

# Public Financial Institutions in Europe

Mathias Schmit - Laurent Gheeraert - Thierry Denuit - Cédric Warny





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**Responsible Editor:**

Dr. Mathias Schmit, Managing Director of Sagora S.P.R.L.  
Avenue De Haverkerckelaan 28, B-1190 Brussels  
m.schmit@sagora.be - www.sagora.eu

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**Authors:**

Mathias Schmit, Laurent Gheeraert, Thierry Denuit, Cédric Warny

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## About the authors

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**Mathias Schmit** has a PhD in Finance from the Solvay Brussels School of Economics and Management (Brussels), where he is a Professor of Finance and conducts research into banking and microfinance at the Centre Emile Bernheim (a Solvay Brussels School Research Centre). He has also worked in banking and public-sector-related activities for 15 years. Since the creation of SAGORA in 2005, a consulting company coping with financial public affairs and risk management missions, Mathias leads a network of senior risk management professionals merging extensive banking experience with strong analytical skills and innovation. He is also a regular speaker at major conferences around Europe on topics relating to the banking industry, with a special focus on financial analysis, risk management and strategic risk-related matters.

**Laurent Gheeraert** has a PhD in finance and economics from the Solvay Brussels School of Economics and Management (Brussels), where he is a Professor of Finance. Until 2005, he was a business analyst at the Benelux office of McKinsey & Company, during which time he was involved in strategic, operational and organisational projects in a wide range of sectors in various regions of the world, including Europe, South Africa and the Middle East. In 2007, he founded Finosophia, a financial and management consultancy, which provides public and private institutions with expert advice on such wide-ranging topics as international finance, Islamic finance, company valuation, portfolio analysis, and financial modelling. He is also attached to SAGORA as an expert. In parallel, Laurent conducts research on financial systems and economic development.

**Thierry Denuit** has a Master's degree in Management Sciences from the Solvay Brussels School of Economics and Management (Brussels) and is working on a PhD in economics at the European Center for Advanced Research in Economics and Statistics (ECARES) at the Université Libre de Bruxelles (ULB), where he is also a teaching assistant in economics. In parallel, he is a researcher at the Centre on Regulation in Europe (CERRE).

**Cédric Warny** has a Master's degree in Management Sciences from the Solvay Brussels School of Economics and Management (Brussels) and is working on a PhD on credit networks and systemic risk at the Solvay Brussels School of Economics and Management and won the 2010 "Prix de Barsy" for best Business Engineering Master thesis on "Asset Pricing in a Complex World".



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## Executive summary

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Our study sets out to examine the scope of public financial institutions, their roles and missions as well as their business models in the 27 EU Member States, Croatia, Macedonia, Norway, Switzerland and Turkey. In addition to analysing the diversity of public financial institutions, our extensive empirical research identifies their missions and business models. This has led to **four key contributions** towards a clearer understanding of diversity in the public banking sector.

**The first contribution** arises from constructing a structured, definition-based, homogenous database of public banks and funding agencies in Europe in which the extent of public-sector involvement is summarised in terms of both ownership and control criteria. The level of public involvement is then refined into four categories, from minor public participation to fully public control. The resulting fine categorisation of financial institutions permits a differentiated analysis of the respective degree of public involvement in them. The originality of our approach lay in taking account of two distinct factors: the *actual* level of control exercised by the public sector as opposed to just its level of ownership, and our ensuing examination of a more continuous spectrum of public influence. The estimated assets of the publicly influenced financial sector amount to €9,883 billion - 21% of total bank assets - with 52% of this total pertaining to public institutions ( $\geq 50\%$  control) and 48% involving entities with public participations (5-49.99% control).

Based on our database, including 221 banks with stakes owned by public authorities and 81 funding agencies, **the second key contribution** towards a clearer understanding of diversity in the public banking sector is our analysis of these institutions' missions in terms of four parameters: their objectives, geographic scope, stakeholders and products and services. Our analysis shows that publicly influenced financial institutions set out to fulfil a wide variety of missions, which can be organized in four grand categories: promotional missions, general-interest missions, geographically focussed missions and the more general missions substantially pursued by financial institutions with a public participation. Banks with a promotional mission primarily address market insufficiencies, such as the SME-financing gap, whereas financial institutions with general-interest missions cover many areas, from supporting the agricultural sector to developing infrastructure and promoting tourism. Regionally focussed public banks are primarily intent on ensuring that nobody is excluded from financial services, so they end up providing mostly retail banking services and pursuing schemes deemed to be in the general interest. Partly publicly controlled financial institutions tend to carry out broader activities and be more internationally oriented.

Our **third contribution** towards a clearer understanding of diversity in the public banking sector is a theoretical discussion underpinning the empirical analysis of missions, for the

broad range of financial institutions' missions constitutes their response to a variety of challenges and market failures identified in the academic literature. Linking the general categories of public banks' missions to a rigorous framework of analysis enables a more precise appreciation of the rationales for the establishment of public financial institutions.

The extensive range of missions and roles fulfilled by the public banking sector has led to the emergence of a number of business models, each of which is geared towards effectively fulfilling specific public-interest missions. So the **fourth major contribution** of our study is its extensive description of the range of business activities covered by the public banking sector in Europe by entities such as development banks and agencies, export credit agencies, municipal credit institutions, savings banks, long-term investors and national or regional development agencies. We provide a broad overview of these typical business models, which helps understanding the numerous hybrid forms and variants that exist on the market.

**Summing up**, most previous research on public banks has focussed on measuring and comparing their performance to that of private banks. To the best of our knowledge, no particular interest appears to have been shown in clearly defining the full range of public banks. Instead, most research has tended to draw on existing global databases or local data. At the same time, purely performance-based results can be challenged. Therefore, our study offers some diverging opinions and questions past results and their significance. Furthermore, our study emphasises the mission statements and roles of public banks, which have not been studied in any real depth before.

The main goals of this study were to question previous definitions of the concept of 'public banks' and remedy what we perceived to be a serious shortcoming in this domain. We believe our approach provides genuine added value by producing clearer answers to questions like **who** public financial institutions are, **what** they do, **why** they do it, and **how** they do what they do.

Readers should gain a clearer understanding of what the terms 'public bank' or 'funding agency' - actually cover, which we believe to be of prime importance, given the huge disparities linked to generally loose definitions. Our approach and methodology provide a **fresh take** on the subject, covering largely new ground, so the results of our study should further enrich the debate on public banks and cast more light on the rationales underlying their existence. After all, a fruitful debate can only be initiated when everyone involved in it knows exactly what they are talking about.

## Introduction

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The objective of this report is to provide an overview of the ‘publicly influenced financial sector’ in 32 European countries, namely the 27 EU Member States, Croatia, Macedonia, Norway, Switzerland and Turkey.

Public influence in the financial sector in Europe is far from insignificant. Firstly, a sizeable number of financial institutions have strong links with the public sector, either through their ownership or control structure, or as a result of their provision of financial services to the public sector. Secondly, even fully privately controlled financial institutions are heavily influenced by public authorities, for instance through banking regulations and supervision. Thirdly, the recent turmoil on the financial markets has shown there to be situations where public authorities have to intervene to safeguard financial institutions.

Notwithstanding recent changes in the structure of Europe’s financial markets, the long-standing co-existence of private and public financial institutions throughout history is in itself an interesting market situation. Today, the factors underpinning this delicate market balance, in a modern economic world increasingly free from direct public intervention, remain far from trivial. Yet, despite the existence of an extensive literature on the roles and performance of public financial institutions, many questions remain unanswered. Do we actually need ‘public banks’? Do such institutions genuinely pursue missions of value to the market? If so, what exactly characterises these institutions and how do they fulfil their mission statements? The overriding aim of this report is to contribute towards a better understanding of exactly *what* a ‘publicly influenced financial institution’ is, *who* the players in Europe are, *why* they exist and *how* they attain their objectives.

This research focuses on studying financial institutions over which public institutions exert a minimum degree of control (the threshold being defined as 5% of the voting rights), henceforth called ‘**publicly influenced financial institutions**’. The latter group is then subdivided into two categories, namely ‘**public financial institutions**’ (≥50% control by public authorities) and ‘**institutions with public participations**’ (5 to 49.99%). The scope of our study covers both ‘banks’ (i.e. institutions that are subject to supervision by the respective national banking supervisor) and so-called ‘funding agencies’, which are non-bank financial institutions falling into one of the three following categories: 1) national and regional reconstruction and development agencies; 2) export credit and guarantee agencies, and 3) municipal credit agencies.

Based on the above definition of ‘publicly influenced financial institutions’, a database of 302 institutions across 32 European countries was compiled and then validated with the

help of professionals from the financial industry. That database allows for a clearer overview than we have had in the past of the relative size and market structure of publicly influenced institutions in the financial sector of each country included in the study.

Moreover, the availability of disaggregated, institution-based information makes it possible to analyse individual bodies' missions and identify the main objectives assigned to publicly influenced financial institutions. We encounter tremendous diversity among financial institutions' missions throughout Europe and find that these missions differed according to the degree of public influence. On the basis of empirically identified missions, we highlight the main rationales behind the existence of publicly influenced financial institutions, thereby linking the theoretical literature with empirical reality.

Finally, we analyse financial institutions' business models to show how they set out to fulfil their objectives and missions. We synthesise the main business models used by publicly influenced financial institutions in Europe and relate them to rationales that explain why such institutions exist at all in the market.

In a nutshell, after giving a short review on the History of the European public banking sector in the next Chapter, this report seeks to enrich the debate on the public finance industry in four aspects.

Firstly, surprising though it may be, the literature review on public banks presented in Chapter 2 does not offer a single, clear-cut definition of the object of study. Based on our methodology described in Chapter 3, we provide a workable, cross-border definition of 'publicly influenced financial institutions'.

Secondly, based on that definition, we construct a unique database of publicly influenced financial institutions across 32 European countries. To ensure that the database is highly reliable and as exhaustive as possible, we use extremely diverse sources of information at both the macro level (e.g. local financial supervisors) and the micro level (e.g. annual reports or the websites of individual institutions). We then submit our database to a validation process by conducting interviews with professionals from the financial industry in several European countries. An overview of the European publicly influenced banking sector is provided in Chapter 4.

Thirdly, we present in Chapter 5 an original analysis of mission statements based on the Grounded Theory.

Fourthly, we synthesise in Chapters 6 and 7 a vast quantity of information into summary overviews of the rationales for public institutions and business models of publicly influenced financial institutions in Europe.

# 1. A history of the European public banking sector

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## 1.1. Classical Antiquity and the Middle Ages: The first banks are strongly tied to political rulers

Throughout history, banks and banking systems have had strong, and often ambivalent, relationships with their respective states or governments. In Ancient Egypt, the first deposits, consisting mainly of grain and other agricultural produce, were stored in state granaries. Royal palaces and temples were the safest places to store gold, as they were well staffed and solidly built. However, these rudimentary depositories cannot be compared to modern banks, for they did not grant loans on the deposits in their custody.

When Egypt was ruled by the Greek dynasty of the Ptolemies after the death of Alexander the Great, the scattered state granaries were unified into a single network of 'grain banks', centrally administered from the capital, Alexandria. For the first time in history, this network allowed payments to be executed by crediting and debiting accounts without actually physically exchanging the grain on which these transactions were based. In other words, the existence of a central government had provided the opportunity for the creation and use of scriptural money as a means of payment for goods and services or to settle debts. Yet even those institutions cannot be regarded as banks in the strict sense of the term, since they still did not issue loans. However, they can be considered the first 'clearing houses', a role still played by specialised banking institutions today.

It was in Ancient Rome that the first institutions akin to 'modern' banks appeared and the charging of interest on loans and payment of interest on deposits became common practice. Within the Roman Empire, banking was primarily a private industry, but it remained strongly linked to the state through the minting of coins, which was an imperial prerogative.

Some Roman bankers were even appointed by the government to collect taxes. Banking was generally not a very highly thought-of profession in the Roman Empire, because of widespread opposition to 'usury', the charging of interest. But tax collectors formed a notable exception, their activity being deemed most respectable. In fact, some receivers-general were so highly regarded that they even became Roman consuls.

The Romans also founded the first public bank striving for the financial inclusion of the poor, with the Emperor Augustus converting property confiscated from criminals into a public fund to lend to impecunious citizens, without charging interest payments. This policy was continued by Tiberius, Augustus' successor.

After the fall of the Roman Empire, banking in general (and public-sector interest in the banking sector in particular) waned owing to religious restrictions on the charging of interest imposed by the nascent Catholic Church, and later on by the Islamic authorities.

It was only much later that the development of medieval trade fairs, primarily in the Hanseatic cities, led to a revival of local banking in a bid to enable the financing of ever-increasing trade volumes. Even though banking was still primarily a private business, it is interesting to note that some cities offered guarantees to their local banks in order to promote trade.

The Crusades (11th-13th centuries), with their accompanying military expenses, necessitated the development of a strong banking industry capable of channelling savings from Western Europe into the military budgets of European monarchs in the Holy Land. The Hospitaliers and the Templars, thanks to their large land holdings throughout Europe, emerged as the main bankers of European royalty. The Templars were even mandated by King Henry II of England to collect taxes and channel their proceeds towards the Holy War in Palestine. Thus was born the first bank geared specifically towards serving public sector needs. However, the monarchy's ambivalence towards the banking sector prevailed, and in 1307, King of France Philippe le Bel arrested most members of the Templar Order in France and confiscated their assets.

Ironically, at around the same time and despite the Church's explicit ban on charging interest, papal bankers gradually developed the most successful banking institution in Western Europe. *Monte di pietà*, institutional pawnshops that circumvented the Catholic ban on charging interest, acquired near-monopolies in granting credit in most medieval cities across Europe. The first European pawnshop was set up in 1450 by the Franciscan monk Barnaba Manassei to help the poor of Perugia in Italy. Pawnshops sidestepped the Catholic ban on charging interest by awarding non-interest-bearing loans. Instead of paying interest, debtors were urged to make donations to the Church.

Apart from these limited banking experiments, the political and economic instability characteristic of the Middle Ages hindered the development of financial markets and therefore impeded the emergence of a sophisticated banking sector and modern public banks.

## 1.2. The Renaissance: Modern public banks emerge

The Renaissance was a golden age for European banking. Italian bankers, especially in Florence, emerged as the leading force in the industry, circumventing the Church's prohibition of usury by disguising loans as regular exchange transactions (e.g. charging high fees for transactions involving paper money). However, these bankers did not provide financial services to the masses, limiting their activities to the profitable upper classes only, leaving the pawnshops to attend to all the needs of the underprivileged masses.

The first public bank in the modern sense of the term was the Bank of Barcelona, primarily an exchange and deposit bank, set up in 1401 by the city's magistrates. Its main characterising feature was that its services were accessible on equal terms to both local citizens and foreigners. As with the *monte di pietà*, a public guarantee was offered, in this case by the City of Barcelona, to secure the bank's operations.

A few years later, in 1407, a second public bank was founded: the Bank of Genoa, its main mission being state debt management. The Republic of Genoa had borrowed large sums of money from its citizens and a sizeable part of the city's tax revenues were entrusted to the bank each year to effect debt and interest repayments.

The oldest bank in the world still active in that capacity today is the Monte dei Paschi di Siena, a public bank founded in 1472 as a pawnshop by magistrates in the City of Siena to aid the underprivileged. In 1624, it became a retail bank, providing financial services to the local community in Siena and the broader region of Tuscany. That same year, Ferdinand II of Tuscany granted the depositors of the bank a state guarantee, which was financed by revenues from the region's pastures (*paschi* in Italian). It was only much later, in 1907, that the bank first became active outside its historic region by opening branches throughout Italy. Its international expansion began in 1946, when it started opening offices in all the major financial centres (including Frankfurt, New York, London and Singapore). In 1995, the bank's ownership was transferred from a fully public company to a foundation fulfilling specific social goals.

### 1.3. The Industrial Revolution: Public banking flourishes

Even though the anecdotal evidence presented above would suggest a long tradition of public banking, it was only during the Industrial Revolution, i.e. in the 18th and 19th centuries, that banking services in general, and public banks in particular, really flourished. Indeed, the new economic context gave rise to two new major types of banks: savings banks and universal banks.

#### 1.3.1. Savings banks

The Industrial Revolution radically changed the economic landscape in which banks operated. Peasants deprived of their land by various reforms moved to sprawling cities to find work in factories. The emergence of urban lower-middle classes with modest savings and the ever-increasing needs to finance fast-growing economies called for the development of a new type of banking institution: the savings bank.

Not all savings banks are public institutions. As Revell showed in 1989, savings banks historically developed in two localities: the UK and Germany. However, the legal forms of these banks differed in each place and they were also subject to different degrees of public control.

In the UK, savings banks were usually set up by philanthropists or entrepreneurs and took the form of private credit cooperatives. Even though these institutions display some striking similarities with public savings banks (which will be described below), they are fully private companies with unlimited liability, guaranteed by the personal assets of their founders. This model rapidly spread throughout the English-speaking world and would later lead to the establishment of 'building societies', credit cooperatives designed to provide lower-middle class industrial workers with loans to finance their housing.

The other centre of development for savings banks was Germany, where they were set up by local authorities (municipal governments, religious groups, trade unions and so on), mostly as charitable foundations offering loans and savings services to members of the respective local middle class. Within these German savings banks, the degree of control exercised by the state was far stronger, since the impetus for establishing them often stemmed from the public sphere. This originally German public savings banks model subsequently spread throughout continental Europe, becoming firmly implanted in Austria, France, Italy, Spain and Switzerland. Financial institutions reproducing this German model frequently enjoyed public guarantees provided by the municipal or regional government.

Despite the private-public dichotomy within the savings banks sector, all these institutions had a number of distinguishing characteristics in common. Firstly, they were created in response to the emergence and needs of a lower-middle class seeking a safe haven in which to deposit their savings. Secondly, they organised their activities and services on the basis of what can be described as a 'territoriality principle', being strongly rooted in their local communities (through both their banking and welfare-related activities). In other words, these savings banks never competed with each other because they enjoyed virtual exclusivity within their respective home territory. In actual fact, this lack of competition enabled a high degree of cooperation between savings banks, leading to the emergence of regional and national associations (examples including the Sparkassen- und Giroverband in Germany, the Associazione di Fondazioni e di Casse di Risparmio in Italy, the Verband Schweizerischer Kantonalbanken in Switzerland and the Confederación Española de Cajas de Ahorros in Spain) and also joint investment companies like DekaBank.

The territorial focus of savings banks was also recognisable in their service mix. Indeed, to this day savings banks focus mainly on retail banking, SME financing and mortgage banking, activities which are all intimately linked to the local development needs of their communities.

The rise of local savings banks prompted governments to impose stringent limitations on the level of investment risks the banks could take, in a bid to guarantee their financial solidity. A popular way of achieving this was to oblige the institutions in question to invest in government

bonds. In the UK, this was done directly through the National Debt Office (NDO) - now known as the Commissioners for the Reduction of the National Debt (CRND). Elsewhere, most notably in France and Italy, this led to the birth of a new type of public financial institution, namely the Caisse des Dépôts et Consignations (CDC) in France and the Cassa Depositi e Prestiti (CDP) in Italy.

The CDC was founded in 1816 in an attempt to reorganise the French financial system after the fall of Napoleon. The CDC was a financial intermediary whose principal purpose was to collect deposits from savings banks and safeguard their financial integrity by investing them in government bonds. The CDP had similar goals, but was created later, in 1850. Deposits entrusted to the CDC and CDP have always benefited from an explicit government guarantee, reducing the risk of savings losses.

At first, the CDC was prohibited to grant loans, even to finance public works. This changed in 1822, when worries about the inflation of government debt, on the one hand, and a tremendous need for development, on the other, rang in legal changes which allowed the CDC to award loans to local governments to finance their development projects. The first such loan was granted to the city of Dunkirk, to finance the development of its port infrastructure.

Both the CDC and the CDP played an important role in the development of national infrastructure in France and Italy respectively, financing the building of roads, railways, bridges, schools and other public infrastructure. They also enabled the reorganisation of local government debt by centralising local government borrowing and guaranteeing access to funding to all their nation's municipalities and regions. As French President François Mitterrand put it: "*No step in the modernisation of France was not entered on the CDC's balance sheet*".

In Italy, as of 1875 the CDP, in addition to collecting savings originating from savings banks, was also entrusted with amassing savings from the country's central post office savings bank. This further consolidated the structural role played by the CDP.

Post office savings banks were created across Europe during the 19th century in an effort to replicate the success of local savings banks. The increase in interregional commerce necessitated the existence of a national financial network to foster growth in trade, prompting the burgeoning of post office savings banks, which made use of the existing network of public and private post offices to create another type of savings bank.

Contrasting the role played by the CDC and CDP, unlike France and Italy, other countries, especially Spain and Portugal, did not issue risk-free government bonds during the 19th century, which precluded the centralisation of savings by an organisation similar to the CDC and instead led to savings banks being structurally linked to existing *montes de piedad* or

*caixas económicas montepio* (pawnshops), as both institutions focussed on serving the same needy public.

In other, more decentralised countries, no restrictions were placed on the range of investment instruments that savings banks were allowed to use. Instead, ad-hoc institutions (jointly owned by all the savings banks in the country in question) were set up to pool resources, develop more complex investment services (which were not readily available from individual savings banks) and settle inter-bank payments. The DekaBank in Germany, founded in 1918 as a *Girozentrale* or clearing house for *Sparkassen* (the German word for savings banks), exemplifies this alternative market structure, being jointly owned by Germany's *Landesbanken*<sup>1</sup> and by the Association of German Savings Banks (DSGV) and acting as those banks' central asset manager.

### 1.3.2. Universal banks

The Industrial Revolution also paved the way for the emergence of another type of bank: the 'universal bank'. In many countries, universal banks were founded by public authorities both to collect the mounting savings accumulated as a result of industrialisation and to channel those savings towards the investment needs of a booming economy. The first public universal banks also served as development banks, helping the government to promote economic growth and development.

