lending risks and associated skill and capital requirements.

Finally, the paper reinforces that, even when the case for a government-owned bank is justified, these banks still need to be well-run and profitable if they are to alleviate credit constraints. The price of lending cannot be isolated from the cost of funding that lending, and a government's fiscal position cannot be isolated from the financial position of a government-owned bank. Any discussion on the role and operation of government-owned banks needs to be grounded on principles of good finance.

BOX 5: INDICATIVE CONTENT FOR CLEAR GOVERNMENT-OWNED BANK POLICY

CONTEXT: ASSESSMENT OF EXISTING CREDIT CONDITIONS

- Structure of financial system.
- Credit indicators e.g. loan to deposit and private sector credit to GDP ratios.
- What are unmet financing needs?

PROBLEM REQUIRING GOVERNMENT INTERVENTION

- Is there a private sector solution?
- Can a government-owned bank address unmet financing needs? Additionality of services or increased sector competitiveness?
- Can a government-owned bank contribute to finance sector development?

GOVERNANCE FRAMEWORK

- Operational relationship with government - consistency with SOE policy and operational independence.
- Financial relationship with government - dividend policy and capital commitment.
- Board skillsets.
- Internal policy framework e.g. credit policy and risk management policy.
- Financial performance metrics (e.g. ROA, ROE).

REGULATION OF GOVERNMENT-OWNED BANK

- Licensing requirements and application of prudential framework.

DIVESTMENT/EXIT STRATEGY

- How to increase value of government shareholding.
- When government would look to reduce shareholding.
- Repositioning to meet other unmet financing needs.

Source: Pacific Private Sector Development Initiative

GOVERNMENT-OWNED BANKS: THEIR ROLE IN PACIFIC FINANCIAL SYSTEMS

Government-owned banks are a pervasive feature of the Pacific financial landscape, but their role is not always clear. This paper aims to assist policy-makers to address questions around government ownership of banks, while highlighting the need to increase private participation in most Pacific financial systems, in order to effectively meet the financing needs of businesses.

Pacific Finance Sector Policy Paper Series

This Pacific Finance Sector Policy Paper is the first of a series published by the Pacific Private Sector Development Initiative (PSDI) covering topical issues in Pacific finance, with the combined aim of assisting Pacific policymakers to alleviate the constraints faced by Pacific businesses when trying to access finance.

About PSDI

PSDI is a technical assistance program undertaken in partnership with the Government of Australia, the Government of New Zealand, and the Asian Development Bank. PSDI supports ADB's 14 Pacific developing member countries to improve the enabling environment for business and to support inclusive, private-sector led economic growth. The support of the Australian and New Zealand governments and ADB has enabled PSDI to operate in the region for 14 years and assist with more than 300 reforms.

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