A good example of such a public universal bank is the Société Générale des Pays-Bas, founded in 1822 by King William I of the Netherlands. Until 1835, it remained the only corporate bank in the southern Netherlands, having been set up to facilitate the integration of the economies of the northern and southern parts of the country (which at that time included what is now Belgium). This universal bank had been given multiple objectives, being tasked on the one hand with "*mobilizing' the national wealth and directing it toward useful enterprise*"<sup>2</sup>, and on the other it performed a series of financial tasks on behalf of the government. These tasks included lending funds to central, provincial and municipal bodies, managing the Netherlands' public debt, carrying out monetary reforms, collecting taxes, and so forth. Once Belgium had gained its independence, the Société Générale de Belgique continued to take the lead in developing "*a unique set of financial institutions geared to supporting industrial development*"<sup>3</sup>. It even remained Belgium's central bank until 1850. Most public universal banks, including the Société Générale de Belgique, were privatised in the 1970s and 1980s.

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<sup>1</sup> *Landesbanken* are regional universal banks in Germany that also serve as the central administration of the local *Sparkassen* within their territory.

<sup>2</sup> Laureyssens (1985).

<sup>3</sup> *Ibid.*

#### 1.4. The 20th Century: Public banks as tools for economic reconstruction

During the first few decades of the 20th century, numerous public institutions were founded to assume a variety of roles. Among these bodies, the first municipal credit institutions (like Bank der Nederlandse Gemeenten in 1914, Kommunalbanken in 1926), development banks (such as Bank Gospodarstwa Krajowego (BGK) set up through a Presidential Decree in 1924 in Poland) and export credit agencies (such as the National Delcredere Office (OND/NDD) in 1921) were established to cater to the nascent needs of municipalities and exporters.

In France, from 1905 onwards, the CDC also financed the development of social housing. Today, no less than one sixth of the French population live in social housing that was financed by the CDC.

During the Great Depression, the role of the CDC in France and the CDP in Italy as the main economic development agencies of their countries was accentuated, and the loans they awarded were designed to promote growth and help to finance efforts to breathe new life into the economy. During both World Wars, these same institutions played key roles by channelling savings towards the war effort. In Italy, the Fascist regime even took direct control of the CDP, integrating it into the Ministry of Finance and Treasury. After World War II, the CDC and CDP were once again called upon to finance the reconstruction of the national economy, the CDC even becoming the official '*Banque du Plan*', or 'planning bank', coordinating and investing all major reconstruction efforts within France.

When the Second World War had come to an end, several national and regional development banks and agencies were set up in Western Europe to channel the reconstruction aid of the Marshall Plan. One prime example of such an institution was Germany's credit institution for reconstruction or Kreditanstalt für Wiederaufbau (KfW), set up in 1948, which has retained its name even to this day. At its creation and continuing throughout the 1950s, the KfW, like many other development agencies, provided valuable support for the (re)construction of housing, since up to 90% of all homes had been destroyed during the war.

The economic boom accompanying the reconstruction of Western Europe after the war also led to a second wave of public companies promoting exports (e.g. Compagnie française d'assurance pour le commerce extérieur (Coface) in France, Oesterreichische Kontrollbank AG (OeKB) in Austria, both in 1946) and also prompting projects designed to meet municipalities' mounting financial needs (e.g. Kommunalkredit Austria, created in 1958).

Following the economic boom of the 1960s, which was accompanied by investments by the CDC and CDP in major infrastructure projects of post-war reconstruction, such as major road networks, the oil crises and ensuing stagnation in the 1970s and 1980s created a real need

to find new ways of stimulating national economies. The CDC started investing in French businesses with the dual mission of acting as a strategic development partner for listed companies and strengthening the capital base of SMEs.

At the same time, the neo-liberal policies pioneered by Margaret Thatcher in the UK and Ronald Reagan in the USA swept through Western Europe, leading to the privatisation of many previously state-owned banks. For example, the nationalisation of the French banking system decreed by President Mitterrand in 1982 was reversed and private control was even extended to banks that had long been under government control. Public interference with the economy was systematically disparaged by neo-liberal economists throughout the 1970s and 1980s, but that respite would only prove temporary as the collapse of Communism, and its attendant development needs soon called for massive state intervention once again.

After the fall of the Berlin Wall in 1989, the reunification of Germany called for a level of public involvement unprecedented since the reconstruction efforts following the Second World War. Once again, the KfW played a major role in channelling funds earmarked for reconstruction. For example, between 1990 and 1997, the Home Construction and Modernisation Programme, administered by the KfW, helped to modernise 3.2 million apartments in the former German Democratic Republic.

The fall of Communism led to the privatisation of entire banking systems in Central and Eastern European (CEE) countries. In most CEE countries, national commercial banks had to be restructured before being privatised, due to the high level of non-performing loans (as high as 50% in 1991 in the Czech Republic, Hungary and Poland)<sup>4</sup>.

For example, Poland's national public savings bank was divided into 9 regional commercial banks, which were duly privatised in turn. And between the privatisation of Wielkopolski Bank Kredytowy (WBK) in 1993 and of the Powszechny Bank Kredytowy (PBK) in 1997 the country's national banking system underwent radical changes.

At the same time, the colossal economic needs of the CEE states led to the creation of several public financial entities in that region. For instance, the Mortgage and Land Bank of Latvia was founded in 1993 to finance the country's agrarian reform and grant long-term mortgage loans to finance reconstruction efforts. In Poland, Bank Gospodarstwa Krajowego's (BGK) operations were reactivated by the Ministry of Finance in 1989 where BGK acted as the government's first debt management agent, thereby adding support to the transformation of the budget and economy at the time. In a bid to underpin economic development, many Eastern European countries also followed their Western counterparts by setting up specific financial institutions to boost economic development and exports.

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<sup>4</sup> Thorne (1993).

At every stage in their evolution, a number of development agencies have sought to follow and bolster government policies through their investment and lending activities. Consequently, it is hardly surprising that bodies such as the CDC in France, the CDP in Italy and the KfW in Germany, along with numerous others throughout Europe, are actively involved today in financing projects designed to combat global climate change.

### 1.5. The recognition of Special Credit Institutions by the European Commission

Finally, the substantial progress in the economic integration of the European Union since the 1990s has raised various issues concerning the fact that certain public banking practices may not be appropriate with regard to European competition regulation. In particular, concerns were raised about the compatibility between the German system of State guarantees for public law credit institutions or special credit institutions (the *Anstaltslast* and *Gewährträgerhaftung* systems) and European State aid rules. In 2002, negotiations between the European Commission and Germany's Federal Ministry of Finance reached a landmark Understanding<sup>5</sup>, which complements the German system with various provisions rendering it compatible with European State aid rules. The Understanding primarily concerns legally independent special credit institutions in Germany aiming at *"supporting the structural, economic and social policies and the public tasks of their public owners in accordance with their public mission. It must be taken care that special credit institutions are only entrusted with promotional tasks in compliance with the State aid rules of the Community. The fulfilment of promotional tasks shall be governed by the respect of the prohibition of discrimination under Community law"*.

The agreement stipulates that the use of the advantages for special credit institutions immanent to the State guarantees and/or refinancing guarantees remain in compliance with the State aid rules of Community law if the activities of special credit institutions fall under a restrictive list of areas (see section 7.2) and the according conditions listed in the Understanding are met.

This agreement has had a great importance as a benchmark for other European countries, de facto establishing some rules for the possible actions of public banks in the European Union.

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<sup>5</sup> European Commission, "Understanding about the orientation of legally independent special credit institutions in Germany", 1<sup>st</sup> March 2002.

## 1.6. Conclusion

Throughout European history, the banking sector has been instrumental in enabling economic prosperity. Many public authorities played an active role in the banking sector through the creation of public or semi-public banks. This public involvement in banking had several key beneficial knock-on effects on the economy. Firstly, it made sure that the lower-middle classes were not denied access to financial services, such as deposits or loans. Secondly, it allowed sizeable investments to be made and paved the way for both private and public reconstruction projects that would not have been feasible without government backing. Finally, through regulatory intervention (such as ensuring the proper management of the public debt), the public sector has always endeavoured to guarantee the stability of the financial system.

## 2. Literature review

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To our knowledge, little has been written with a view to establishing a broadly recognised definition of public banks or the public financial industry. While many studies have been published in this field, we note that authors tend to focus on comparing and contrasting public and private banks instead of selecting criteria for establishing a clear definition of public banks.

Most authors appear to use existing samples taken from existing databases (see, for example, Altunbas et al. (2001), Barry et al. (2009), Micco et al. (2004), Fries and Taci (2005), Iannotta et al. (2006)), but do not reassess how public banks have been defined.

Indeed, generally speaking, public banks definition relies on “ownership” being the most prevalent breakdown criterion (see, for example, Farabullini and Hester (2001), Beck et al. (2003), Iannotta et al. (2008), etc.).

The literature review is presented as follows. In Section 1, we present findings drawn from the banking literature comparing public banks and private ones based on performance. In Section 2, we say a few words about the reasons for those findings. Section 3 is our conclusion.

### 2.1. Comparing performance

There are two tendencies when it comes to the performance of public banks.

The first suggestion is that public banks systematically perform not as well as private banks, especially in developed countries. Studies on the profitability of banks show that public banks are relatively less efficient than private ones in the OECD countries. Numerous authors - as well as the International Monetary Fund - share this view, claiming that state-owned banks are characterised by low profits and low cost efficiency, sometimes leading to reduced access to credit (see, for example, La Porta et al. (2002), Barth et al. (1999), Beck et al. (2003)). It has also been argued that state ownership of banks is linked to a higher likelihood of financial crisis (see, for example, Caprio and Martinez Peria (2000) cited in Rudolph (2009))

A critical note on the performance by mutual banks and public banks was also found by Iannotta et al. (2006) in a study of the 181 largest banks in 15 European countries, over the period 1999-2004. Similar studies focusing on specific European countries seem to concur fully with these findings (like Hau and Thum (2009)) and (Farabullini and Hester (2001)).

Consequently, most of these authors recommend more bank privatisation in order to increase operating efficiencies. As reported below, these findings are confronted by many authors.

It is useful to say a few words about the so-called “transition countries” (basically the former Soviet Union and communist countries). As a result of the former communist regimes and their policies, many banks in transition countries are still state-owned. Here too, many authors favour privatisation. For instance, the findings published by Fries and Taci (2005) tend to prove that state-owned banks are less cost-efficient than privately owned banks (out of a sample of 15 Eastern European countries), suggesting that private banks (especially those that are foreign-owned) are the most efficient.

However, a second opposite view challenging these findings (or at least their reliability and significance) has also gained support. For instance, drawing on a sample of German banks, Altunbas et al. (2001) seem to find that state-owned banks do not underperform, even going so far as to suggest that they might enjoy a small cost and profit advantage over private banks. This contradicts the findings of Hau and Thum (2009).

Other authors are more neutral, concluding that neither underperformance nor overperformance can be established, and suggesting that ownership structure might not be correlated with performance. As a result, they state that public banks should not necessarily be considered less efficient *a priori* (Levy-Yeyati et al. (2004) using La Porta et al. (2006) data, Micco et al. (2004) for the industrial countries).

The same holds true for the transition countries. For instance, the findings of Grigorian and Manole (2006) and Bonin et al. (2004) (cited in Karas et al. (2010)) are completely different. Indeed, these authors verify that the better performance of private banks was not statistically significant. Based on a sample of 1999-2002 data on Russian banks, Styryn (2005) also proved that there were no noteworthy correlations between type of ownership and efficiency. This too totally contradicts the above-mentioned findings (cited in Karas et al. (2010)).

From their research on the Croatian financial system, Kraft et al. (2006) confirm this last point, suggesting that privatisation cannot be linked to systematically better results. Finally, after considering deposit insurance, Karas et al. (2010) emphasised a tendency of state-owned banks to outperform current domestic private financial institutions, although they also emphasised that “older” private banks might be more efficient and thus that *“better banks were privatised first”*.

## 2.2. Reasons for results

The reasons advanced to explain the poorer performance of public banks are usually classified into three categories.

### 2.2.1. The social and development view

According to this view, public banks are needed to support local and regional activities.

Indeed, the purpose of state-owned banks is to develop less profitable sectors that provide significant social utility for the community where they are located. Consequently, these banks aim to reduce market inefficiencies by developing industries that would have otherwise been left behind. Therefore, numerous authors are in line with this view concerning government-owned banks' mission, which allows them to explain eventual underperformance compared to private institutions. It has also been argued that they help to prevent unfair coalitions of private banks and capital drain, again with a view to improving social welfare (Gerschenkron (1962), Atkinson and Stiglitz (1980), Stiglitz et al. (1993), Beck et al. (2003), Berger et al. (2005), Andrianova et al. (2006), Hakenes and Schnabel (2006)).

### **2.2.2. The political view**

While the social and development view was quite popular in the last four decades, it has recently been challenged by a much more cynical point of view. In fact, some authors suggest that the allocation of resources has become more of a politicised process, with the emphasis on strategic challenges.

Among the supporters of this view, many authors focus on the Italian banking sector. Let us cite, for example, Shleifer and Vishny (1994), Shleifer (1998) and Barca and Trento (1997), according to whom there is evidence of the politicisation of resources in Italy, leading to poorer operating performance by state-owned banks. In order to prevent bribery issues, they recommend more bank privatisation. Other examples, such as Ginsborg (1990), suggest that differences in terms of loans granted to the South and the North of Italy correspond to the disparities in terms of political patronage between these regions. Lastly, Sapienza (2004) sheds light on the political challenges by demonstrating that state-owned banks tend to favour companies with strong political affiliations.

Other findings by Cecchetti and Krause (2001) as well as Kane (1977) have pointed out the unfavourable impact of public ownership on monetary policy efficiency and the granting of loans. Again, the main implications of these papers relate to the fact that political considerations prevail over socioeconomic ones.

### **2.2.3. The agency view**

Supporters of the agency view suggest that bureaucratisation and bribery in public banks are such that they can offset social gains. They argue that public banks are more prone to bureaucratisation, agency issues and poorer governance than their private counterparts, leading to some misallocations (see Barnerjee (1997) and Hart et al. (1997)).

**Table 1 - Categories of reasons explaining performance of public banks**

	Social view	Political view	Agency view
Andrianova et al. (2006)	x		
Barnerjee (1997)			x
Beck et al. (2003)	x		
Gerschenkron (1962)	x		
Ginsborg (1990)		x	
Hakenes and Schnabel (2006)	x		
Hart et al. (1997)			x
La Porta et al. (2002)		x	
Sapienza (2004)		x	
Shleifer (1998)		x	
Shleifer and Vishny (1994)		x	
Stiglitz et al. (1993)	x		
Tirole (1989)			x

Source: Compiled by the Authors.

A problem in assessing which view is closest to reality is that they all come to the conclusion that public banks are potential underperformers. This is explained by the fact that either these banks promote regional development and social welfare to the detriment of profit and cost efficiency (social view) or by the fact that state-owned banks are used as a way to supply political patronage and therefore do not take action to optimise performance (political view). The third approach is also consistent with public bank underperformance as the latter are prone to agency cost issues and sometimes bribery.

As a result, one of the approaches recommended for assessing the role of public banks is to look at their impact on the development and economic growth of the financial sector. This point has been tested by various authors, including La Porta et al. (2002), who studied 92 banks in 1996. They conclude that public banks harm financial development, upholding the view that only political influences could justify this phenomenon. However, it is worth mentioning that other authors - such as Levy-Yeyati et al. (2004), who also used La Porta et al. (2000) data - have challenged these findings.

Furthermore, even though several studies have provided theoretical rationales to explain their findings, we have not found any paper that specifically aims to classify mission statements and to establish a definition of public banks. Rather, such findings are used to

support performance and efficiency results. Besides, performance analysis relies mainly on accounting ratios, which should be treated with caution since they are subject to important limitations. Most importantly, they do not make it possible to take into account non-financial focuses, which is arguably an essential pillar of public banks' objectives. Finally, it should be stressed that comparing only financial performance measures without looking at mission statements and roles is also highly questionable.

### 2.3. Conclusion

In conclusion, this literature review demonstrates that most of the research conducted on public banks has focussed on measuring and comparing their performance to private banks. To our knowledge, it appears that no particular interest has been shown in establishing a definition of public banks, with research relying mainly on existing global databases or local data. There is also evidence that performance results can be challenged; diverging opinions have been provided, questioning the results and their significance. Moreover, it should be stressed that most of these analyses rely on accounting ratios (e.g. ROE, ROA, cost-efficiency, profit-efficiency) which are also prone to financial analysis limitations.

In addition, this survey allowed us to note that rationales to explain public bank performance were mentioned in the public banks' literature. However, these are mainly theoretically discussed via the three different views explained in Section 2, and should also be treated with caution. As emphasised above, comparisons of performance results, based on accounting and financial ratios (e.g. financial sector development) should be interpreted cautiously, even if there is strong evidence that all of these findings fuel and enrich the debate on public banks.

For all these reasons, we believe that our approach provides a new viewpoint and pertinent added value on the subject. The main goal of this paper is to question the pre-existing definitions of the concept of "public banks" as mentioned in the literature.

Firstly, our study aims to give a general overview of the public financial sector in Europe by analysing market share and volume. This overview will enable us to analyse the public financial sector in terms of how much market influence the public authorities have over the financial sector.

Secondly, it thoroughly analyses missions and roles, not to confirm or repudiate performance hypotheses, but to find similarities between public financial institutions on various levels: objectives, geographical focus, stakeholders, products and services. This will allow us to classify public financial institution' missions into major categories.

Finally, by comparing the missions thus identified to the main theoretical rationales for the existence of public financial institutions, we can develop a rigorous description of the main

models of public financial institutions in Europe (e.g. savings banks, financial intermediaries/banks for banks, development banks, export credit agencies). The objective is thus to provide a better understanding of what the term “public financial institutions” actually means. This is a complex task considering the huge disparities linked to its loose definition. Our multiplicity of approaches and our methodology enable a new look at the subject, in a manner not yet covered. This could further enrich the debate on public banks and financial institutions and the rationales for their existence, for a fruitful debate can only be initiated when we precisely know what we are talking about.

## 3. Methodology

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### 3.1. Scope and definitions

#### 3.1.1. Geographic scope

The geographic scope of the present study - '*Europe (27+5)*' - should be understood as consisting of 32 countries, namely the 27 countries that have been EU Member States since 1 January 2007, plus Croatia, Macedonia, Norway, Switzerland and Turkey. The study only included institutions that were legally incorporated in one of these countries.

#### 3.1.2. Financial institutions: banks and funding agencies

For the purpose of our study, the term '*bank*' was defined as *an entity subject to supervision by the national banking supervisor* of one of the aforementioned countries. Since banking regulations can differ substantially between countries, the scope of this definition may vary from one country to another, but the simplification entailed by the above definition was made possible by the existence, for all EEA members (i.e. 28 out of the 32 countries included in the scope of our study<sup>6</sup>), of a single '*European passport*' for credit institutions (first introduced by the Second Banking Directive), which enforces the mutual recognition of banking regulations between EEA member countries.

Moreover, all the other countries for which we collected data, except Switzerland, have already launched accession talks with the EU and are thus gradually adopting the '*acquis communautaire*', which has already brought about and will continue to result in enhanced convergence between banking regulations across Europe. Nonetheless, for the purposes of the present study, the rules governing the supervision of Swiss banks can be considered equivalent to EU banking regulation, thanks to a continuous '*regulatory dialogue*' between the Swiss authorities and the European Commission.

For cross-border financial institutions, regulation is shared between the respective '*home*' and '*host*' countries. Thus, all cross-border financial institutions are both regulated in the country where they are incorporated and supervised on a consolidated basis at group level (so-called '*home*' regulation). Under this framework, branches with no legal personality may operate in a host country whilst being solely supervised by their '*home*' supervisor. On the other hand, subsidiaries with a legal personality distinct from that of their owner are supervised by the respective watchdog in the country where they are incorporated (a so-called '*host*' supervisor). All banks covered by the present study were assigned to the country where they

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<sup>6</sup> The 27 EU Member States plus Norway are the EEA member countries included in the scope of the present study.

are incorporated, i.e. on an unconsolidated basis.<sup>7</sup> This unconsolidated treatment of financial institutions offers the additional advantage of being compatible with the definition of ‘resident units’ as per the European System of Accounts (ESA95), which defines such ‘resident units’ as having “a centre of economic interest on the economic territory of a country”<sup>8</sup>.

The present study also covers additional financial institutions not subject to supervision by national financial supervisory authorities. We refer to these as ‘funding agencies’. To our knowledge, there is no established, simple, single workable definition of this term, and we found no structured reference to such financial institutions in the scientific or business literature we examined. Due to the absence of any legal or academic definition of such agencies, and the inherently varied nature of such bodies, the definition of funding agencies used in the present study is mission-based, thus potentially encompassing entities with articles of association and/or legal forms that may differ substantially.

The different types of funding agencies considered within the framework of our study are defined below, based on current definitions offered by intergovernmental organisations.

a) National and regional reconstruction and development agency<sup>9</sup>

A non-monetary financial institution controlled by the public sector that is primarily active in equity participations and bond issue subscriptions and awards long-term loans (that are beyond other financial institutions’ capability or willingness to provide) in a bid to further national and regional development.

b) Export credit and guarantee agency<sup>10</sup>

An agency in a creditor country that provides guarantees or loans for exports of goods and services.

c) Municipal credit agency<sup>11</sup>

A financial cooperative whose member-owners are municipalities or regions and that awards its members collectively guaranteed loans at the lowest possible rates of interest.

Note that the three types of funding agencies considered cover the potential scope of activities of ‘special credit institutions’ as defined in the EU Commission Understanding (see section

<sup>7</sup> Surveying banks on a consolidated basis would have been inappropriate for the study in question because it would have over-represented the public banking sector in countries with sizeable internationally active banking groups, but under-represented its public presence in other countries, serviced mainly by subsidiaries of foreign banking groups (for example, several German and Austrian banking groups have subsidiaries in Ireland and spread throughout Eastern Europe, so adopting a consolidated approach would have led to the over-representation of Germany and Austria and the under-representation of many Eastern European countries and Ireland).

<sup>8</sup> Council Regulation (EC) 2223/96.

<sup>9</sup> Based on the OECD and IMF definition of ‘development banks’.

<sup>10</sup> Based on the OECD and IMF definition of ‘export credit agencies’.

<sup>11</sup> Based on the definition of ‘credit unions’ of the European Network of Credit Unions.

1.5). Therefore, the latter institutions may be classified either as banks or funding agencies, according to the fact they are subordinated to a financial supervisory authority or not.

Once the scope had been clearly defined, both in terms of geographic and institutional coverage, a coherent database can be constructed.

## 3.2. Creating a database of public banks and funding agencies

### 3.2.1. Coverage objectives per country

To ensure that the database remained of workable size, whilst remaining sufficiently exhaustive, a size threshold was introduced for financial institutions. Drawing on the experience of the EU's recent Sector Inquiry on Retail Banking<sup>12</sup>, the present study set out to cover at least 80% of the European banking market as measured by total assets as at 31 December 2009. However, the coverage of individual national markets varied, depending on their concentration. Strongly concentrated markets were analysed up to a higher threshold and less concentrated markets by adopting a lower threshold. The present study was always intended to be at least as exhaustive as the Sector Inquiry on Retail Banking, and if at all possible even more comprehensive. The coverage rates for the different national markets covered by the present study are detailed in the table below.

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<sup>12</sup> European Commission : COM(2007)33 and IP/06/999.

**Table 2 - Coverage of the respective national banking markets**

<b>Country</b>	<b>National banking market coverage (% assets) in the EU's Sector Inquiry on Retail Banking</b>	<b>National banking market coverage (% assets) attained in this study</b>
Austria	> 60	> 80
Belgium	> 90	> 90
Bulgaria	N/A	> 90
Croatia	N/A	> 90
Cyprus	> 80	> 90
Czech Republic	> 70	> 80
Denmark	> 80	> 90
Estonia	> 70	> 90
Finland	> 90	> 90
France	> 80	> 80
Germany	> 50	> 80
Greece	> 90	> 90
Hungary	> 80	> 90
Ireland	> 60	> 90
Italy	> 70	> 70
Latvia	> 50	> 90
Lithuania	> 80	> 90
Luxembourg	> 30	> 90
Macedonia	N/A	> 90
Malta	> 90	> 90
Netherlands	> 90	> 90
Norway	N/A	> 90
Poland	> 70	> 80
Portugal	> 80	> 90
Romania	N/A	> 90
Slovakia	> 80	> 90
Slovenia	> 80	> 90
Spain	> 70	> 80
Sweden	> 90	> 90
Switzerland	N/A	> 70
Turkey	N/A	> 90
United Kingdom	> 80	> 80

The total banking assets covered in the present study derive from statistics published by the European Central Bank (ECB) on Monetary Financial Institutions (MFIs)<sup>13</sup>. These market statistics were compiled in accordance with the European System of Accounts (ESA95), using the unconsolidated definition of 'resident units'. Hence they can be used to measure national market sizes, as well to compute market shares and coverage rates per country.

Unfortunately, such market-coverage-related objectives and corresponding assets totals could not be obtained for funding agencies, since no definition of them existed prior to our study. Accordingly, there was no way of systematically assessing the comprehensiveness with which funding agencies are covered, and other methods (see below) had to be employed to ensure a sufficient degree of exhaustiveness. As no information is available on the size of this particular market, no analysis of the market share of funding agencies was carried out. To focus our analysis on the most significant financial institutions, only those funding agencies with assets of 3 million euro or above (as at 31 December 2009) were included in the dataset.

### 3.2.2. Identifying banks and funding agencies

#### a) Banks

Various sources of information were used to draw up a list of banking institutions in a given country complying with the coverage criteria outlined above. For highly concentrated countries, or when exhaustive data on institutions' assets were available, national supervisors' lists of supervised entities were used. Whenever necessary, these were complemented by various national bank rankings (based on their asset size) found in the business literature, and national databases providing banking information were cross-checked if need be by conducting interviews with bank executives in the countries included in the survey.

#### b) Funding agencies

As pointed out above, no market-size-related or coverage-related criteria could be applied to funding agencies, which threatened to jeopardise the comprehensiveness of the study. To remedy this, the present research used membership lists of various professional organisations to ensure optimal market coverage. The resulting database of funding agencies was further complemented by conducting interviews with bank and funding agency executives in the surveyed countries.

### 3.2.3. Identifying public financial institutions

#### a) Two complementary criteria: ownership and control by a public authority

The existing scientific literature offers no comprehensive and authoritative definition of what

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<sup>13</sup> <http://www.ecb.int/stats/money/aggregates/bsheets/html/index.en.html>

is meant by the term '*public bank*'. Most studies<sup>14</sup> use some variants of share ownership by public authorities as a criterion for defining public banks, yet neither the nature of such ownership, nor the term 'public authorities' are further defined in the literature.

The present study follows the literature in using *ownership by public authorities* as a first criterion for defining the public character of financial institutions. Consequently, in accordance with International Financial Reporting Standards (IFRS), ownership is defined as the fact of "*holding equity interests of an investor-owned entity*"<sup>15</sup>.

However, one possible shortcoming of merely considering the ownership structure of the studied banks is that actual control over management decisions might differ statutorily from ownership, making the criterion of ownership less relevant as an indicator of actual decision-making power in the institutions in question. For this reason, in keeping with IFRS standards, we introduced a second criterion for assessing the public nature of banks, namely control. IAS 27, dealing with "*Consolidated and Separate Financial Statements*", defines control as "*the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities*"<sup>16</sup>.

In the most straightforward scenarios, where a 'public authority' directly owns a proportion of a bank's or funding agency's shares with normal voting rights, both criteria can be expected to yield similar results. However, when the ownership and voting rights structures are not identical, or when the banks or funding agencies under consideration are part of a complex ownership chain, the control criterion may offer a different insight from that gained by applying the ownership criterion. For this reason, the following section provides a more explicit account of the treatment of complex ownership and control chains.

Another key term that needs to be clearly defined before public banks can be properly categorised is what we might refer to as '*public authorities*'. For the purposes of the present study, in line with the EU directive on the transparency of financial relations between the Member States and public undertakings<sup>17</sup>, public authorities were defined as "*all public authorities, including the State and regional, local and all other territorial authorities*".

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<sup>14</sup> See, for example, Altunbas, Evans & Molyneux (2001); Micco, Panizza & Yaez (2007).

<sup>15</sup> IFRS glossary 2010.

<sup>16</sup> IAS 27 "Consolidated and Separate Financial Statements", 2010.

<sup>17</sup> Directive 2006/111/EC.

b) Categories of partly publicly owned institutions

We define two main categories of part-publicly-owned financial institutions.

- **Public banks or public funding agencies** are financial institutions that qualify as ‘public undertakings’ within the meaning of Directive 2006/111/EC, i.e. banks or funding agencies where public authorities exercise a ‘*dominant influence*’ over the undertaking, meaning that they control over half the voting rights or own over half the shares.
- **Banks or funding agencies with a public influence** are financial institutions over which public authorities exercise a sizeable but minority influence, i.e. where the public interest is at least 5% (in terms of either ownership or control). Within this category, we can also identify various levels of public-sector involvement in financial institutions, using analogous interest thresholds to those defined in IFRS consolidation rules for financial statements<sup>18</sup>.

Both thresholds used in IAS 27, i.e. 20% and 50%, are consistent with the existing literature on the analysis of control and ownership. As might be expected on the basis of intuition, the 50% mark has been shown to be a theoretically acceptable threshold for effective control. The 20% threshold has been widely used in the literature for assessing control at lower levels of ownership, in keeping with a very influential paper by La Porta et al. (1999). The categorisation of **publicly influenced** (>5% public control) banks and funding agencies used in the present study is set out in the table below.

**Table 3 - Control and ownership levels with their corresponding categorisation**

Level of ownership and/or control (%)	Overall categorisation	Detailed categorisation
0 - <5	Non-public company	No public involvement
5 - <20	Company with public participation <sup>19</sup>	Minor public participation
20 - <50		Significant public participation
50 - <100	Public company	Strong public influence
100		Fully public

It is important to note that for the purposes of the present study, institutions in which public bodies owned less than 5% of the shares were not considered, since they primarily equate to investments on the part of the State.

<sup>18</sup> IAS 27 "Consolidated and Separate Financial Statements"; IAS 28 "Investment in Associates", 2010.

<sup>19</sup> In this report, public participation is also indifferently referred to as public involvement.

c) Dealing with ownership and/or control chains

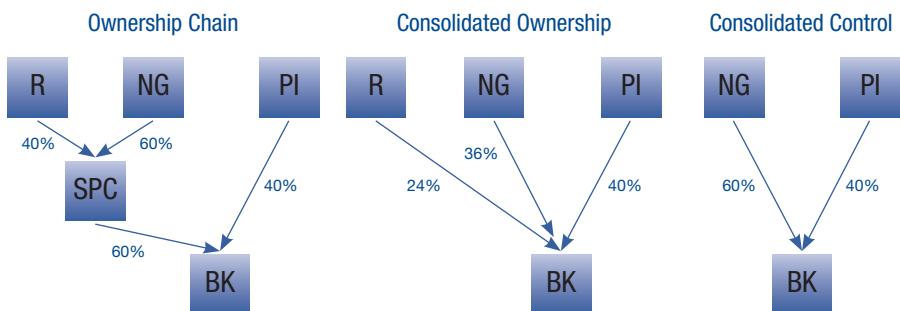
Complex ownership chains make the controlling shareholder hard to identify and at first sight, in the context of our study, make a qualification of public involvement extremely challenging. To resolve this problem, a comprehensive, standardised approach was called for. We opted to deal with ownership and control chains in the same way as Szafarz & Chapelle (2005).

*Ownership* chains can be dealt with in a relatively straightforward manner. If company A owns a certain stake of  $x\%$  in company B, which in turn owns a stake of  $y\%$  in company C, then A's total ownership of C can be calculated as  $x*y$ .

However, calculations of total *control* are less straightforward. If a company A owns a stake  $x$  in company B, which owns a stake  $y$  in company C, A's total degree of control over C will depend on whether or not A effectively controls B. If  $x > 50\%$ , the A's total degree of control over C will either be calculated using the formula  $x*y$  or A will be assumed not to exert any control over C at all.

An illustration of this methodology is provided below. In this example, the National Government (NG)'s degree of *ownership* of a bank BK is calculated by multiplying NG's stake of the 60% ownership of the State Participation Company (SPC) by SPC's ownership stake in BK (60%), yielding a final result of 36%. Yet using a *control* approach, SPC and NG are fully consolidated because NG owns more than half of SPC's shares (and controls a corresponding proportion of the voting rights). As a result, NG fully controls SPC's 60% stake in BK. In the graph below R and PI are private shareholders.

Figure 1 - Ownership and control chains



To compile a list of banks and funding agencies *with public ownership*, ownership and control structures were examined for each bank and funding agency meeting the scope- and coverage-related criteria. Ownership information was collected from a variety of sources

for all banks and funding agencies in our database. The sources in question included the respective financial institutions' websites and annual reports, the specialist business press and interviews conducted with banking executives in the countries included in the survey<sup>20</sup>.

### 3.3. Analysis of institutions' missions and roles

The missions and roles of public banks and funding agencies were collected from mission statements and general business presentations provided by the financial institutions themselves in their annual reports or on their websites. **Grounded theory** (see below) was applied to the aforementioned statements in an attempt to produce the most relevant categorisation of the data we had collected. This categorised data was subsequently used throughout the resulting analysis to provide significant insights into the business models, roles and missions of public financial institutions.

#### 3.3.1. What information do mission statements provide?

A mission statement can be defined as *"an enduring statement of purpose that distinguishes one organisation from other similar enterprises, a mission statement is a declaration of an organisation's 'reason for being'."*<sup>21</sup>

This makes mission statements extremely interesting, because they not only provide a clear picture of how banks try to position themselves at a given moment in time, but also enable a dynamic understanding of what these financial institutions are intent on achieving in the long term. Their mission statements also clearly state their commitment to particular causes and objectives and highlight the focus they have chosen, as reflected by the range of products they offer. As Peter Drucker put it in 1973, *"a business is not defined by its name, statutes, or articles of incorporation. It is defined by the business mission. Only a clear definition of the mission and purpose of the organisation makes possible clear and realistic business objectives."*<sup>22</sup>

Another advantage of using explicit textual mission statements is that they can easily be analysed using Grounded Theory, which produces the best results if used on existing texts, i.e. texts constructed independently of the researcher, thus constituting an optimal basis for unbiased, objective analysis.

However, mission statements also have potential shortcomings. On the one hand, they reflect how an institution views itself, yet there is no way of checking the consistency of such a self-image with how that image is perceived by the outside world. In addition, mission statements cannot be used to check the extent to which a bank or funding agency is actually fulfilling

<sup>20</sup> In the vast majority of cases, it was reasonable to assume that direct ownership and control coincided. The only source of a potential difference between the extent of public involvement according to ownership as opposed to control criteria, is the effect of ownership and/or control chains.

<sup>21</sup> David (1989).

<sup>22</sup> Drucker (1973).

the mission it has supposedly set itself. Another, more limiting shortcoming with respect to our study was the fact that not all the banks included in the data set had produced explicit mission statements. This can be attributed to the fact that the mission statement is, to a large extent, an established management and strategy concept in primarily English-speaking business circles, rather than one that is universally applied in a European context. In an effort to overcome this limitation, general descriptions (which were provided by all banks in the sample) were used to complement mission statements as our primary data source. These descriptions were then complemented by conducting interviews with banking executives in the countries included in the survey.

Based on the components of mission statements identified by David (1989), the present study considers the following broad categories for analysis:

- (1) Objectives – What are the bank’s broad objectives?
- (2) Geographic focus – Where does the bank compete?
- (3) Stakeholders – Who are the bank’s stakeholders?
- (4) Products and services – What products and services does the bank offer?

### **3.3.2. Grounded theory: how to analyse mission statements**

Grounded Theory analysis was used to extract and categorise data from the collected mission statements. Grounded Theory was then applied to the data in the following manner:

#### **a) Initial sampling**

The initial sample consisted of 64 banks (two banks for every country included in the study). Those banks were not chosen arbitrarily, but rather with a view to ensuring the variety and richness of the data. Those data provided basic terms, or ‘codes’, on which the ensuing analysis was based, i.e. keywords that were identified in the collected texts.

#### **b) Summarising codes into concepts**

Distinct - but related - codes were then compiled and used to produce concepts, which are lower common denominators than codes and therefore enabled data to be grouped for further analysis. Every code was based on one of the broad categories defined above. The following concepts were identified in our data:

- 1) Stakeholders
  - a. General public
  - b. Customers
  - c. Shareholders
  - d. SMEs
  - e. Public entities
  - f. Other banks
  - g. Employees
  
- 2) Location
  - a. Regional
  - b. National
  - c. International
  
- 3) Products and services
  - a. Retail banking
  - b. Commercial banking
  - c. Wholesale banking
  - d. Mortgage banking
  - e. Asset management
  - f. Investment banking
  - g. Public banking
  - h. Consulting
  - i. Guarantees and insurance
  - j. Settlement
  - k. Subsidies
  
- 4) Objectives
  - a. Job creation
  - b. Economic development
  - c. Financial inclusion
  - d. Sustainable development
  - e. Agriculture
  - f. Tourism industry
  - g. Education
  - h. Infrastructure
  - i. Energy
  - j. Sports and culture
  - k. Pawnshop
  - l. Export promotion
  - m. Innovation

#### c) Theoretical sampling

In the theoretical sampling phase, the categorisation developed above was applied to all mission statements and general descriptions included in the data set. At the same time, the concepts listed above were enriched and further defined by further linking them to new codes.

### 3.4. Conclusion

One of the key challenges in analysing public financial institutions - if not *the* prime challenge - is to define a clear, homogenous scope for the study. In this respect, one of the major contributions of the present study is its construction of a structured, definition-based, homogenous database of public banks and funding agencies in Europe. The data collection and validation processes relied on a variety of sources, including national supervisors, institutions' websites and annual reports, scientific literature, the specialist business press and last, but not least, a significant number of interviews with banking executives in the countries included in the survey. The extent of public-sector involvement was summarised using both ownership and control criteria, and by applying various thresholds, in line with the scientific literature. The resulting fine categorisation of financial institutions permitted a differentiated analysis of the given degree of public involvement, whilst the structured collection of mission statements allowed us to study the various objectives, roles and functions of public financial institutions and to identify the main business models used by public banks and funding agencies.

## 4. An overview of the European publicly influenced banking sector

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### 4.1. Introduction

This chapter provides a descriptive analysis of the European publicly influenced financial sector. It also explores patterns of public authorities' influence over the financial sector, though it stops short of actually investigating their respective roles and missions, which will be covered in the following chapter. The originality of this chapter lies in the scope and comprehensiveness of our study, for whereas most previous studies of public banking were narrower, either in their geographic scope or regarding the types of publicly influenced banks under consideration, our study covers a large span of countries – 32 – of the continent and all types of publicly influenced financial institutions, including funding agencies. Moreover, whereas other studies tend to rely on a binary distinction between 'public' (i.e. publicly controlled) and 'non-public' (privately controlled) banks, our approach entails viewing the spectrum of public influence as more of a continuous spectrum.

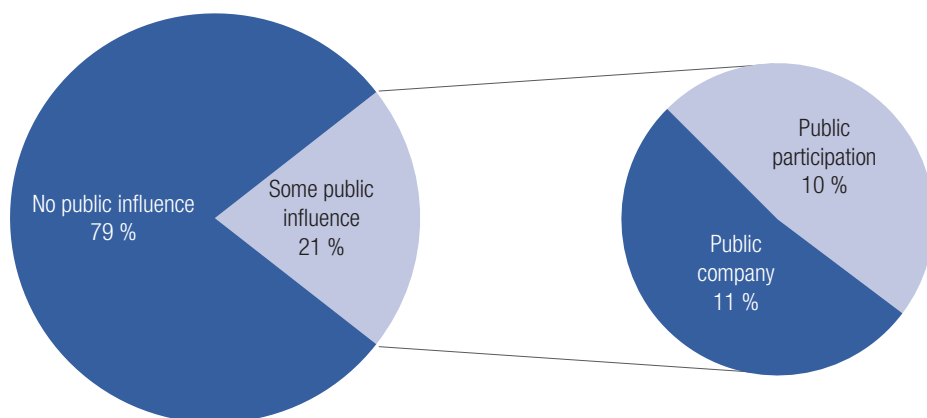
Our database numbers no fewer than 221 banks and 81 funding agencies in Europe that are subject to varying degrees of public influence. The associated financial sector assets amount to €9,883 billion - 21% of total assets of the financial sector<sup>23</sup> - with 52% of this total pertaining to public companies ( $\geq 50\%$  public control) and 48% to companies not controlled by public authorities (5-49.99% public control). Our examination of the spectrum of public influence was further refined by distinguishing between fully public companies (100% public control) and companies subject to strong public-sector influence (50-99.99%), and also by drawing a distinction between significant public-sector involvement (a 20-49.99% public participation) and minor public involvement (a 5-19.99% public participation).

At the same time, our study does not include previously private banks recapitalised by public authorities through equity subscription during the financial crisis. This excluded category amounts to 14 banks managing assets worth €4,375 bn, equivalent to 9% of total European financial assets.

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<sup>23</sup> Total asset of the European financial sector is defined as the total assets under management of all banks (with and without public influence) and all funding agencies (which are all subject to a certain public involvement) in "Europe 27+5", as of 31 December 2009. Note that the four identified pan-European multilateral development banks, totalling €408 bn, are not included in our total market size. Given the coverage objectives used in each country for identifying the list of publicly influenced institutions (cf. methodology outlined in Chapter 3), market shares (as a part of a country's total assets) represent, therefore, a *minimum* market share of publicly influenced financial institutions.

**Figure 2 - Public-sector influence in the European financial sector  
(as a percentage of total assets in “Europe 27+5”)**



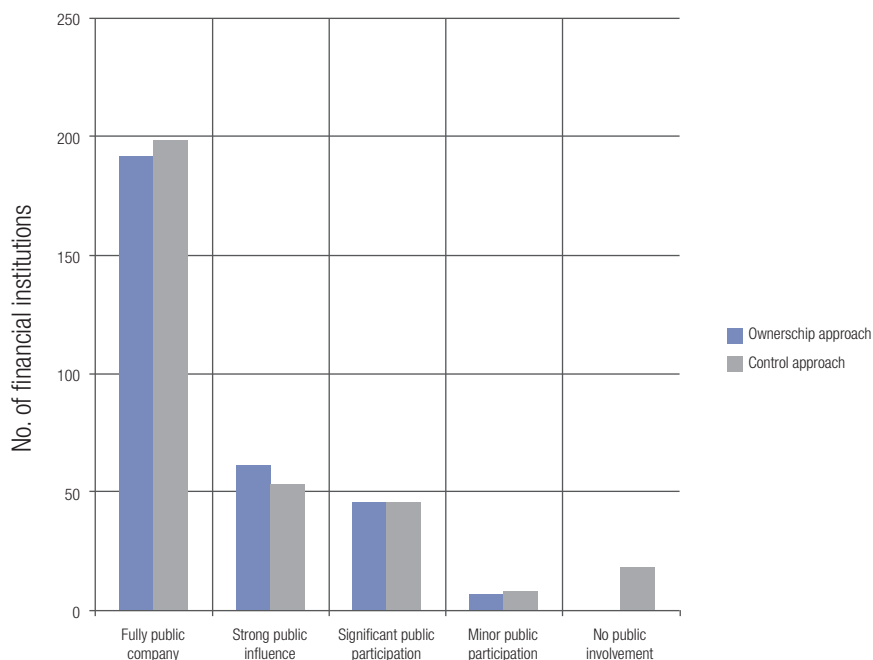
Source: Elaborated by the Authors.

Bailed-out banks were excluded from the scope of the present study since our prime objective was to ascertain the roles and missions of financial institutions that are subject to long-term public influence. Formerly private entities that were only recently nationalised or benefited from public capital lifelines did not fit the bill, either because only short-term measures were involved or because the changes were too recent for the mission of the affected entities to have already readjusted to their new status as publicly controlled bodies.

As indicated above, existing studies in this domain usually define public banks in terms of their level of public ownership. To provide a more detailed and more accurate description of the real level of involvement of public authorities in the banking system, the present study favoured a ‘control approach’, in line with IFRS accounting standards.

The graph below contrasts so-called ‘ownership’ and ‘control’ approaches in connection with our sample of European financial institutions, based on the methodology set out in Chapter 3. Defining public banks in terms of control rather than ownership actually accentuates the patterns of public-sector influence. Consequently, some financial institutions previously categorised as companies subject to strong public control (50-99.99%) now qualify as fully public companies (100% control). The 7 institutions switching categories from ‘subject to strong public influence’ to ‘fully public company’ control combined assets worth €46 bn.

**Figure 3 - Contrasting the 'control' and 'ownership' approaches**



Source: Elaborated by the Authors.

On the other hand, some institutions falling into the 'significant public participation' category under the ownership approach emerge under the control approach as institutions with only minor or even no public involvement. In all, 14 financial institutions (controlling assets worth €711 bn, representing almost 21% of the total for institutions subject to significant public participation) switch from the 'significant' to either the 'minor' public participation category or to 'no public involvement' category, whereas 6 financial institutions (controlling assets totalling €50 bn) switch from the 'minor public participation' to 'no public involvement' category.

**Table 4 - Contrasting the 'control' and 'ownership' approaches**

		Control approach					Total (€bn)
		Fully public company	Strong public influence	Significant public participation	Minor public participation	No public involvement	
Assets (€bn)							
Ownership approach	Fully public company	100.0%	0.0%	0.0%	0.0%	0.0%	4,197
	Strong public influence	3.5%	96.3%	0.1%	0.0%	0.0%	1,299
	Significant public participation	0.0%	0.0%	82.7%	0.7%	16.6%	4,106
	Minor public participation	0.0%	0.0%	0.3%	89.3%	10.3%	1,414
	Total (€bn)	4,243	1,252	3,402	1,291	830	11,017

Source: Elaborated by the Authors. The table indicates the share of assets that migrated from one level of public influence to another as a percentage of the total assets under the ownership approach to the control approach. For instance, 3.5% of the total assets which under the ownership approach were under strong public influence have migrated to a 'fully public company' under the control approach.

Generally speaking, these changes can be explained by the fact that the more discriminating control approach leads to a more strongly dichotomised classification. The more discriminating control criteria used in our study (as opposed to the more traditional ownership criteria) offer the advantage of contrasting two radically different sets of public financial institutions: on the one hand those subject to public control, which constitute part of a focussed strategy by the authorities to fill specific gaps in the market left by private companies, and on the other hand institutions with public participation in which the authorities retain a residual stake, either for historic reasons or as an investment.

## 4.2. An overview of the European publicly influenced financial sector

The patterns of public influence in the financial sector vary among European countries, as the following table shows:

**Table 5 - An overview of the European publicly influenced financial sector**

Country	Coverage rate (%) (1)	Total assets (€bn) (2)	Public company						Company with public participation					
			Fully public company (5)			Company subject to strong public influence (5)			Significant public participation (5)			Minor public participation (5)		
			No. of banks (3)	No. of FA (4)	Mkt share (%) (6)	No. of banks (3)	No. of FA (4)	Mkt share (%) (6)	No. of banks (3)	No. of FA (4)	Mkt share (%) (6)	No. of banks (3)	No. of FA (4)	Mkt share (%) (6)
Austria	>80	1.083	9	1	6,9	6	0	2,6	2	0	0,2	0	0	0,0
Belgium	>90	1.291	1	5	0,1	1	1	0,6	1	1	19,7	0	0	0,0
Bulgaria	>90	37	1	1	1,8	1	0	1,3	0	0	0,0	0	0	0,0
Croatia	>90	57	2	2	14,6	1	0	3,4	1	0	0,7	1	0	0,3
Cyprus	>90	124	0	0	0,0	0	0	0,0	0	0	0,0	0	0	0,0
Czech Republic	>80	156	1	1	1,2	1	0	1,5	0	0	0,0	1	0	1,1
Denmark	>90	1.066	0	2	1,9	0	0	0,0	0	1	1,1	2	0	2,2
Estonia	>90	22	0	1	0,9	0	0	0,0	0	0	0,0	0	0	0,0
Finland	>90	426	1	2	9,2	0	0	0,0	0	0	0,0	0	0	0,0
France	>80	8.102	21	2	4,2	3	0	0,0	0	0	0,0	1	0	15,3
Germany	>80	8.562	39	5	23,9	3	0	9,0	1	0	0,0	1	0	0,0
Greece	>90	459	0	1	n.a.	2	0	8,3	1	0	3,9	0	0	0,0
Hungary	>90	127	0	3	4,0	1	0	7,1	0	0	0,0	0	0	0,0
Ireland	>90	1.755	6	0	11,7	1	0	10,7	0	0	0,0	0	0	0,0
Italy	>70	3.933	0	14	6,0	2	8	0,1	1	0	0,0	0	0	0,0
Latvia	>90	32	1	0	3,9	0	0	0,0	0	0	0,0	0	0	0,0
Lithuania	>90	26	0	0	0,0	0	0	0,0	0	0	0,0	0	0	0,0
Luxembourg	>90	1.259	4	0	5,7	0	0	0,0	2	0	7,5	0	0	0,0
Macedonia	>90	5	1	0	1,0	0	0	0,0	2	0	4,3	1	0	4,0
Malta	>90	44	0	0	0,0	0	0	0,0	1	0	14,0	0	0	0,0
Netherlands	>90	2.310	2	1	6,9	0	0	0,0	0	0	0,0	0	0	0,0
Norway	>90	499	0	5	5,6	1	0	5,7	1	0	35,4	0	1	5,4
Poland	>80	252	3	1	3,3	2	0	16,0	2	0	2,9	0	0	0,0
Portugal	>90	484	3	0	23,5	0	0	0,0	0	0	0,0	0	0	0,0
Romania	>90	83	1	0	5,9	2	0	1,4	0	0	0,0	0	0	0,0
Slovakia	>90	57	1	3	1,6	0	0	0,0	0	0	0,0	0	0	0,0
Slovenia	>90	50	3	9	8,7	1	0	9,1	2	0	40,2	0	0	0,0
Spain	>80	3.425	1	5	1,9	0	1	n.a.	24	0	32,9	0	0	0,0
Sweden	>90	923	3	2	5,9	0	0	0,0	1	0	12,8	0	0	0,0
Switzerland	>70	818	19	1	22,5	12	0	11,6	1	0	1,2	0	0	0,0
Turkey	>90	330	4	0	34,3	3	0	9,6	0	0	0,0	0	0	0,0
United Kingdom	>80	9.264	0	1	0,0	0	0	0,0	1	0	16,7	0	0	0,0
<b>Total</b>		<b>47.060</b>	<b>127</b>	<b>68</b>	<b>8,1</b>	<b>43</b>	<b>10</b>	<b>2,7</b>	<b>44</b>	<b>2</b>	<b>7,2</b>	<b>7</b>	<b>1</b>	<b>2,7</b>

Note 1. 'Coverage rate' is the ratio of the assets of the banks surveyed to constitute our initial database divided by total assets of the financial sector per country

Note 2. 'Assets' means total banking assets for that country, whether held by public or non public entities

Note 3. 'Banks' are entities with a banking license in the country

Note 4. 'FA' stands for 'Funding Agencies' as defined in the Methodology Section

Note 5. Under the control approach, the label 'Fully public company' applies to financial institutions 100% under public control; 'Company subject to strong public influence' means 50-100% public control; 'Significant public participation' means 20-50% public control; 'Minor public participation' means 5-20% public control; 'No public involvement' means 0-5%

Note 6. 'Market share' is the ratio of assets under a given degree of public influence divided by total assets of the financial sector per country

Note that the figures in the table above were computed on a non-consolidated basis i.e. based on the assets of locally incorporated legal entities. For instance, the assets of a foreign-owned local subsidiary are those of the subsidiary only; similarly, the assets of the mother company do not take into account the assets of its subsidiaries.

Two important remarks should be kept in mind while examining the above table:

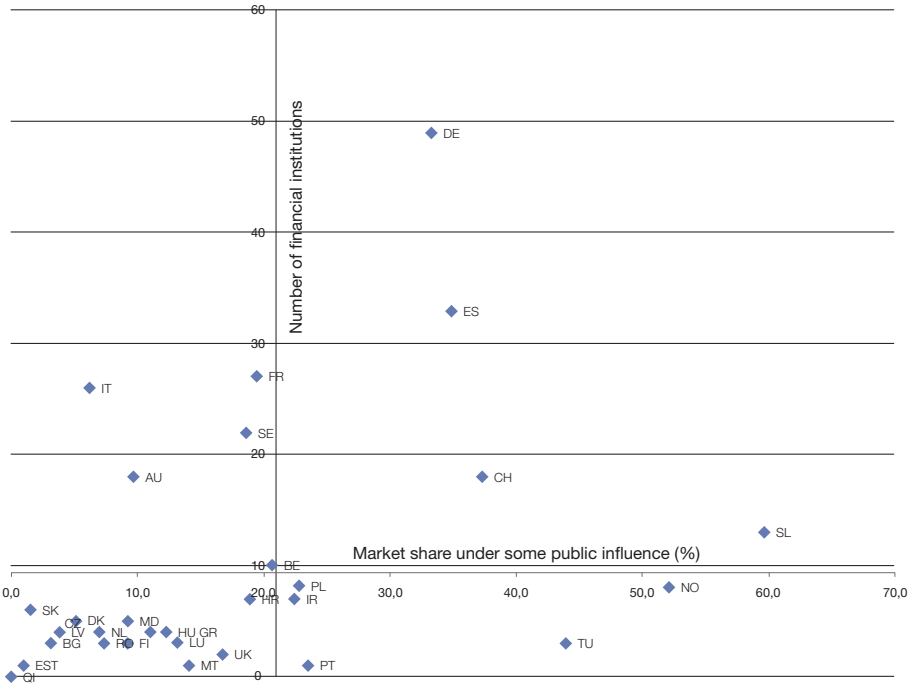
- In the United Kingdom, one bank, Barclays, is remarkable for accounting for a very large share of European banking assets subject to significant public participation and 17% of the UK's total banking assets. However, the reason for such a high level of public participation is the significant stake in Barclays' capital owned by the Qatari government. If this Qatari shareholding was ignored under the assumption that the Qatari government is not out to mitigate a market failure, Barclays would not be considered a bank with significant public participation.
- Among banks with 'minor public participation', France dominates, with €1,234 bn of assets subject to minor public participation (78% of the total in this category for Europe as a whole), equivalent to 16% of the French banking sector as a whole. Yet this is exclusively due to the Belgian government's involvement through the Société Fédérale de Participations et d'Investissements in BNP Paribas, a leading global bank, following the bail-out of the Belgian bank Fortis, subsequently acquired by BNP Paribas<sup>24</sup>. As such, the significance of the 'minor public participation' in France, in the framework of the present study, should not be overrated. Only Romania, and to a lesser extent Slovenia, have a high level of 'minor public participation' in their domestic financial industries. Naturally, such low-level involvement does not yield governments any decisive degree of control over the companies in question, and as such it may be interpreted as signalling a desire for a broadly ranging presence in the banking sector to contribute to help finance the economy at large.

To show that the patterns of public involvement in the European financial sector are greatly varied, the graph below plots 'Europe 27+5' countries in function of their publicly influenced market share and the number of institutions constituting that market share, with the axes crossing at the European averages. This graph not only hints at the different ways of organizing the markets among European countries but also informs on the average sizes of the publicly influenced institutions.

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<sup>24</sup> In this case, BNP Paribas's control structure has been impacted indirectly by the financial crisis, through the buyout of bailed-out bank, i.e. Fortis Bank.

Figure 4 - Patterns of public involvement in the European financial sector



Source: Elaborated by the Authors.

On the one hand, there are countries whose market share under public influence is attained by a great number of companies, meaning that public involvement is spread among many entities (e.g., Germany, Spain, Switzerland, Italy), whereas on the other hand we find countries whose publicly influenced market share is attained by a few number of entities (e.g., Turkey, Norway, Portugal).

For instance, Turkey, with only 4 banks under full public control already covers 44% of the domestic banking market, whereas the 44 fully public German financial institutions (mostly banks and five funding agencies) cover 24% of the German banking sector's total assets<sup>25</sup>.

Furthermore, one can have high concentration but over an under-average publicly influenced market share (e.g. Eastern-European countries) or over an above-average publicly influenced market share (e.g., Turkey, Norway). Similarly, we find that Germany, Spain or Switzerland are

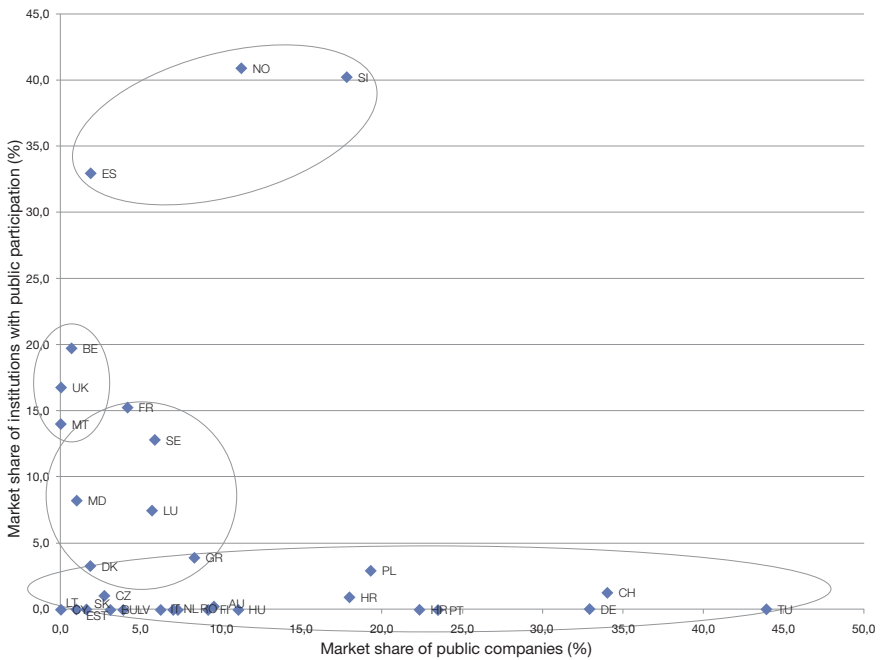
<sup>25</sup> Note that there are 431 Sparkassen in Germany totaling €1,073 bn of assets, amounting to a total market share of approximately 15%. In line with the average threshold we defined (80% market coverage), our database does not include small financial institutions with tiny market shares. In particular, our database overlooked many German savings banks (Sparkassen) due to their very small size. Only the Sparkassen large enough to pass the 80% coverage criterion are included in our database.

characterized by a low concentration on an above-average market share, whereas Italy also has a low concentration but on a less significant market share.

### 4.3. Degrees of public influence

When assessing the various levels of involvement in the banking industry by European public authorities, it is interesting to try and ascertain whether or not there is any link between how broadly a government is involved (as reflected by the market share covered of institutions subject to varying degrees of public influence) and how strong such involvement is (as measured by the level of effective control exercised by the authorities in question). To this end, the positions of European countries are plotted as a function of, on the one hand, the market share of the public institutions ( $\geq 50\%$  control) and, on the other hand, the market share of the institutions with public participation ( $< 50\%$  control).

**Figure 5 - Levels of public involvement in the European financial industry**



Source: Elaborated by the Authors.

As we see, four distinct models for public authorities' involvement in the financial industry seem to emerge.

The first model, adopted by Malta, the United Kingdom and Belgium, entails public authorities exerting diffuse influence over a significant portion of an otherwise privately controlled banking sector, though it should be remembered that the market share subject to this diffuse level of public influence in the United Kingdom is exclusively due to Barclays, whose share of public control is in turn attributable to the shareholding owned by the Qatari government. Bank of Valetta is the only institution subject to such a low level of influence by the Maltese authorities. In Belgium, the public sector has a significant participation into two companies representing 20% of the Belgian banking sector. This is mainly due to Dexia, in which the French State has a 12% stake.

A second model, seemingly embraced by Norway, Slovenia and Spain, entails complementing diffuse control over broad swathes of the financial sector with a strong public presence in key financial institutions that fulfil specific missions. Slovenia's only bank with (significant) public participation commands a national market share of 29%. In Norway, the leading bank with a non-controlling public involvement is DnB NOR, which is characterised by an extensive international outreach and a broad range of services. It is notable that a single Norwegian bank with significant public participation, namely DnB NOR, holds as much as 45% of domestic assets. On the other hand, the Norwegian government fully controls various special-purpose entities, such as the Norwegian State Educational Loan Fund (SLU), the Norwegian Guarantee Institute for Export Credits (GIEK) and Innovation Norway, a government-led financial assistance programme designed to foster innovative business projects.

In Spain, a noteworthy fact is that the public sector involvement in banking takes the form of strong public influence in the country's *cajas*. Those account for a combined total of 33% of the Spanish banking sector and are incorporated under a cooperative governance system whereby the main stakeholders (including municipalities, employees, depositors, and founders) exercise control over the bank. In fact, the degree of public control resulting from this organisational structure oftentimes totals around 50%. However, since the *cajas* are organized in foundations and have a strong tradition of independence, we consider that the public sector, although theoretically holding a controlling shareholding, merely exercises a significant public influence.

A third model, apparently adopted by France, Sweden, Greece, Luxembourg, Macedonia and Denmark, closely resembles the aforementioned model favoured by Norway and Slovenia, but is greatly diluted, since both the authorities' diffuse and concentrated presence in the banking sector cover smaller fractions of the market.

France's fully public companies are almost exclusively so-called 'municipal credit banks'. Although France numbers 15 such entities, they only account for a negligible percentage of the banking industry due to their small size and predominantly local scope. What drastically

increases the share of (full) public control in banking in France is the Banque Postale and the Caisse des Dépôts et Consignations (CDC), respectively totalling €171 bn and €104 bn of assets. CDC is a funding agency under direct parliamentary control and active mostly in public banking (managing savings and pension funds, financing cities or universities, serving as a vehicle for strategic long-term government investments, etc.) but also involved in commercial undertakings through its subsidiaries.

In Sweden, a strong public presence is maintained primarily in financing municipalities, this activity being centralised by Kommuninvest, and in the provision of long-term funding for export industries (exports account for almost half of Sweden's GNP). The 13% market share subject to (minor) public participation is due to the presence of Nordea, the Stockholm-based financial services group operating principally in the Nordic and Baltic countries.

Greece's two public companies serve specific purposes: the Export Credit Insurance Organisation (ECIO) strives to facilitate exports, while the Agricultural Bank of Greece (which is one of the smallest financial institutions in Greece) concentrates on the primary sector, though it is currently modernising itself and expanding its scope.

A fourth apparent model, adopted by most of the countries in our sample, aims to ensure public control over a few key financial institutions, which by virtue of the services they propose fulfil specific missions in the national banking market. That said, this strong influence can significantly vary in scope from one country to another (namely from 1% of the domestic market in Estonia to 44% in Turkey). On the other hand, the countries implementing this model are characterised by an almost total lack of any diffuse public-sector involvement in the financial industry. A notable proportion of Eastern European countries, including Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Macedonia and Romania display this degree of involvement. Poland would also belong to this group, but displays a greater share of banks subject to strong public influence, thanks mainly to Bank Gospodarstwa Krajowego, a Warsaw-based State development bank specialising in servicing and financing enterprises, local government entities and regional development projects (including financing of infrastructure and support of EU programs), and also to PKO Bank Polski, a former major state-controlled bank undergoing privatisation, having been floated in 2009 but in which the government retains a controlling stake of 51%.

Switzerland also appears to belong to that fourth model. However, it should be borne in mind that Switzerland is characterised by unusually intensive activity in the private banking and asset management sectors, both of which are rather estranged from the public sector, so it could be argued that the extent of public involvement in banking in Switzerland is underestimated. If the levels of public-sector involvement by European countries in their banking industry were adjusted in terms of their ratio of total banking assets to GNP, the

Swiss authorities' level of strong involvement in the banking sector would appear significantly higher.

Finally, we did not find any publicly influenced financial institutions in two countries covered by our study, namely, Cyprus and Lithuania.

#### **4.4. Pan-European multilateral development banks**

Although they are not included in the analysis above, there are some major pan-European multilateral development banks, which are incorporated under international law. These include the following institutions:

##### **4.4.1. European Investment Bank (EIB)**

Historically established in 1958 by the Treaty of Rome to support the development and integration of economically weaker regions, the EIB has since broadened its mission and is now considered more generally the investment arm of the European Union, intent on furthering EU policy goals. Endowed with assets totalling €362 bn (as of 2009), the EIB is geared mainly towards the following kinds of investment: packages to stimulate SMEs, measures designed to attain EU cohesion and convergence goals or fight climate change, funding for environmental protection or to guarantee energy security and sustainability, promote the growth of Europe's knowledge economy or develop trans-European networks. In particular, the European Investment Fund (EIF), controlled by the EIB and benefiting in its own right of the Multilateral Development Bank status, is a specialist provider of SME risk finance. The EIF does not however directly finance SMEs but rather provide funds to intermediaries such as banks and venture capital funds, which in turn will be involved in SME funding.

##### **4.4.2. Council of Europe Development Bank (CEB)**

Set up in 1956 to alleviate refugee problems, the CEB has progressively expanded its scope of action and is now devoted to bolstering social cohesion in Europe by financing social projects, acting on behalf of refugees (e.g. by making a donation to Georgia following the 2008 war in South Ossetia), migrants and displaced persons, but also by promoting social housing and enhancing the infrastructure of public services (among other things by building all-weather roads in Albania, expanding and upgrading the sewerage and drainage facilities in the Greater Nicosia Area, improving waste collection and treatment facilities in the Baltic states and building schools in Portugal).

##### **4.4.3. European Bank for Reconstruction and Development (EBRD)**

Founded shortly after the fall of Communism in Russia and Eastern Europe, the main goal of the EBRD was to help formerly Communist countries make the transition to a market economy and the establishment of private sectors. Its membership, totalling 61 countries, is roughly divided between financing members and recipients of investments. Acting in

partnership with private companies, the EBRD provides project financing for banks, industries and businesses, underpinning the privatisation process, the restructuring of state-owned firms and the improvement of municipal services.

#### 4.4.4. Black Sea Trade and Development Bank (BSTDB)

The BSTDB is the financial pillar of the organisation dubbed Black Sea Economic Cooperation (BSEC), whose 12 members are Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Serbia, Turkey and Ukraine. It is an international financial institution supporting investors and companies with a regional focus on the Black Sea Region. *“The purpose of the Bank is to accelerate development and promote cooperation among its shareholder countries. BSTDB supports regional trade and investment, providing financing for commercial transactions and projects in order to help Member States establish stronger economic linkages.”*<sup>26</sup>

#### 4.4.5. Nordic Investment Bank (NIB)

Headquartered in Helsinki and co-owned by Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden, the NIB borrows funds on the international capital markets and offers long-term loans and guarantees to private and public clients. Its main areas of focus encompass infrastructure and environment-enhancing investments. Moreover, in cooperation with other financial intermediaries, the NIB targets SMEs to help them grow and develop.

### 4.5. Conclusion

Our study finds that 21% of the financial industry in Europe is subject to public involvement. The patterns of this public involvement in turn is greatly varied across European countries, with a large dispersion around the 21% mean, as well as great differences in the degrees of public influence, the market shares and concentrations.

The originality of our approach lies in our taking account of the *actual* level of control exercised by the public sector instead of just the level of ownership and our examination of a more continuous spectrum of public influence, ranging from full public control (39% of the market under public influence), to public control (13%), significant public participation (34%) and minor public participation (13%).

Our database, including 221 banks and 81 funding agencies, reveals that the public banking sector in Europe spans a continuum of situations, with clusters of countries adopting distinctive models surfacing. Germany, Spain and Switzerland are conspicuously similar in how they structure their public involvement, as characterised by their networks of regional entities: *Landesbanken* in Germany, *cajas* in Spain and cantonal banks in Switzerland. The relatively high number of such entities spotlights the local embeddedness of their respective

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<sup>26</sup> Source: BSTDB website.

banking industry, due to historical decentralisation in the three countries concerned.

The United Kingdom stands out starkly among European nations as a country with relatively little government intervention in the banking industry, the exception being the Barclays Group, due to the Qatari share in its capital mentioned above. And if we bear in mind that most public banks in Ireland are subsidiaries of large German institutions and accordingly leave them out of the reckoning, the share of the Irish banking sector subject to public-sector influence drops drastically. So the existence of a more general 'Anglo-Saxon model' of public involvement in banking could be posited.

The Nordic countries differ markedly from other European countries in the substantial share of their banking sector in which their public authorities have a significant level of participation (20-49.99%). In reality, though, this situation actually turns out to be attributable to just two very sizeable outfits, namely Nordea in Sweden and DnB NOR in Norway. Otherwise Nordic countries interestingly exercise a rather low level of public-sector involvement in the banking sector. An additional peculiarity of Nordic public banks is the importance of municipal credit institutions and promotional institutions which are funding agencies that provide loans and guarantees to facilitate exports and finance SMEs.

Finally, we note that most Central and Eastern European countries adopt a model of public-sector involvement in the banking sector that aims to project a strong influence over a few financial institutions with a specific focus. However, these financial institutions seldom constitute a large proportion of the overall banking market, except in Poland.



## 5. Overview of public financial institutions' missions

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### 5.1. General categories of publicly influenced financial institutions

Publicly influenced financial institutions fulfil a wide variety of missions, as evidenced by the many topics encountered in our review of mission statements. Based on annual reports and websites of the banks composing our database, we categorised mission statements according to four major components identified by David (1989) as described in Chapter 3:

Objectives – What are the bank's broad objectives?

Geographic focus – Where does the bank compete?

Stakeholders – Who are the bank's stakeholders?

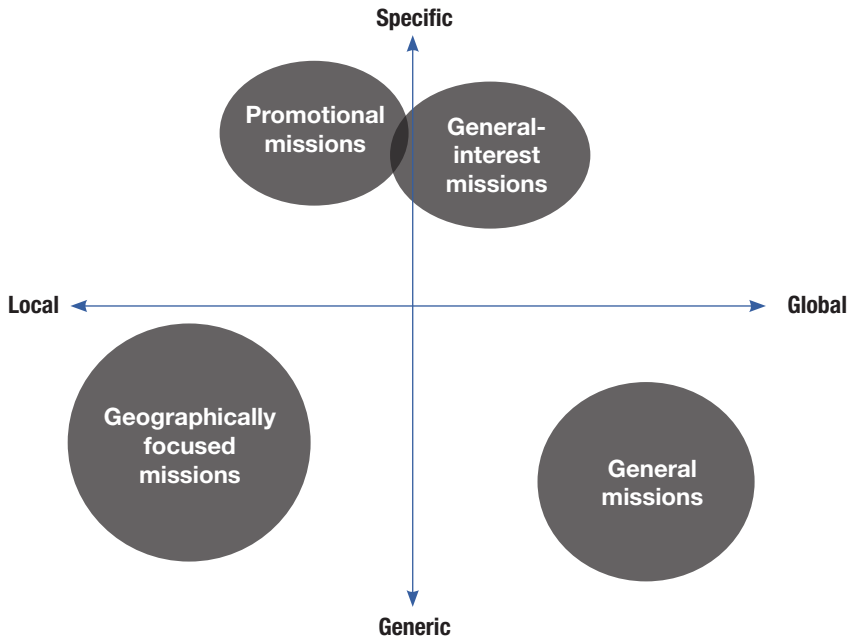
Products and services – What products and services does the bank offer?

Relying on a so-called 'attraction-repulsion' analysis<sup>27</sup> complemented with interviews conducted with professionals of the European financial industry, we distinguish two main dimensions discriminating the missions. These two dimensions are firstly the degree of specificity in the objective of the mission and secondly the targeted geographic scope of the financial institution. Along these two dimensions, as shown on figure 6, four categories of missions have been defined: promotional missions, general-interest missions, geographically focussed missions and general missions. These analyses have been carried out for the public financial institutions ( $\geq 50\%$  of public control) on the one hand and the institutions with public-sector participation ( $< 50\%$  of public control) on the other hand. The results of the mission collection are reported per categories in table 6 provided at the end of this chapter.

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<sup>27</sup> Attraction-repulsion analysis compares the theoretical and actual numbers of entities fulfilling a specified mission and the degree of public influence over them. Such an analysis reveals whether the mission in question, relatively speaking, 'attracts' or 'repels' a particular category of financial entity with reference to set thresholds. This, in turn, can show up the existence of 'biases'.

Figure 6 - General categories of the missions of publicly influenced financial institutions



Source: Elaborated by the Authors

### 5.1.1. Public financial institutions

Our analyses highlighted that among public financial institutions ( $\geq 50\%$  of public control), three main types of missions ('promotional', 'general interest', and 'geographic focus') emerged:

- a. Promotional missions: These missions are highly specialised and precise in their objectives. Generally, the names of the entities pursuing this kind of missions reflect their purpose (including names such as Pawnshop, Export, Housing, Land, Guarantee, or Development, among others), as opposed to some brand or other proper noun. These entities were also found to be more likely to have a national geographic scope. They aim to fill market gaps left by private financial institutions. Development banks are a prominent example of public financial institutions with promotional missions.
- b. General-interest missions: These missions focus either on investing in socially valuable but financially non-profitable ventures or on compensating the private sector's short sightedness by funding long-term investments. These objectives are aimed at complementing traditional market financing in promoting socially desirable outcomes.

- c. Geographically-focussed missions: These missions convey the objective of serving a specific geographic area. For example, entities coping with these geographic oriented missions are 'municipal credit banks in France, cantonal banks in Switzerland, *Hypo banks* in Austria and German *Landesbanken* (regional banks) and *Sparkassen* (local savings banks).

### 5.1.2. Institutions with public-sector participation

Financial institutions in which public authorities own a non-controlling stake are widely characterised by their engagement in 'universal banking activities' on a national scope and showing a greater proclivity for internationalisation. Often consisting of sizeable banking groups with local subsidiaries in neighbouring countries, such as banks with a pan-Scandinavian scope, Austrian banks that have expanded eastwards or German banks that are becoming involved in the Benelux countries or in France.

The purpose of the following sections is to further refine the characteristic missions of these major categories of publicly influenced financial institutions, not only in terms of their stated objectives and geographic scope, but also in terms their 'key' stakeholders and the products and services they offer.

## 5.2. Promotional missions

Beyond contributing to economic development at large, special-purpose public financial institutions cover a very wide variety of specific missions. Generally, such institutions address market insufficiencies, such as the financing of SMEs, the promotion of exports and the fostering of innovation.

As already stated in the historical overview of public banks, promotional institutions were set up in the aftermath of the Second World War to channel Marshall Plan funds towards the reconstruction of European industry. Later on, those institutions that did not go down the path towards privatisation expanded into other domains and developed alternative forms of financing. In 2002, an important decision of the DG Competition of the European Commission<sup>28</sup> made it plain that promotional institutions should primarily aim to mitigate market insufficiencies and cooperate with the private sector, rather than competing with it. The promotional mission of mitigating market insufficiencies is further reflected in a strong propensity to offer investment banking services including venture capital, guarantees, subsidies and consulting services).

By supporting economic development and job creation, banks with promotional missions fill a gap in the economy by financing projects that commercial companies disregard for various reasons, in particular when SMEs are involved. Accounting for 99% of existing

<sup>28</sup> European Commission, "Understanding about the orientation of legally independent special credit institutions in Germany", 1<sup>st</sup> March 2002.

enterprises in Europe and, as such, constituting the backbone of most economies, SMEs play a crucial role in economic development and are responsible for creating a significant share of new jobs<sup>29</sup>. Despite this, in most countries, SMEs are underserved by financial markets. Generally speaking, the literature seems to attribute this ‘financing gap’ issue to either a lack of collateral or a lack of information. A major problem seems to lie in the high fixed overheads of commercial financial institutions, which make it unprofitable for them to pay attention to small entities like SMEs.

By assuming these costs and underwriting these risks, public financial institutions with a promotional mission can promote the development of the local economy. For example, Finland’s Finnvera’s activities are meant to *“focus on rectifying shortcomings in the availability of financial services”*.<sup>30</sup>

Accordingly, innovation emerges as a major preoccupation of governments, which closely relates to their support of SMEs. Indeed, various studies have established that SMEs are ‘seedbeds of innovation’. *“In advanced countries, SMEs appear to contribute more than their share of innovations, particularly when one considers their superior ability to move innovations into the marketplace”*.<sup>31</sup> More generally, innovation supposedly entails high risks insofar as the associated research is basically a sunk cost that could potentially generate no gains. And even if the research does prove successful, sometimes there is no way of privatising a sufficient share of the social benefits derived from the innovation in question. Such considerations may harm private companies’ investment in innovation and go some way towards explaining why fundamental research is usually funded by governments and why public research and development centres are subsidised through public financial institutions.

Innovation Norway is a prominent example of a public company emphasising support to innovative companies. According to its objects clause, Innovation Norway is to be the *“backer and promoter of entrepreneurs, newly-founded and small and medium-sized enterprises (SMEs) that seek to grow, as a rule in an international market. The organisation’s role is to provide or arrange financing, link customer enterprises to know-how and help them build networks for their innovation projects”*.

Finally, in the eyes of some governments, the special commercial and political risks and challenges involved in export activities, which prove a deterrent to some enterprises, justify public authorities stepping in to promote growth and employment through exports. The aforementioned risks may be legal, political or logistical.

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<sup>29</sup> Some economists criticise this evidence, though, for not taking account of the net creation of jobs, claiming that SMEs may also be responsible for most ‘job destruction’. Nonetheless, there remains a strong economic case for arguing that government subsidies provided to SMEs foster job creation.

<sup>30</sup> Act on Credits and Guarantees Provided by the State-Owned Specialised Financing Company, 18 June 1998 (445/1998).

<sup>31</sup> *Is Small Beautiful and Worthy of Subsidy?*, T. Biggs, World Bank, 2001.

- Legal risks are related to the fact that the international legal framework is often complex, sometimes nonexistent and constantly changing. Related to this are the hazards associated with international payments, such as risks of non-payment or the need to master payment technologies and methods.
- Political risks, in the form of instability in the client country leading to defaults on payments, the confiscation of assets or the obstruction of exchange transfers, represent hidden transaction costs that may hamper international trade. Some studies argue that such circumstances amply justify government insurance schemes. For instance, Moser et al. (2008) show that German public export credit guarantees mitigate the blockage of trade flows stemming from political risks and thus promote exports. They explain that the reason for promoting exports through public credit agencies *“is that the private market is unable to provide adequate insurance for all risks associated with exports. As a consequence, firms’ export activities are limited in the absence of insurance provision.”* Indeed, they conclude that public-sector guarantees have a significant, positive impact on exports.
- There are also major transport-related risks involved, entailing possibilities of theft, damage or destruction of goods.

In view of all these hazards associated with the export activity and the direct benefits of export businesses for domestic economic development and job creation, export promotion appears to be one of the most frequent promotional missions.

### 5.3. General-interest missions

Next to the promotional missions, another great type of missions fulfilled by some public financial institutions consists in general-interest missions, ranging from supporting agriculture to promoting tourism and financing education, infrastructure and/or sustainable development.

#### 5.3.1. Agriculture

Insofar as food self-sufficiency is considered a key political goal of European governments, there is clearly a need for some way of channelling funds to a sector that, if left to economic forces alone, would shrink dramatically. Food sovereignty is the main rationale for the existence of the European Union’s Common Agricultural Policy (CAP), which sets out to guarantee farmers minimum prices for their output, whilst also subsidising their exports and safeguarding their rural lifestyle. Consequently it is critical to organise public institutions in such a way that they can channel financial support to the farming sector.

- In Poland, Bank Gospodarki Żywnościowej (according to its website) is the leading provider of banking products and services *“facilitating the management of a farm and enabling the efficient functioning of agricultural food-industry companies”*. The products offered consist of credits for various kinds of investments, loans to cover disasters, and leasing

services for machines and equipment (cars, pick-up trucks, lorries, and so on).

- In Greece, ATE bank (formerly the Agricultural Bank of Greece), offers savings-related and financing services to farmers, among others.
- The largest Turkish bank is the Agricultural Bank of the Republic of Turkey, which aims to sustainably finance the entire agricultural sector in a bid to sponsor specific projects set up for a product/region, cover every type of investment and operating cost for producing, processing, evaluating, storing and distributing agricultural produce that can be readily marketed domestically and abroad, and fund hi-tech developments and advances in knowledge that boost production.<sup>32</sup>

Besides the political importance of agriculture the sector is also economically significant in a number of mainly Eastern European countries<sup>33</sup>, including Bulgaria (accounting for 8.5% of GDP), Croatia (7.4%), Lithuania (5.3%), Macedonia (13%) and Romania (10.5%). In Romania, for instance, CEC Bank focuses in particular on agricultural SMEs, whilst ATE bank also has a subsidiary there.

Since 1997, when the European Council defined the ‘European Model of Agriculture’ as a modern, sustainable sector with quality standards and embedded in the rural way of life, one main goal among post-Communist countries in Eastern Europe with the attainment of those targets in mind, has been to reorganise a ruined farming sector characterised by fragmentation, low incomes and a low level of market integration. In this context, “*agricultural development serves as a poverty alleviation strategy*”<sup>34</sup>. Support provided to the farming sector in these countries often takes the form of underwriting collateral for bank loans as well as direct lending.

### 5.3.2. Education

Since education enables a long-term increase in productivity and prepares Europeans for an increasingly knowledge-based economy, it is deemed one of the most important long-term investments for our economies. The universal nature of education and the extent of the associated investment horizon are both arguments invoked in favour of government intervention for promoting education and accordingly for the use of financial institutions to channel the necessary funds.

In practice, education can be promoted in several ways, e.g. by promoting the financing of public school buildings and universities or providing loans for teaching aimed at unemployed adults. Promoting education is thus closely related to job promotion. For example, in the German federal state of Thuringia the *Gesellschaft für Arbeits- und Wirtschaftsförderung*

<sup>32</sup> Paraphrased from [www.ziraat.com.tr](http://www.ziraat.com.tr)

<sup>33</sup> These 2006 figures come from EarthTrends.com: [http://earthtrends.wri.org/searchable\\_db/index.php?action=select\\_countries&theme=5&variable\\_ID=214](http://earthtrends.wri.org/searchable_db/index.php?action=select_countries&theme=5&variable_ID=214).

<sup>34</sup> The Role of Agriculture in Central and Eastern European Rural Development: an Overview, M. Petrick, P. Weingarten, in Studies on the Agricultural and Food Sector in Central and Eastern Europe, 2004.

(GFAW), a subsidiary of the publicly owned Thüringer Aufbaubank, implements sophisticated programmes for promoting education, using both internal funds and financing stemming from the European Social Fund (ESF), playing particular emphasis on training for young people. Founded in 1957, the ESF aims to improve people's job prospects by developing their skills, boosting their productivity and promoting training designed to enable them to face new global challenges more effectively. Accordingly, educational institutions routinely apply for funding, and the GFAW then decides whether or not to allocate the respective funds.

### 5.3.3. Infrastructure

Infrastructure is traditionally recognised as the prerogative of governments owing to the high capital expenditure involved, the long-term effects and potentially massive impact on development. One typical example of a public bank strongly geared towards financing public infrastructure development is the Dutch entity Nederlandse Waterschapsbank, which, among other things, finances hydraulic projects across the country, meeting an obvious national need.

There is an abundance of other examples of public financial institutions strongly committed to financing infrastructure projects. For instance, the Czech-Moravian Guarantee and Development Bank (CMZRB) provides Czech municipalities with long-term loans to help them fund *“specific projects focussed on improving the infrastructure of towns and municipalities, particularly their water supply and waste water treatment”*. Similarly, the website of the Investment Bank of Schleswig-Holstein (IBS-H) claims that it supplies solutions for *“public infrastructure financing as well as for city development, environmental and energy projects”*.

The overall rationale for public financing of infrastructure is, as L-Bank, the state bank of Baden-Württemberg, argues, that *“people and companies prefer to settle in communities with a suitable infrastructure - in other words, where modern public facilities and public transport exist”*.

Yet local public authorities, on a stand-alone basis, would mostly be excluded from market financing because of their small size. In some countries, municipalities are thus naturally led to join together and centralize the fund raising, particularly if it is to take place on the international market. Prominent examples of this strategy can be found in the various Nordic countries, for example one can name Municipality Finance in Finland.

### 5.3.4. Tourism

The fact that Europe is the world's leading tourist destination makes tourism *“an economic activity capable of generating growth and employment in the EU, while contributing to the development and economic and social integration, particularly of rural and mountain areas, coastal regions and islands, outlying and outermost regions or those undergoing*

*convergence*". The European tourism industry numbers some 1.8 million businesses, mainly SMEs, representing nearly 10 million jobs and generating over 5% of the EU's GDP. *"Taking into account the sectors linked to it, tourism's contribution to GDP is even greater; it is estimated to generate over 10% of the European Union's GDP and provide approximately 12% of all jobs"*<sup>35</sup>. Besides this economic clout, tourism is also an important way for Europe to project its image and social model throughout the world.

Tourism's significance for Europe has been recognised in the Lisbon Treaty, which sets out a series of systems designed to shore up the European Union's capability to support, coordinate and complement actions taken by the Member States and thereby lay the foundations for a European tourism policy. In particular, Article 195 of the Treaty on the Functioning of the EU stipulates that the European Union can *"promote the competitiveness of undertakings in this sector and create an environment conducive to their development"*. These advances are likely to necessitate the strengthening of financial institutions collaborating with key players from the tourism industry.

The most representative example of such an institution is the Austrian Bank for Tourism Development (ÖHT), which not only offers low-interest loans to SMEs active in the tourism and leisure industry all around Austria, but also conducts consultations, particularly on business planning, as well as providing training on the restructuring and financing of tourism businesses. In 2009, some 1,500 projects received support totalling around €32 million and 186 tourism entrepreneurs received financial assistance to launch an activity. Moreover, in 2010, in keeping with the emphasis placed on the importance of the tourism industry for Europe, the European Investment Bank, which functions as the EU's bank, granted ÖHT a €110 million loan *"to finance SMEs active in the Austrian tourism industry"*.

### 5.3.5. Environmental sustainability

Environmental sustainability is an essential goal for the governments of many countries, particularly advanced economies, which set ambitious targets for internalising or curbing economic externalities that pose a threat to the environment (e.g. cutting greenhouse gas emissions), improving energy efficiency and increasing the proportion of energy derived from renewable resources.

Yet all too often the systems and technologies needed to reach these targets are either uneconomical or subject to network effects that require state intervention. For instance, public financial institutions invest in relevant R&D and fund companies that generate renewable energy (e.g. via wind turbines, solar installations, use of biofuels, and so forth) or any innovative project capable of enhancing the environment. Moreover, various housing banks

<sup>35</sup> Europe, the world's No 1 tourist destination – a new political framework for tourism in Europe, Communication from the European Commission, 30 June 2010, Brussels.

finance building renovation designed to ensure compliance with tougher energy efficiency norms (one example being Husbanken in Norway).

In Poland, Bank Ochrony Środowiska (BOS) is an excellent example of a bank that offers a wide range of credit facilities for financing investments in environmental protection. In particular, it offers 'pro-ecological preferential credits' from earmarked (national or European) ecological funds for the conservation of water, air and land surfaces, as well as credits for waste collection and processing businesses.

The Nordic Investment Bank (NIB), the international financial institution serving the Nordic countries (Denmark, Finland, Iceland, Norway and Sweden), is another example of a public financial institution intent on promoting sustainable development. The NIB's mission statement declares that it "*promotes sustainable growth of its member countries by providing long-term complementary financing, based on sound banking principles, to projects that strengthen competitiveness and enhance the environment*". Before making any lending decisions, the NIB analyses the direct and indirect environmental impact of the projects it is being asked to co-finance.

#### 5.4. Geographically focussed missions

Historically, local banks, known as 'savings banks', were set up by local government authorities to deploy their assets in awarding loans designed to benefit their local economy, thereby de facto acting as retail banks from the outset, albeit with various restrictions imposed on their lending practices. Although established by government authorities, they were deliberately autonomously managed. Subsequently, similar institutions flourished at various territorial levels, but always with the emphasis on being a financial institution serving a certain area, which is why we use the term 'geographically focussed public banks' to describe them.

Today, the main products and services offered by geographically focussed public banks (mainly municipal credit banks, cantonal banks, Austrian 'Hypo banks', *Landesbanken* and *Sparkassen*) still mostly revolve around retail banking.

In terms of stakeholders, geographically defined public banks view 'other banks' as relatively important stakeholders. By contrast, interestingly, although close to 30% banks subject to strong public influence consider SMEs to be important stakeholders, SMEs do not seem to be privileged target stakeholders. What is more, public companies tend to 'under-focus' on their employees and show less concern for their shareholders. Typically, their customers have always included persons and institutions with few financial assets, thus compelling them to keep risks to a minimum.

Geographically focussed missions have two main characteristics:

a) Universal service

The provision of banking services to the underprivileged has always been key to ensuring the integration of such people into everyday life. Ensuring that everybody has a bank account is essential in today's modern economies, where most financial transactions are effected via intermediaries, using a complex infrastructure. In that respect, it is an important duty of public authorities to provide some basic financial services in places where commercial institutions do not find the necessary economies of scale and to people whom commercial institutions view as unprofitable. Since banking services are to be regarded as a universal service, similar to postal services, public authorities must aim to ensure that there is a sufficient number of bank branches within their respective territory. This is usually the case where post office banks, cantonal banks or regional and savings banks are concerned.

b) Financial inclusion

Financial inclusion emerges as the overriding objective of geographically focussed public banks, which value proximity with the client and relationship-based banking (many define the general public as their customer base). Furthermore, only some of these public banks offer a pawnshop service, which clearly is a financial inclusion tool in so far as pawnshops are institutions designed primarily to help the poor and underprivileged. Often constituting a 'last-resort' service, pawnshops are a very old form of banking service.

### 5.5. Financial institutions pursuing a more general mission

Financial institutions in this cluster are not characterized by precise objectives and their missions target a rather wide audience, with products and services relatively diverse. Moreover, among them, we find many financial institutions with public participation having a greater tendency to follow the path of internationalisation.

In keeping with this, regarding the names of these companies, we find more frequent instances of terms like 'Bank' or 'Group' and encounter numerous subsidiaries of sizeable groups, like DnB NOR or BNP Paribas<sup>36</sup>. Usually, the names of these entities resemble brands, comprising proper nouns, like Nordea, Vipa or Clientis. The sole objective of financial institutions with only minor public participation also appears to be the broadest possible, namely 'economic development', a fact that appears to confirm that financial institutions with only a small public shareholding are those with the greatest proclivity for involvement in general activities. Furthermore, shareholders emerge as these institutions' most important stakeholders alongside their employees.

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<sup>36</sup> However, it is important to bear in mind that BNP Paribas, a leading global bank, appears here exclusively due to the Belgian government's stake, held via the Federal Holding and Investment Corporation (FHIC), in BNP Paribas' capital, following the bail-out of the Belgian bank Fortis, subsequently acquired by BNP Paribas. As such, the significance of this shareholding in the framework of the present study should not be overrated.

We can identify two main types of banking institutions with non-controlling public-sector involvement:

a) Strategic ownership

In a number of cases, governments deliberately hold on to a significant yet non-controlling stake in such financial institutions so that the respective public authorities can retain some strategic influence, or a blocking minority, to safeguard national interests. DnB NOR in Norway is a case in point. A report published in 2008 by the Norwegian Ministry of Trade and Industry on the government's ownership policy states that *"the purpose of the state's ownership interest in DnB NOR ASA is to ensure that the group has its head office in Norway and that the company acts as a partner for Norwegian companies in Norway and in the export market. This provides business and industry with access to a large and highly competent Norway-based financial group."*

b) Domestic ownership with international scope

We also find banks that are characterised by domestic ownership but subsequently expanded internationally. It would seem that public authorities either just 'happen' to hold stakes in these institutions or have maintained their interest as the bank progressively evolved and moved further away from being a strictly public company.

For example, in the late 1990s the Swedish bank Nordea started to expand into a truly international group through various mergers and acquisitions, covering all Nordic countries first and later the Baltic countries and Poland. Today it has more employees in Finland and Denmark than in Sweden and considers itself a *"universal bank with leading positions within corporate merchant banking as well as retail banking and private banking. It is also the leading supplier of life and pensions products in the Nordic countries"*<sup>37</sup>.

In Slovenia, the Nova Ljubljanska Banka (NLB) Group was established in 1994 by a legislative act of the country's National Assembly to assume the assets and liabilities of Ljubljanska Banka. NLB went on to make various acquisitions and forge a number of strategic partnerships. Then in 2001, the government launched its privatisation programme for NLB, which entailed the bank continuing to increase its domestic market share and later expanding its activities into South-East Europe, in the process becoming the largest banking group in Slovenia and offering a tremendous variety of products and services (ranging from lease financing to commercial banking, asset management, private banking and corporate finance).

## 5.6. Conclusion

The missions of publicly influenced financial institutions are arrayed in four major categories: promotional missions, general-interest missions, geographically focussed missions and general mission, the latter being mainly constituted of financial institutions with a public participation.

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<sup>37</sup> Nordea's 2009 annual report.

Public financial institutions fulfil a huge range of specific missions. Among these, banks with a promotional mission stand out by primarily addressing market insufficiencies, such as the SME-financing gap, covering the hidden transaction costs of exports and fostering innovation, whereas other financial institutions are more likely to address general-interest missions, from supporting the agricultural sector to developing infrastructure and promoting tourism. These missions all respond to market needs which, for various reasons - ranging from the extent of the investment horizon to the presence of external factors - are underserved by the private banking sector.

In addition, promotional and general interest focussed public financial institutions also appear to complement geographically oriented public banks remarkably well. Indeed, while the former concentrate on mitigating market insufficiencies, public banks that are primarily focussed on their regional geographic scope primarily strive to financially include everyone, and therefore end up providing mostly retail banking services and pursuing schemes deemed to be in the general interest.

Finally, financial institutions with a public participation tend to be more internationally oriented and appear less focussed on narrower objectives. Investment banking and asset management - services that are infrequently on offer from public companies - are more frequently provided by institutions falling into this category and, significantly, shareholders emerge as their most important stakeholders alongside these banks' actual employees.

This tremendous variety and diversity in the missions assumed by public financial institutions can be explained by structural market characteristics calling for public intervention. The next chapter provides insights into the economic rationales that underpin public banks' missions.

**Table 6 - Overview of the missions of publicly influenced financial institutions**

Category	Code	Promotional missions	General interest missions	Geographically focused missions	General missions
Objectives	Job Creation	20%	10%	3%	3%
	Economic Development	91%	64%	70%	34%
	Financial Inclusion	5%	5%	21%	3%
	Environmental Sustainability	11%	22%	6%	3%
	Agriculture	5%	17%	3%	6%
	Tourism Industry	5%	2%	1%	3%
	Education	5%	8%	1%	3%
	Infrastructure	14%	31%	4%	0%
	Energy	9%	7%	2%	0%
	Sport and Culture	0%	5%	7%	0%
	Pawnshop	0%	0%	21%	0%
	Export	32%	5%	2%	0%
Innovation	32%	12%	4%	0%	
Geography	Regional	50%	31%	88%	13%
	National	57%	76%	18%	59%
	International	11%	14%	11%	41%
Stakeholders	General Public as Customers	7%	27%	89%	88%
	General Public as Stakeholders	16%	10%	11%	9%
	Shareholders	7%	7%	6%	25%
	SMEs	75%	44%	46%	41%
	Public Entities	36%	56%	17%	22%
	Other Banks	16%	24%	13%	13%
Activities	Employees	5%	5%	12%	16%
	Retail Banking	7%	25%	85%	88%
	Commercial Banking	77%	63%	73%	84%
	Wholesale Banking	70%	54%	65%	84%
	Mortgage Banking	14%	46%	58%	38%
	Asset Management	11%	8%	9%	34%
	Investment Banking	66%	19%	32%	44%
	Public Banking	18%	47%	16%	19%
	Consulting	34%	31%	5%	13%
	Guarantees/ Insurance	23%	20%	25%	28%
Settlement	0%	3%	5%	3%	
Subsidies	32%	19%	1%	0%	
TOTAL (N umber of institutions)		68	74	114	34

NB: In each segment, the percentages do not add up to 100% because one institution can take several of the codes

Source: Elaborated by the Authors.



## 6. Rationales for the existence of public financial institutions

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### 6.1. Introduction

The previous chapter highlighted the broad array of missions fulfilled by publicly influenced financial institutions and organised that diversity into four empirically identified clusters, namely:

- promotional missions;
- general-interest missions;
- geographically-focussed missions; and
- general missions.

The reasons for such diversity can be ascertained by relating the variety of public financial institutions to the many different challenges and types of market failures they must face, remedy or counter<sup>38</sup>. Accordingly, this chapter will discuss those challenges and market failures in a bid to draw up a clear, comprehensive list of scenarios in which public banks are necessary.

Since the ‘general mission’ cluster substantially concerns banks with public participation, rather than ‘public financial institutions’ in the strict sense of the term, we will only focus here on the first three clusters of missions, providing theoretical underpinnings to the mission descriptions of each.

The rationale for the existence of public banks and their ensuing missions and characteristics is invariably closely linked to the general characteristics and related inefficiencies of the banking sector as a whole. However, such inefficiencies need not automatically lead to public banking. Indeed, public intervention in the banking sector can assume multiple forms, the establishment of a public bank being just one specific variant, and when public intervention is essential public authorities have various means of intervention at their disposal.

If all the characteristics of the service that is under-supplied in a free market owing to a given market failure involve measurable returns and goals, public authorities have the choice of either imposing the provision of that service on market operators by law or outsourcing the provision of the service to a private contractor. Theoretically, public authorities could also opt to provide the given service by establishing a public company or adopting suitable regulations, but in a perfectly contractible scenario the preferred form of public intervention often entails establishing a public institution. In practice, most of the missions fulfilled by public banks and surveyed in Chapter 5 do not involve measurable returns and goals.

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<sup>38</sup> See for example Hart, Schleifer & Vishny (1997), Revell (1989), Levy-Yeyati, Micco & Panizza (2004), Hakenes & Schabel (2006), Andrianova, Demetriades & Shortland (2006), Rudolph (2009).

Furthermore, since private-sector operators also have an incentive to maximise profit, direct public-sector involvement is also preferable in cases where the objective of profit maximisation would lead to some deterioration in the quality of the provided service. Regulation can also constitute a solution to these types of market failures, but might yield results inferior to the ‘public bank’ option due to the existence of information asymmetries between the supervisor and the regulated entity.

In short, public banks are a preferred form of public intervention when a valuable service to society would be under-provided in a free-market setting, or when the all-too-self-interested behaviour of a private contractor might be detrimental to the quality of the provided service.

Now let us investigate the challenges to which public banks, through their many missions, attempt to respond.

## 6.2. Promotional missions

Promotional missions focus on market insufficiencies and thus attempt both to mitigate negative externalities and overcome information asymmetries.

### 6.2.1. Mitigating negative externalities

Negative externalities are said to occur when a company or individual taking a decision does not bear the full cost of the consequences of that decision. In other words, either other persons or society at large will end up having to pay. ‘Negative externality’ is a very wide-ranging concept that can refer to anything from pollution to forest fires to the shadow of a neighbour’s tree on your balcony. In general, insurance companies offer their clients protection against *potential* negative externalities, bearing the ensuing costs arising when a hazard materialises. They can afford to do this by diversifying their insurance portfolio. However, when diversification is not a possibility they will shun the risk and avoid covering it. In economics, one well-known negative externality that a private insurance company can hardly cover is an export risk, since such a risk often does not readily permit diversification (usually export companies have very few clients, who are all prone to the same kind of risks). Of course, this will depend on the diversification of the domestic export industry itself. In a country with a highly diversified portfolio of clients, private insurance companies are more likely to be present. Otherwise, this externality explains why promotional banks step in to support exports.

In the banking sector, the emergence of systemic risk appears to be the main potential negative externality. Indeed, the maturity mismatch between assets and liabilities in banks, on which their business model is based, creates an inherent bias toward illiquidity and makes banks particularly vulnerable to self-fulfilling bank runs and widespread bank failures. Moreover, the principle of limited liability and the fact that in most private banks management and

ownership are separate creates a bias toward risk-taking by their managers. Consequently, it is crucial to exercise a certain level of control over risk-taking in the context of banks' investment-related activities. In this connection, public banks may help to mitigate the level of risk in the banking system by being more committed to providing the citizens with incentives to invest in low-risk financial products.

### 6.2.2. Overcoming information asymmetries

Banking activities per se are highly information-intensive. As Stiglitz (1993) pointed out, *"information is, in a fundamental sense, a public good. Information possesses [...] the two fundamental features of a pure public good, [namely] non-rivalrous consumption (the consumption of the good by one individual does not detract from that of another) and non-excludability (it is impossible, or at least very costly, to exclude anyone from enjoying the public good)."* Furthermore, information entails fixed acquisition costs, since spending on information does not increase with the amount of lending.

When a demand for funds originates from sectors or ventures about which the banker knows little, like agriculture, innovation projects or SME financing (Rudolph, 2009), credit rationing or adverse selection quickly materialises. When faced with a high level of uncertainty, bankers will simply tend either to stop lending or to raise interest rates on all their lending activities and thereby run the risk of attracting more bad borrowers. Public banks, by underwriting these risks and uncertainties, can promote economic development.

Another example of information asymmetry that some public financial institutions seek to overcome occurs when small, and thus relatively unknown, entities need to gain access to market financing. Since information has fixed acquisition costs, private investors are unwilling to lend to these entities. Therefore, the strategy devised by these entities (which may be municipalities, regional authorities or small public financial institutions) is to team up to attain the 'critical mass' needed to attract market financing. This allows financial investors to spread the fixed cost of information acquisition between a larger number of entities. At the same time, this pooling strategy opens up the way for major potential economies of scale.

## 6.3. General-interest missions

Financial institutions pursuing general-interest missions focus either on investing in socially valuable, but financially unprofitable, ventures or on compensating for the private sector's short-sightedness by funding investments that yield only a long-term return.

### 6.3.1. Maximising positive externalities

One important trait of the private banking system is the limited incentives it has to finance projects associated with large positive externalities. Investment projects that are of great social benefit but are financially unprofitable (since the social benefits cannot be privatised) are less

likely to be financed by private lending institutions. As a result, many potential improvements to the welfare system ultimately remain unfulfilled.

By contrast, public banks can realistically consider positive externality projects in their investment choices such as in the environmental, social, cultural or sport domains. These potentially major positive externalities are not reflected in their balance sheets and profits, although they are essential to the respective local and national communities. This attention paid to social benefits in addition to sustainable financial profitability defines the so-called 'dual-bottom line' banks.

Another positive externality arises when public banks provide funds for other services. On the one hand, public banks are the main back-up source of liquidity for all other financial institutions in the economy; on the other, they are one of the main channels for implementing government monetary policy. Indeed, the private banking system has no incentive to lend during economic downturns, which diminishes the effects of an expansionary monetary policy. In this connection, it is vital to have public banks ready to channel funds and thus implement countercyclical financial policies.

### **6.3.2. Compensating the private sector's short-sightedness**

In market economies, market pressure and competition often prevent private companies from investing in long-term projects. They usually cannot afford high levels of illiquidity on their asset-side balance sheet, simply because, as J. M. Keynes pithily put it, "*in the long run we are all dead*", the exception being public authorities. This is a very basic, yet crucial, rationale for the establishment of public financial institutions. Typical illiquid and long-term projects include electric utilities (e.g. power stations), energy networks (such as gas or oil pipelines) or even simply roads.

## **6.4. Geographically-focussed missions**

As noted in the previous chapter, many public financial institutions were expressly set up to serve a given territorial area. The main rationales for this are to be found in the risk of capital drain and in the need to foster private savings by the general population.

### **6.4.1. Preventing capital drain from poorer to richer regions**

In a richer region, entrepreneurs can promise to pay higher interest rates than in a poorer region. If both regions display symptoms of credit rationing, private financial intermediaries will maximise profits by diverting capital away from poorer to richer regions. This capital drain can be countered by establishing a public bank bound by a territoriality principle.

### **6.4.2. Jump-starting financial development to avoid disintermediation**

Public banks can play an important role in the economic and financial development of nations.

In developing countries, some private banks might behave opportunistically, e.g. by not honouring their contracts with depositors when the probability of legal contract enforcement is low. When institutions are underdeveloped, depositors will tend to shun private banks for fear of such opportunistic behaviour and instead favour safer, state-run banks. Public banks can thus help by keeping private banks honest and generating the level of confidence in the financial system that is essential for avoiding disintermediation and jump-start financial and economic development.

The development of financial markets by public banks itself helps to foster economic development, thus starting a virtuous circle of economic and financial welfare creation. From the national viewpoint, this may not be deemed relevant nowadays, but at the local level it can remain quite relevant. Indeed, the development of local economies is one of the main rationales for public banks. The presence of trustworthy local public banks fosters the accumulation of savings by the general public. This intermediary role played by public banks in unsophisticated financial markets is important, since it allows for economic agents in financial surplus (depositors) to allocate funds efficiently to economic agents in financial deficit (borrowers). This fundamental role of public savings banks paves the way for a much closer relationship between the bank and its customers, further reducing informational asymmetry, which remains characteristic in arms-length relationships.

Financial inclusion is another of the main rationales for the existence of public banks. As pointed out above, the provision of financial services for both depositors and borrowers in rural and isolated areas gives rise to tremendous benefits in terms of economic development, employment and poverty reduction, but often proves financially unprofitable. The same situation arises with respect to the provision of basic financial services for the underprivileged. More fundamentally, the provision of financial services to all citizens, regardless of their geographical location, is often considered an essential, fundamental right.

## 6.5. Conclusion

This chapter provided some theoretical arguments underpinning the empirically determined missions presented in Chapter 5. The tremendous diversity of missions corresponds to the variety of challenges and market failures identified in the academic literature. By linking the general categories of public banks' missions to a rigorous framework of analysis, we can form a clearer understanding of the reasons underlying the establishment of public banks. The respective links and reasons involved are summed up in the following table.

**Table 7 - Rationales for public financial institutions**

Promotional missions		General-interest missions		Geographically-focused missions	
Mitigate negative externalities	Overcome information asymmetries	Maximise positive externalities	Compensate for the private sector's shortsightedness	Avoid capital drain from poorer to richer regions	Jump-start financial development and avoid disintermediation
<ul style="list-style-type: none"> <li>Promote exports to overcome export-related risks</li> <li>Control the level of risk by incentivising low-risk investments</li> </ul>	<ul style="list-style-type: none"> <li>Invest in projects plagued by uncertainties due to large information asymmetries</li> <li>Centralise the financing needs of multiple, small, unknown public entities</li> </ul>	<ul style="list-style-type: none"> <li>Invest in socially valuable but financially unprofitable projects</li> <li>Act as the ultimate provider of liquidity and transmitter of monetary policy</li> </ul>	<ul style="list-style-type: none"> <li>Invest in highly illiquid, very long-term projects</li> </ul>	<ul style="list-style-type: none"> <li>Establish public banks bound by a territoriality principle</li> <li>Invest in poorer regions</li> </ul>	<ul style="list-style-type: none"> <li>Diffuse trust in the banking system and encourage savings by the population</li> <li>Provide financial services to the underprivileged and the rural population</li> </ul>

Source: Elaborated by the Authors.

## 7. Public financial institutions' business models

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### 7.1. Introduction

The different rationales underpinning the creation of public financial institutions have led to the emergence of different business models by which public financial institutions operate. This chapter aims at refining and further specifying the general notion of 'public banks' by providing an archetypal typology of public financial institutions' business models. It is important to note that it would be virtually impossible to provide an exhaustive overview of all the existing business models for public financial institutions in Europe. Therefore, the present study identifies and presents a set of key business models that are not meant to describe particular financial institutions (in particular, a given financial institution can pertain to more than one of business models presented hereunder). Rather, they show how particular rationales for public intervention to a great extent influence and determine the typical characteristics of the resulting business models. We will successively cover Special Credit Institutions (comprising of National and Regional Development Banks and Agencies, Export Credit Agencies, and Municipal Credit Institutions), Long-Term Investors, , Public Savings Banks, and Public Financial Intermediaries. Each business model will be characterized by its activities, its financing, significant elements of its business environment and the public goals pursued.

### 7.2. Special Credit Institutions

In accordance with the 2002 EU-Germany Understanding<sup>39</sup>, Special Credit Institutions in the EU are allowed to be active in the following restrictive list of area:

- Fulfilment of public promotional activities e.g. financing SMEs, risk capital, environment-friendly investment, technology, innovation, infrastructure, housing as well as internationally agreed promotional programmes (e.g. CIRR, LASU, etc.) and co-operation with developing countries,
- Participation in projects in the interest of the Community, which are co-financed by the European Investment Bank or similar European financing institutions,
- Granting of loans and other forms of financing to the Federal State, Länder, municipalities and special purpose associations of public legal form (öffentlich-rechtliche Zweckverbände),
- Measures with a purely social character, e.g. social housing, financing of social institutions, financing fulfilling the conditions laid down in provisions of social law (regarding educational situation, unemployment, low income or wealth, handicaps, etc.)
- Export financing outside the European Union, the European Economic Area and countries with the official status of a candidate for accession to the European Union, as far as this is in compliance with international trade agreements, which bind the Community, in particular the WTO-agreements.

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<sup>39</sup> European Commission, "Understanding about the orientation of legally independent special credit institutions in Germany", 1<sup>st</sup> March 2002.

Special credit institutions may also engage in services and other financial activities, such as treasury management, risk management and consultancy on their promotional activities, as long as they are directly in connection with the fulfilment of their promotional tasks and serve that purpose.

We identify three key business models pertaining to the above restrictive list of allowed activities for Special Credit Institutions, namely (1) National and Regional Development Banks and Agencies (NRDBAs), (2) Municipal Credit Institutions (MCIs), and (3) Export Credit Agencies (ECAs). Below, we give an overview of the key characteristics of each of these business models we may find in Europe.

### 7.2.1. National and Regional Development Banks and Agencies (NRDBAs)

National and regional development banks and agencies are financial institutions set up by public authorities either at a regional or national level to implement investment projects in the local economy aimed at fostering economic and social development, for example by investing in infrastructure or providing support for SMEs.

NRDBAs, also known as ‘promotional banks’, constitute a financial institution category that has been recognised as such by the EC<sup>40</sup>. Promotional banks are special credit institutions acting as instruments of state economic policies and their public mission is usually stipulated in a short special law indicating the purpose and ways of operations of the institution. To avoid any conflict between European State aid rules, the scope of activity of these entities has to be in direct connection to their assigned tasks. Moreover, in fulfilling its mission, NRDBAs should strive to correct the market insufficiencies and be complementary to private banks rather than competing with them.

Section 1 below describes the various ways in which NRDBAs are financed. Attention will also be drawn to the important role played by EU funds in financing NRDBAs. Section 2 concludes by presenting an overview of NRDBAs’ products and services.

#### a) Financing

Like all other public financial institutions, NRDBAs are endowed by the public authorities with a certain amount of equity capital when they are founded. Most development agencies resort to market financing while only a minority is solely funded through public equity endowments. In Belgium, an example of the latter is the Regional Investment Company of Wallonia (SRIW) has a €745 million investment portfolio that is wholly financed through equity capital and retained earnings.

Yet most NRDBAs take advantage of their explicit or implicit state guarantee to resort to market financing, mostly by issuing bonds and benefiting from attractive rates. For instance,

<sup>40</sup> European Commission, “Understanding about the orientation of legally independent special credit institutions in Germany”, 27<sup>th</sup> March 2002.

in Germany, at the regional (state) level, development banks act on behalf of their regional authorities and support the respective state (Bundesland) in fulfilling its structural tasks. Each state has its own development bank e.g. Thüringer Aufbaubank, NRW.Bank for Northrhine-Wesphalia, Wirtschafts-und Infrastrukturbank Hessen. Development banks operate, from the competitiveness point of view, in a neutral and non-discriminatory manner, i.e. their services are provided to everybody on equal terms. Furthermore, the benefits gained from the guarantor liability provided by the individual state authorities and preferential terms of refinancing achieved are supposed to be reinvested in the promotional funding cycle. In Germany, development banks are independent of their particular legal constitutional state and are financial institutions in the terms of the "Kreditwesengesetz" (KWG) and are subordinated to the German Bundesbank and the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht). In Germany, apart from the regional development banks, two development banks exist at the national level: the Landwirtschaftliche Rentenbank which is the central institute for refinancing the German agricultural and food industry and KfW Bankengruppe which we consider as a long-term investor (see part 7.4).

Besides this, there exist various EU sources of funds for NRDBAs. Indeed, European Structural Funds have gradually grown in importance as a financing tool for NRDBAs. At present, the EU is endowed with 3 major structural funds: the European Regional Development Fund (ERDF), the European Social Fund (ESF), and the European Agricultural Fund for Rural Development (EAFRD). These structural funds aim to fulfil 3 objectives, respectively: 1) foster the economic development and structural adjustment of regions that are lagging behind; 2) ensure the economic and social conversion of areas facing structural difficulties; 3) finances the rural development programmes of the Member States.

The European Commission requires partial co-funding by national authorities for projects supported by structural funds and proper management, monitoring and evaluation of the funds' use. For these reasons, NRDBAs' expertise and operational independence from governments have put them at the heart of the EU's development policies. When a regional or national project is being funded jointly out of the EU's structural funds and by national or regional authorities, NRDBAs coordinate, manage and monitor the respective project's expenditure and progress and then report back to both the national or regional officials and the European Commission.

#### b) Activities

The promotional areas privileged by NRDBAs encompass *"SME financing, risk capital, environment-friendly investment, technology, innovation, infrastructure, housing as well as internationally agreed promotional programs and co-operation with developing countries"*<sup>41</sup>.

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<sup>41</sup> European Commission, "Understanding about the orientation of legally independent special credit institutions in Germany", 1<sup>st</sup> March 2002.

NRDBAs can adopt a direct or an indirect lending scheme, the former requiring decentralized operations through regional offices. Nordic countries are strong proponents of this first strategy. Oseo in France is another striking example of the direct lending model. An indirect lending strategy, in contrast, leads to greater centralization of operations and delegation of project selection and risk assessment to other banks. In this case, NRDBAs often act as a refinancing tool for more local banks ('house banks' or 'principal bank').

The indirect lending model is traditionally more present in Spain or Germany (there, referred to as the 'Hausbankenprinzip'). This model relies on that an enterprise deals with a preferred bank chosen by itself whatever the type of bank (saving bank, private bank, co-operative bank, etc.). The enterprise transacts the main share of its business to a principal bank where the current account is maintained and the business relationship is supposed to be long-lasting. When the enterprise needs a promotional loans and financial aid, it applies to the principal bank. The development bank then stipulates the terms and conditions of the funding loan. The principal bank has no possibility of controlling or changing the terms and conditions of the promotional loan although it may ensure the complete financing of the project and produces sources and disposition statements for the contract which are necessary for the project.

This system of financing allows for an improvement of financing terms. Moreover, although the principal bank acting as intermediary usually takes on much of the credit risk, risk sharing is also encountered. On its side, the development bank has neither an influence on an enterprise's choice of principal bank nor on the total volume of promotional loans. Hence, the principal bank procedure as a distribution channel for the promotional financing of companies meets the required competition neutrality and non-discriminatory nature of development banks. Of course, this system does not preclude resorting sometimes to direct financing, for example in the case of entrepreneurial loans.

More generally, to fulfil their mission of fostering economic and social development, NRDBAs must be capable of adapting their products and services to the particular requirements of individual projects. For this reason, NRDBAs propose a wide variety of products and services tailored to the individual needs of their customers. Besides traditional commercial loans and guarantees to support SMEs and innovative firms, they also act as business angels by providing seed and venture capital to entrepreneurs and innovative SMEs. Some NRDBAs even undertake management buyouts and cooperate to establish joint ventures to support SMEs throughout their development.

### **7.2.2. Municipal Credit Institutions (MCIs)**

MCIs are banks or funding agencies that specialise in providing financial services to municipalities. Through their activities, they aim to reduce the cost of capital for local

governments. For example, Kommuninvest of Sweden estimates that it has helped to reduce the municipal sector's financing costs by €32.2 million. The following sections will shed some light on the various organisational structures of MCIs, on their sources of financing and on the products and services they offer.

#### a) Organisational structures

MCIs can have very different organisational structures, namely being established either as customer-oriented firms, or as member-owned credit cooperatives. When founded as customer-oriented firms, their share capital is commonly owned by either the central government or the municipalities or jointly by both. Using their equity capital and debt instruments issued on financial markets, they provide financial services for municipalities within a certain geographical area (i.e. a country). Examples of this customer-oriented setting are provided by Kommunalkredit Austria (99.8% owned by the Austrian State and 0.2% by the Association of Austrian Municipalities (ÖGB)) and Kommunalbanken Norge, which is wholly owned by the Norwegian state.

The second organisational structure under which MCIs are often set up is a member-owned credit cooperative, where MCIs provide their members (i.e. municipalities) with financial services that are partly funded by members' original equity capital, but mainly through market financing. The members of municipal credit cooperatives are then jointly liable for their MCI's financial obligations. Examples of such cooperatives are Kommuninvest in Sweden, and Kommunekredit in Denmark.

A third structure can be found in Bank Nederlandse Gemeenten (BNG) that is a statutory two-tier company under Dutch law. Half of the bank's share capital is held by the State of the Netherlands and the other half by municipal authorities, provincial authorities and a water board.

#### b) Financing

As Sweden's Kommuninvest puts it: "*The tough economic conditions of the times were driving municipalities to look for credit, but, at the same time, high interest rates were a problem, and the capital and money markets were undergoing far-reaching changes. So although they were intrinsically creditworthy, the municipalities and county councils still found it tough to find attractive loan rates*".<sup>42</sup> This, in a nutshell, is the problem most municipalities face: although their investment projects might be profitable, their small size denies them access to market financing at attractive rates.

Nevertheless, by pooling their resources within a single entity (a MCI), municipalities can combine to attain the 'critical mass' required to bring attractive market financing within reach. The attractiveness of municipality finance for investors is further enhanced by some

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<sup>42</sup> See <http://www.kommuninvest.se//website1/en-gb/evolution/evolution.php>

form of state guarantee on the financial obligations of MCIs. Sometimes the state guarantee to MCIs is explicit, sometimes in the form of a maintenance statement. Mostly, though, the state guarantee is implicit, in which case the liability is limited and borne by the shareholders in the case of customer-oriented institutions (who often include the state), or it is borne by its members, in the case of cooperatives, and is then usually unlimited. The assumption that the financial activities of MCIs benefit from state guarantees and/or supports are clear from the financial ratings enjoyed by of these institutions, which mostly mirror their country's rating.

**Table 8 - Financial ratings of MCIs**

Institution	Financial rating (S&P)
Kommunekredit (Denmark)	AAA
Kommunalbanken (Norway)	AAA
BNG (Netherlands)	AAA
Kommuninvest (Sweden)	AAA
Kommunalkredit (Austria)	A
Municipality Finance (Finland)	AAA

Source: S&P 2009

### c) Activities

MCIs offer a wide variety of financial products, all tailored to the specific needs of municipalities (and other local public bodies). Since most local authorities are under a legal obligation to balance their budgets, debt financing is paramount for local governments. So it is hardly surprising that debt financing is the primary financial service that MCIs offer to municipalities.

Other types of financing have been developed over the years, tailored to the specific needs of municipalities and local quasi-public institutions (such as housing institutions, educational establishments, healthcare institutions, and so on). Consequently, most MCIs also offer project finance loans for local infrastructure projects or loans guaranteed by sector-specific state guarantee funds (such as the Waarborgfonds Sociale Woningbouw (WSW) for social housing and the Waarborgfonds voor de Zorgsector (WFZ) for the healthcare sector in the Netherlands). Some MCIs even provide financing for public-private partnerships or venture capital for riskier public projects.

### 7.2.3. Export Credit Agencies (ECAs)

Export Credit Agencies' main mission is to help finance exports of national goods and services to international markets. As such, they aim to boost domestic exporters' competitiveness

in global markets. Since ECAs can significantly impact on international trade, potentially distorting it, they are subject to specific international legislation.

The legal framework governing the operations of ECAs is discussed first, then the following section considers the specific products and services that ECAs offer to exporting firms. The final section explores possible future challenges facing ECAs and what has been and still can be done to overcome them.

#### a) Legal framework

Since export credits and guarantees can potentially distort competition in international trade, they are subject to the Agreement on Subsidies and Countervailing Measures (SCM Agreement) adopted by the World Trade Organisation (WTO). Specifically, Annex 1 of the SCM Agreement provides an 'Illustrative List of Export Subsidies' prohibited by the WTO. Among other things, Annex 1 prohibits:

*1° The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.*

*2° The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and other credit terms and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.*

However, the second paragraph of point 2 provides for an exception for WTO member countries applying the provisions of the OECD's Arrangement on Guidelines for Officially Supported Export Credits, stating that they "*shall not be considered an export subsidy prohibited by this Agreement*".

The OECD's Arrangement on Guidelines for Officially Supported Export Credits, which is currently ratified by Australia, Canada, the European Union, Japan, Korea, New Zealand, Norway, Switzerland and the United States, first entered into force in April 1978. However, it is a 'gentlemen's agreement' and does not carry the legal force of an official OECD act. Its stated purpose is to "*provide a framework for the orderly use of officially supported export*

*credits” and to “foster a level playing field for official support [...] in order to encourage competition among exporters based on quality and price of goods and services exported rather than on the most favourable officially supported financial terms and conditions”.*

Amongst other things, the aforementioned Arrangement covers the financial terms and conditions for export credits. The OECD also provides a list of official ECAs complying with the Arrangement.

For the EU Member States, Article 132 of the Treaty Establishing the European Community stipulates that “*Member States shall progressively harmonise the systems whereby they grant aid for exports to third countries, to the extent necessary to ensure that competition between undertakings of the Community is not distorted. On a proposal from the Commission, the Council shall, acting by a qualified majority, issue any directives needed for this purpose.*” To this end, Council Directive 98/29/EC sets out provisions for the harmonisation of export credit insurance with medium and long-term cover.

#### b) Activities

ECAs cover both commercial and political non-payment risks for exports. The commercial risks at issue here include debtor insolvency and unwillingness to pay. The political risks include the confiscation of goods, restrictions within the international payment system, payment moratoria, the non-convertibility or non-tradability of foreign funds, legislative or administrative measures taken by public authorities against exporting firms, and war or similar hostilities.

Furthermore, ECAs provide export pre-financing loans designed to finance the expansion of production needed to fulfil export orders or provide guarantees for banking loans to export companies. To facilitate the conclusion of export contracts, ECAs also provide buyer’s credits to foreign customers of exporting firms, whereas some additionally offer insurance services that cover foreign investments by domestic companies. What is more, some ECAs provide extensive studies of country-specific risks so that potential exporters can assess the risks associated with exporting to particular countries. For example, Hungary’s Eximbank has a total loan portfolio of €580 million and total guarantees totalling over €150 million.

#### c) Challenges and recent developments

Due to ECAs’ special purpose, they have often come under fire. Some observers object to them on economic grounds, viewing their services as nothing more than disguised export subsidies that distort world trade. Others, most notably NGOs, object to allegedly perverse social and environmental effects of ECAs’ policies. As a result, the Jakarta Declaration in 2000 called for the reform of ECAs. More precisely, the signatory NGOs demanded that ECAs adopt stringent environmental, social, human rights and anti-corruption guidelines.

In response to the NGOs' objections, many ECAs have adopted social and environmental codes of conduct and laid down strict rules governing corruption and respect for human rights. And under pressure from the economic criticisms of ECAs, many have also tightened up the rules specifying the conditions under which they agree to intervene in a bid to promote, as opposed to hinder, trade by encouraging exports.

### 7.3. Public savings banks

Public savings banks are banks whose operations are primarily defined through the geographical scope of their activities. They have strong ties to a particular region and primarily deliver financial services within that geographic area. Most institutions of this kind are retail banks, of the type found in numerous countries (*crédits municipaux* in France, *cajas de ahorros* in Spain, *Landesbanken* and *Sparkassen* in Germany, cantonal banks in Switzerland, *Regionalbanken* ("*Hypo*") in Austria, etc.). Yet whereas these public banks are all savings banks, not all savings banks are public banks. Accordingly, we will first clearly differentiate between savings banks in general and public savings banks in particular. The following section will provide a detailed description of a particular type of public savings bank, the postal savings bank. The third section provides an overview of the products and services offered by public savings banks.

#### a) Typology: Savings banks and public savings banks

Savings banks can be generically defined as regional banking institutions, primarily involved in retail banking. As shown earlier, savings banks have historically developed around two rather different business models, involving different institutional forms: cooperatives or foundations. Cooperative banks are member-owned organisations which belong to local citizens in a given area and are therefore private institutions. For this reason, they are de facto excluded from the scope of the present study.

The defining peculiarity of foundations is that, strictly speaking, they do not have any 'owners'. Rather, they are self-owned financial institutions which grow primarily through retained earnings. Yet despite this lack of owners, the operations of foundations are controlled by a Board of Trustees, the exact composition of which is defined in the respective bylaws. This means that savings banks set up as foundations can be either public or private, depending on the exact composition of their Board. The control criterion adopted in the present study allows us to distinguish between these two types of 'ownerless' foundation.

At the same time, it is important to note that as corporate law evolved throughout the 19th and 20th centuries, some savings banks abandoned either of the aforementioned forms, opting instead to become fully-fledged joint stock companies.

#### b) Postal savings banks

Postal savings banks (sometimes called post office savings banks) were set up throughout the 19th century to offer retail banking services to the masses, building on the success of local savings banks and extensive networks of post offices. The fact that postal savings banks draw both on the philosophy underlying savings banks and the ethos of post offices, makes them, in the words of France's Banque Postale, “*animated by the dual values of proximity and service to the masses*”<sup>43</sup>.

Historically, proximity has been achieved by making all retail banking services available in existing post offices. This drastically lowered the cost and sped up the development of postal savings banks, superposed on the existing network of post offices. That approach, which was extremely successful throughout the 19th and 20th centuries, is at risk today as a result of the disappearance of post offices, linked to declining volumes of mail.

Serving the masses, even underprivileged customers, has always been a key aspect of the activities of savings banks. Financial inclusion has now generally become a fundamental public policy objective, supported by public savings banks, both geographically (providing access to financial services in remote areas) and socially (providing basic banking services to all, regardless of their financial attractiveness).

#### c) Activities

As pointed out above, public savings banks mainly provide retail financial services, essentially bank accounts and general payment services (debit cards, credit cards) for use by their customers and the general public. Yet as their name indicates they also offer savings accounts, often covered by some kind of state guarantee protecting individual savings, and other mainstream savings instruments for retail consumers.

They also use the funds deposited with them as savings to offer loans to their retail customers, both for consumption and investment purposes, such as purchases of durables (like cars and appliances) or housing. In addition, they also provide loans to foster the activities of local SMEs and entrepreneurs.

Finally, alongside their banking activities, they offer the commonest insurance products, such as car and home insurance, life insurance, and so forth.

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<sup>43</sup> See <http://www.labanquepostale.fr>

## 7.4. Long-term investors (LTIs)

LTIs' main mission is to fund profitable or general-interest projects that other financial institutions are either unwilling or incapable of financing. In so doing, they contribute to the economic and social development of the country or region where those projects are implemented. The Long-Term Investors' Club (LTIC) defines long-term investments as “*an investment that has a long-term horizon and that may contribute to sustainable growth, employment and financial stability. [In particular, this refers to] investment in large-scale projects which can express their return potential only over several years, such as knowledge and labour-intensive general interest, low-carbon or infrastructure projects. [It also refers to] an investment that generates stable cash flows in the long run, and thereby, a financially sustainable long-term risk-adjusted rate of return. [Finally, it may refer to] an investment that contributes to financial markets' stability*”<sup>44</sup>.

The following sections will look at how such institutions are financed; consider the various roles they fulfil; and show how national European LTIs have cooperated to promote European projects.

### a) Financing

Long-term investors have three main sources of financing: regulated savings, equity stakes held by the state, and market financing (mostly via bonds).

#### 1) Regulated savings

France's Caisse des Dépôts et Consignations (CDC) and Italy's Cassa Depositi e Prestiti (CDP) are both in charge of 'managing regulated savings and channeling them safely to the financing of public-interest initiatives'<sup>45</sup>. 'Regulated savings' are a particular set of financial savings instruments that are guaranteed by the state, which also sets their interest rates. France has numerous such regulated savings instruments (including the Livret B, Livret Bleu, LDD and Livret Jeune and so on), but the most famous and most widespread one is definitely the Livret A, which comprises more than 75% of all French household savings. In Italy, the CDP's main sources of financing are postal savings products, distributed by the Italian Post Office, Poste Italiane. These savings products are particularly attractive to retail consumers for two reasons: firstly because they are guaranteed by the state, and secondly because their proceeds are exempt from tax.

#### 2) State-owned equity stakes

All LTIs have a separate legal personality from the state that established them. This guarantees the necessary investment independence from political interference, as illustrated by the oath taken by the director of the Caisse des Dépôts et Consignations to '*maintain with all his power*

<sup>44</sup> Based on Annex 2 of the LTIC's Workgroup Conclusions on Banking Supervision, 2010.

<sup>45</sup> Profile of the Caisse des Dépôts et Consignations (see <http://www.caissedesdepots.fr>).

*the sanctity of the Caisse des Dépôts et Consignations'*.<sup>46</sup> When set up, LTIs are endowed with initial equity capital by the respective government. Yet, as shown in table 8 below, the share capital only represents a minor part of the overall financing needs of LTIs. Nonetheless, LTIs are in no way dependent on government expenditure or tax proceeds for their financing.

**Table 9 - Share of equity in the total financing of LTIs**

<b>Institution</b>	<b>Equity (% of total liabilities)</b>
Caisse des Dépôts et Consignations (CDC)	14.46%
Cassa Depositum et Præstitum (CDP)	6.58%
KfW Bankengruppe	3.28%
European Investment Bank (EIB)	8.60%
Instituto de Crédito Oficial (ICO)	4.50%

Source: Institutions' Annual reports (2009)

### 3) Market financing

Like all institutional investors, LTIs depend on market financing, and more specifically on bond issues, for their financial needs. Unlike regulatory savings, bonds issued by LTIs are not guaranteed by the state, but because of the strong involvement both of LTIs in national economies and of national governments in LTIs, bonds issued by the latter often enjoy the same financial ratings as assigned to their home country (and thus financing conditions on financial markets). This greatly reduces the cost of capital for LTIs. Table 9 below provides an overview of the financial ratings of the main LTIs in Europe.

**Table 10 - Financial ratings of LTIs**

<b>Institution</b>	<b>Financial rating (Fitch)</b>
Caisse des Dépôts et Consignations (CDC)	AAA
Cassa Depositum et Præstitum (CDP)	AA-
KfW Bankengruppe	AAA
European Investment Bank (EIB)	AAA
Instituto de Crédito Oficial (ICO)	AA+

Source: Fitch Rating 2009

<sup>46</sup> General presentation of the CDC (see <http://www.caissedesdepots.fr>).

## b) Activities

One activity of some LTIs (the CDC and the CDP) was already mentioned above, namely managing regulated savings to reduce the risk borne by individual savers. Thus, LTIs aim to limit the systemic risk of the financial system by both offering a state guarantee on particular savings and supervising the use of funds.

Having said that, LTIs' main activity is investing in long-term projects that are beyond the capability and/or willingness of market operators. A first key type of project falling under this category involves investments in infrastructure. Infrastructure projects supported by LTIs range from transport networks (railways, highways, seaports, airports, and so forth) to energy networks (power grids, gas and oil pipelines, and so on) and generation (power plants, renewable energy, etc.). Sometimes, rather than directly investing in such infrastructure projects, LTIs set up specific funds to finance them. One example of such a fund is the Italian *Fondi Italiani per le Infrastrutture (F2i)*, set up by the CDP.

Another type of long-term commitment by LTIs are investments in rent and price-controlled social housing and educational infrastructure. Through its offshoot *Société Nationale Immobilière (SNI)*, France's CDC manages over 300,000 units of social housing and builds 90,000 new units every year. Similarly, the German banking group *KfW Bankengruppe* has a retail bank subsidiary (*KfW Privatkundenbank*) that promotes the construction of new homes and the modernisation of existing housing. Between 1990 and 1997, KfW helped to modernise over 3.2 million homes in the former German Democratic Republic (DDR). In France, in the domain of educational infrastructure, the CDC has already signed 52 agreements with over 130 educational institutions (including 65 universities) to help them develop their campuses and student housing. In a comparable effort in Italy, the CDP has established the *Fondo Rotativo per il Investimenti in Ricerca (FRI)* to promote R&D activities in companies and universities.

In addition to their long-term investment horizon, the aforementioned projects are all strongly in the public interest. Other areas of intervention for LTIs that are characterised by a strong degree of public interest are support for SMEs and companies of strategic importance, efforts to protect the environment and promote sustainable development, and the funding of public bodies.

As the European Commission has emphasised: "*SMEs are a key part of European industry, not least as they contribute up to 80% of employment in some industrial sectors [...]. SMEs are a major source of entrepreneurial skills, innovation and contribute to economic and social cohesion.*"<sup>47</sup> As such, it is understandable that all LTIs are seeking to develop specific financing products to foster the development and growth of SMEs. In 2005, the CDC set up Oséo to provide risk capital and loans to start-ups, VSEs and SMEs. Similarly, the KfW banking

<sup>47</sup> See the European Commission's COM(2005) 551.

group's KfW Mittelstandsbank promotes SMEs, business founders and start-ups and has already invested over €23.8 billion in businesses.

In addition to developing nascent and small businesses, governments have also aimed, with help from LTIs, to develop strategic industries and companies. For example, the CDP in Italy created its Fondo Rotativo per Infrastrutture Strategiche (FRIS) and France's CDC helped to set up the Fonds Stratégique d'Investissement (FSI) which has invested over €1.4 billion in strategic businesses and sectors.

Another area of strong public interest is sustainable development and the protection of natural resources. LTIs contribute to the ecological transformation of our societies through specifically designed funds (e.g. the CDP's Kyoto Fund, CDC's Biodiversity Fund, KfW's Carbon Fund) and through general sustainability criteria applied to all their investments.

One last area of activity for LTIs is the financing of public entities, where LTIs help local communities to finance infrastructure and mortgage projects. For example, the CDC has invested over €425 billion in regional development in France. Some LTIs also operate as public sector financial institutions, offering banking services to ministries, government departments, social security organisations and such like. In fact, in France the CDC is even in charge of managing the country's public and semi-public pension systems. In Poland, BGK finances long-term projects in infrastructure (such as railways, highways, roads, airports, gas) and acts as financing manager and bond issuing agent of the National Road Fund (*Krajowy Fundusz Drogowy*), thereby financing the construction and modernisation of all highway and road infrastructure in Poland.

#### c) International cooperation of LTIs

In 2009, Europe's main LTIs (the EIB, CDC, CDP and KfW) set up the Long-Term Investors' Club (LTIC) "*to coordinate their activities in the global economy in support of sustainable economic growth*"<sup>48</sup>.

Previously, in 2009, together with the ICO and PKO Bank Polski, the future LTIC's members founded the 2020 Euro Fund for Energy, Climate Change and Infrastructure, dubbed the 'Marguerite Fund'. This fund totals €1.5 billion and its objectives are to invest in the development of Trans-European Networks in Transport and Energy (TEN-T and TEN-E respectively) and contribute towards the implementation of the EU's 20-20-20 climate change abatement strategy by investing in renewable energy. The Marguerite Fund's core backers have so far been joined by Malta's Bank of Valletta, Portugal's Caixa Geral de Depósitos and the European Commission.

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<sup>48</sup> See <http://www.ltlic.org>

The CDP, CDC and EIB are also teaming up with Morocco's Caisse de Dépôt et de Gestion (CDG) and Egypt's EFG-Hermes Holding to develop the Inframed Fund, dedicated to long-term investments in sustainable urban, transportation and energy infrastructures in Southern and Eastern Mediterranean countries. The fund's resources total €400 million.

### 7.5. Public Financial Intermediaries (PFIs)

Public Financial Intermediaries are public financial institutions which, in a centralized fashion, provide investment products and services to other (public) decentralized financial institutions. This business model is strongly linked to the public banking sector's structure in Germany and will be explained in the following section. Another example of PFIs is provided by the pooling of regulated savings by central institutions such as the Caisse des Dépôts et Consignations and the Cassa Depositi e Prestiti. This will be briefly discussed in the final section.

Ever since the creation of the first municipal savings bank in Göttingen in 1801, public savings banks have rapidly spread around Germany. Given local and federal laws and regulations restricting savings banks' operations to their original municipality, most savings banks have remained extremely small in terms of capitalization. To compensate for the potential disadvantages arising from their reduced size, they have all joined together in a countrywide network of savings banks, the Sparkassen-Finanzgruppe (S-gruppe). Another important member of the S-group are the Landesbanken, Germany's much bigger regional public banks. On top of their own retail activities, Landesbanken also provide multiple services to the Sparkassen within their home region.

Due to the fact that banking laws and regulations generally do not allow savings banks to hold equity participations or to perform risky investments, and since Sparkassen are often of extremely limited size, the Landesbanken provide the Sparkassen with complex, non-standard products and services tailored to the investment needs of their customers.

Second, the Landesbanken act as central banks and clearing houses for the Sparkassen within their region, providing emergency liquidity and settlement services to them. Indeed, a peculiarity of the German banking system is the existence of so-called 'giro networks', referring to *"payment procedures which are used within one banking group or within a bank's branch network. Settlement is effected by one or more of the banking group's central institutions"*<sup>49</sup>.

At the national level, DekaBank, a financial institution owned by the Landesbanken and by the National Association of Savings Banks, in turn provides the Landesbanken and Sparkassen with central asset management services, offering investment products and services to

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<sup>49</sup> Payment systems in Germany, Committee on Payment and Settlement Systems, Bank for International Settlements, 2003.

the retail customers of the regional and local public banks. Contrary to the Landesbanken however, DekaBank does not have a central bank or settlement function.

This three-layered public banking system allows the strongly decentralized German banking market to operate efficiently by pooling together on a wide scale those services in which economies of scale and scope are dominant, while maintaining local managerial independence at the level of the individual savings bank.

### 7.6. Rationales underpinning the operations of the different characteristic business models

As shown on figure 7 below, by focusing on fostering economic and social development through the promotion of education and infrastructure projects, NRDBAs clearly aim at maximizing positive externalities. Second, the support they provide to SMEs and innovation help overcome information asymmetries. Also, their investments are often characterized by a long-term horizon (such as transport and energy infrastructure), thus partly compensating for the private sector's short-sightedness.

The main rationale underpinning the activities of ECAs is to maximize positive externalities. ECA's activities help establish commercial ties with foreign nations, thus contributing to the reputation of their home country, a positive externality that will positively affect the national economy as a whole. Second, as described above, private insurance companies are not inclined to provide export credit guarantees because this type of risk is not easily diversifiable. Therefore, by filling this market gap, ECAs mitigate negative externalities.

Because of the fixed acquisition cost of information, private investors will mostly be unwilling to invest in debt instruments issued by small municipalities. By forming a cooperative or by setting up a dedicated financial institution, municipalities can strongly reduce this acute case of information asymmetry. Also, by making the issue of local government debt more cost-effective, MCIs reduce the overall financial burden carried by local taxpayers, thus providing a valuable positive externality to society.

As can be seen on figure 7, public savings banks are mostly bound by a strong territoriality principle. This strong local focus allows public savings banks to prevent capital drain. As described above, the phenomenon of capital drain is linked to the fact that entrepreneurs in a richer region can achieve higher returns than in the poorer region (due to the development differential) and thus literally drain capital away from the poorer region.

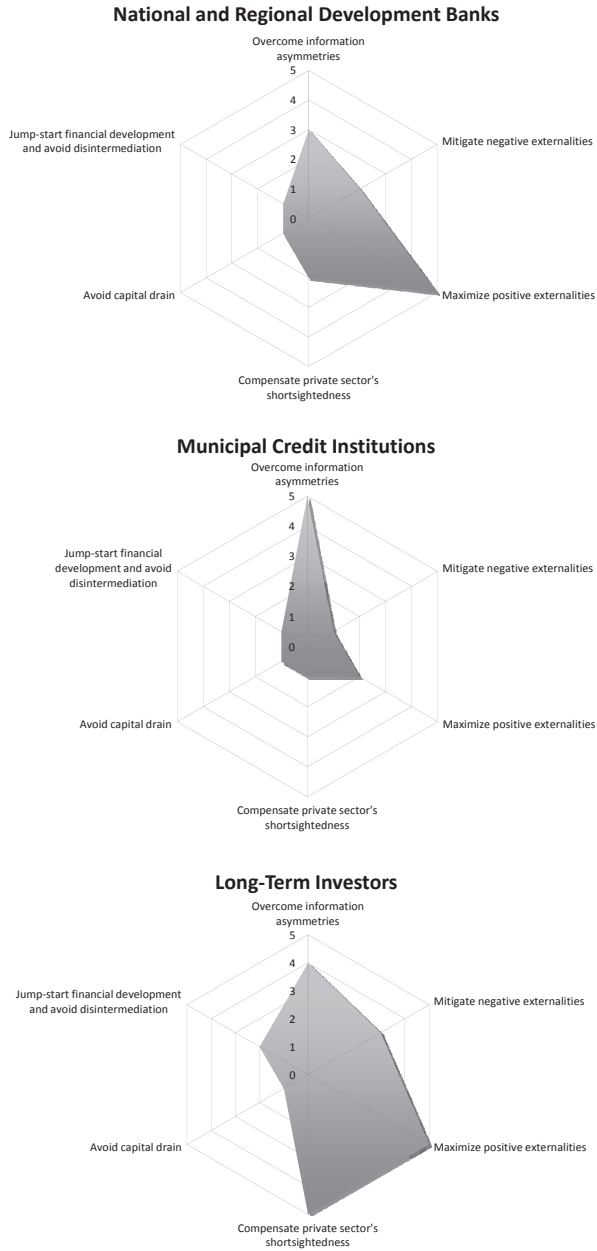
By offering an explicit or implicit state backing, savings banks can also play an important institutional role in fostering public confidence in the banking sector as a whole, thus attracting savings towards the formal financial system. This avoids disintermediation and can

jump-start local financial and economic development. Financial inclusion is another of the main rationales of public savings banks. As pointed out above, both the provision of financial services for depositors and borrowers in rural and isolated areas generate enormous benefits (regarding economic development, employment, poverty reduction) but are often financially unprofitable. Public savings banks, through their general-interest missions are best placed to provide such services. By focusing on their local customers and getting to know them well, public savings banks can strongly reduce the information asymmetry hampering SME financing, thus promoting the development of local enterprises and jobs.

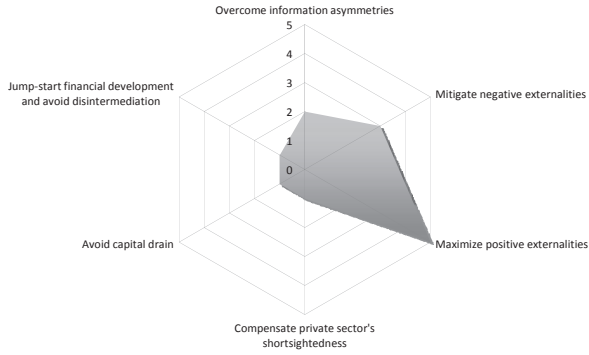
By nature, LTIs' long-term investment horizon is aimed at compensating the private sector's short-sightedness. Furthermore, by investing in sustainable development, social housing and education, LTIs strongly contribute to maximizing positive externalities. Their support to SMEs and innovation on the other hand aims at overcoming information asymmetries. Finally, some LTIs (notably the CDC and CDP) mitigate negative externalities by limiting systemic risk.

By spreading the fixed informational costs of central asset management among the Sparkassen, the Landesbanken and DekaBank enables the German public banking sector to fully exploit economies of scale, thus improving its cost-efficiency. This reduces the information asymmetry, thus allowing local savings banks to offer complex financial products to their customers. A large positive externality generated by PFIs originates in the provision of services that have a public good nature: the Landesbanken are the main back-up source of liquidity for the Sparkassen, thus contributing to the stability of the German banking market.

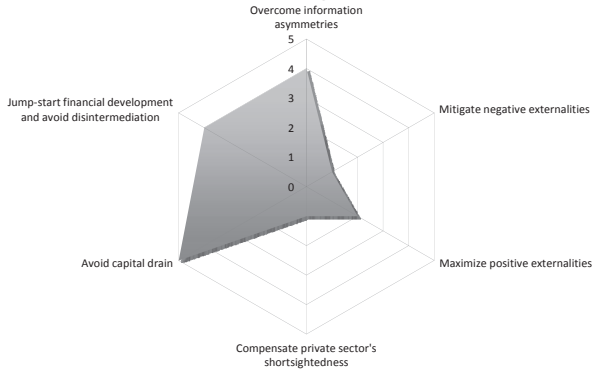
Figure 7 - Rationales underpinning the operations of public financial institutions



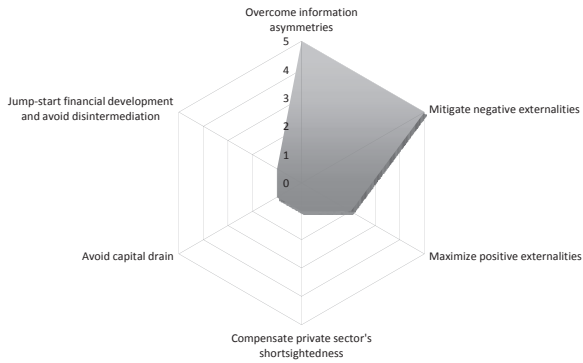
### Export Credit Agencies



### Public Savings Banks



### Public Financial Intermediaries



Source: Elaborated by the Authors

## 7.7. Conclusion

The targeted missions of public financial institutions have led to the development of specific business models. Six characteristic business models were described above: National and Regional Development Banks and Agencies (NRBDAs), Export Credit Agencies (ECAs), Municipal Credit Institutions (MCIs), public savings banks, Long-Term Investors (LTIs) and public financial intermediaries (PFIs).

The variety and complexity of missions carried out by public financial institutions has led to the emergence of numerous hybrid and alternative business models that were not presented above. Nonetheless, despite operational variations and differences between specific goals and business models of public financial institutions, they all share two common goals: to correct situations where the market has failed to deliver, and to complement the shortcomings of private financial institutions.

## Conclusion

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The existing literature on public financial institutions has two main shortcomings that are addressed by the present study.

Firstly, although many works discuss the performance of public banks, there is no clear definition of what actually constitutes a 'public bank'. Most existing studies use a single threshold (usually 50%) of ownership by public authorities as a definition of what constitutes a public financial institution. However, this approach presents some structural flaws because the use of a single threshold is an oversimplification that, as we demonstrated, obscures a broader diversity of existing ownership structures. At the same time, the use of an ownership-based classification utterly ignores the many situations in which ownership of an institution's equity does not entail actual decision-making power. Consequently, this study follows the more realistic IFRS consolidation rules, defining public banks in terms of an 'effective control' criterion.

A second shortcoming of the literature is that it provides no proper classification of the wide variety of existing public financial institutions. Yet this is essential, since the identification of an institution's objectives is a prerequisite for measuring its performance in terms of the degree to which those goals are being or have been attained. Our study aims to bridge this gap in the literature by providing a framework for classification based on an extensive analysis of the missions and roles of public financial institutions.

The starting point of our research project was to draw up an exhaustive list of public financial institutions in Europe, which for the purposes of this study, was taken to mean the 27 EU Member States plus Croatia, Macedonia, Norway, Switzerland and Turkey. To provide an exhaustive overview of the public banking sector in Europe thus defined, the study covers more than 80% of Europe's banking assets and identifies all those public financial institutions with public-sector involvement in excess of 5%. The mission statements of these financial institutions were collated and categorised along the lines of grounded theory. The resulting classification covered the respective public financial institutions' geographic scope, their stakeholders, products and services, and also their objectives.

Using the collected mission statement information, 4 categories of missions were identified on the basis of the two key dimensions of public banks' missions: their geographic scope (local vs. global focus) and the specificity of their objectives (specific vs. generic goals).

The first and second groups are composed of highly specialised public financial institutions providing specific products and services aimed at fulfilling strongly targeted objectives.

The distinction between these two categories of institution is that the first group is made up of banks fulfilling **promotional missions**, i.e. boosting exports, supporting SMEs and financing innovation, whereas the second group includes banks pursuing a **general-interest mission**, e.g. promoting sustainable development, social progress, education, agriculture and tourism.

The third group consists of banking institutions with a **strong geographic focus**. These types of institution (mostly regional and savings banks) are strongly rooted in their home region and mainly offer retail banking services.

The last of these groups comprises mainly financial institutions where the state only controls a minority interest. Most financial institutions of this kind are **universal banking groups** with a propensity for international expansion.

Based on this typology, we identified the main underlying economic rationales justifying public intervention in financial markets. Market failures necessitating public intervention in financial markets cover a whole range of economic phenomena: mitigation of negative externalities (such as systemic or export risks), reduction of information asymmetries (with respect to SMEs, innovation and municipal financing), maximisation of positive externalities (i.e. the promotion of socially desirable but financially unprofitable projects), compensation for short-sightedness on the part of the private sector (e.g. the construction of transport and energy infrastructure), and jump-starting financial and economic development in less privileged regions.

The final section of our study presented the most characteristic and/or widespread business models developed by public financial institutions to achieve their objectives. For each business model (national and regional development banks and agencies, municipal credit institutions, export credit agencies, long-term investors, public savings banks, , and public financial intermediaries), we described the significant characteristics of their business environment, their activities and financing. We also showed the extent to which each type of public financial institution helps to mitigate the specific market failures listed above.

In conclusion, we would like to stress that the diversity of public financial institutions in Europe stems from their different goals and the inherent shortcomings of the private financial sector they set out to redress. This wide range of underlying economic rationales renders meaningless most performance-based analyses of public sector banks, since all that such analyses measure is financial performance (which presupposes the overriding aim of profit maximisation), neglecting all other kinds of objectives pursued by public financial institutions.

Based on this study's typology of economic rationales behind the operations of public financial institutions, further research is needed to develop new performance metrics that enable the accurate measurement of the degree to which public banks and funding agencies attain their respective objectives.



## List of acronyms

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BGK	Bank Gospodarstwa Krajowego
BOS	Bank Ochrony Srodowiska
BSEC	Black Sea Economic Co-operation
BSTDB	Black Sea Trade and Development Bank
CAP	Common Agricultural Policy
CDC	Caisse des Dépôts et Consignations
CDP	Cassa Depositi e Prestiti
CEB	Council of Europe Development Bank
CEE	Central and Eastern Europe
CMZRB	Czech-Moravian Guarantee and Development Bank
Coface	Compagnie française d'assurance pour le commerce extérieur
CRND	Commissioners for the Reduction of the National Debt
DDR	German Democratic Republic
DSGV	Association of German Savings Banks
EAGGF	European Agricultural Guidance and Guarantee Fund
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Export Credit Agency
ECB	European Central Bank
ECIO	Export Credit Insurance Corporation
EEA	European Economic Area
EIB	European Investment Bank
ERDF	European Regional Development Fund
ESA	European System of Accounts
ESF	European Social Fund
EU	European Union
FIFG	Financial Instrument for Fisheries Guidance
FRI	Fondo Rotativo per il Investimenti in Ricerca
FRIS	Fondo Rotativo per Infrastrutture Strategiche
FSI	Fonds Stratégique d'Investissement
GFAW	Gesellschaft für Arbeits- und Wirtschaftsförderung
GNP	Gross National Product
IAS	International Accounting Standard
IBS-H	Investment Bank of Schleswig-Holstein
ICO	Instituto de Crédito Oficial
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund

KfW	Kreditanstalt für Wiederaufbau
LTI	Long-Term Investor
MCI	Municipal Credit Institution
MFI	Monetary Financial Institution
NDO	National Debt Office
NGO	Non-Governmental Organisation
NIB	Nordic Investment Bank
NLB	Nova Ljubljanska Banka
NRDBA	National and Regional Development Banks and Agencies
OECD	Organisation for Economic Co-operation and Development
OeKB	Oesterreichische Kontrollbank AG
ÖHT	Austrian Bank for Tourism Development
OND/NDD	National Delcredere Office
PBK	Powszechny Bank Kredytowy
PFI	Public Financial Intermediary
ROA	Return on Assets
ROE	Return on Equity
SME	Small- and Medium-sized Enterprise
SNI	Société Nationale Immobilière
UK	The United Kingdom
USA	The United States of America
WBK	Wielkopolski Bank Kredytowy
WFZ	Waarborgfonds voor de Zorgsector
WSW	Waarborgfonds Sociale Woningbouw
WTO	World Trade Organisation

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- VOEB ([www.voeb.de](http://www.voeb.de))
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### About EAPB:

The European Association of Public Banks is the European banking association that represents public banks and funding agencies and their specific tasks at the European level. EAPB has several members from various European countries representing about 100 financial institutions. EAPB members constitute an essential part of the European financial sector, in which they play a decisive role with a market share of approximately 15 %, a balance sheet of about EUR 3.500 billion and around 200.000 employees. Members of the EAPB are financial institutions, funding agencies, public banks, associations of public banks and banks with similar interests.  
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# Public Financial Institutions in Europe

This research aims at improving the understanding of the variety and the roles of publicly influenced financial institutions in the 27 EU Member States, Croatia, Macedonia, Norway, Switzerland and Turkey. While most previous studies on public banks rely on existing global databases or local data, the authors constructed a structured, definition-based database of public banks and credit institutions in Europe.

Based on this unique database, the authors depicted varied patterns of financial institutions with public involvement across Europe. Clusters of countries adopting distinctive models are described.

Furthermore, the research shows the extensive range of roles fulfilled by the public financial sector and the need of a number of business models, each of which is geared towards effectively fulfilling one or several specific public-interest mission(s).

The reader of this book will get an understanding of who the public financial institutions are, what they do, why they exist and of how they operate in Europe.