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Development banks, risk and basle ii: some assessments¹Rogério Sobreira²

Abstract:

The implementation of the Basle II agreement in the financial markets of world economies has been seen as a significant advance in relation to the model enforced under the first agreement (Basle I). It is generally understood that the new agreement represents a substantial advance in relation to the first because it allows banks to better deal with the risks to which they are exposed. Nevertheless, when the application of these principles to development banks is considered it can be noted that certain inconsistencies exist, notably the fact that these institutions are typically public institutions – or at least strongly dependent on public funding – and they do not operate the payment system of the economy. Therefore, the application of the Basle rules to these institutions does not make sense. This means that Basle does not represent an appropriate set of recommendations for how these institutions should deal with their risks, whether because the proposed form of dealing with risks is inadequate, or because other relevant risks for these institutions are not covered by Basle I and II.

Key words: development banks, Basle II, risk

Resumo

A implementação do Acordo de Basiléia II nos mercados financeiros das economias mundiais é visto como um avanço significativo em relação ao modelo implementado no primeiro acordo (Basiléia I). É comumente entendido que o novo acordo representa um avanço substancial em relação ao primeiro porque ele permite aos bancos lidar melhor com os riscos aos quais eles estão expostos. No entanto, quando se considera a aplicação desses princípios para bancos de desenvolvimento nota-se que certas inconsistências existem, notadamente o fato de que essas instituições são tipicamente instituições públicas - ou pelo menos fortemente dependentes de recursos públicos - e que não operam o sistema de pagamentos da economia. Portanto, a aplicação das regras de Basiléia para essas instituições não faz sentido. Isto significa que Basiléia não representa um conjunto apropriado de recomendações a respeito de como essas instituições deveriam lidar com seus riscos, seja porque a forma proposta de lidar com os riscos é inadequada, seja porque outros riscos relevantes para essas instituições não são cobertos por Basiléia I ou II.

Palavras-chave: bancos de desenvolvimento, Basiléia II, risco.

¹ This paper is based on the discussions that took place among a group of researchers – Fernando Cardim Carvalho, Jennifer Hermann, Mário Rubens Filho and Mauro Santos Silva, and the author himself – during their work for the Brazilian Development Bank (BNDES). Thus, I would like to acknowledge their contributions to the discussions and opinions. However, all the usual caveats apply.

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1. Introduction

The implementation of the Basle II agreement in the financial markets of world economies has been seen as a significant advance in relation to the model enforced under the first agreement (Basle I). It is generally understood that the new agreement represents a substantial advance in relation to the first because it allows banks to better deal with the risks to which they are exposed, notably credit, market and operational risks.

Both the original agreement and Basle II have the essential concern of avoiding the excessive exposure of banks to the risk of bankruptcy, with perverse reflections for the banking system, especially because typical commercial banks are the institutions responsible for the payment system of economies and as a result the bankruptcy of one institution could unleash a domino effect for the banking system as a whole, with perverse consequences for the economy.

Nevertheless, when the application of these principles to development banks is considered it can be noted that certain inconsistencies exist, notably the fact that these institutions are typically public institutions – or at least strongly dependent on public funding – and they do not operate the payment system of the economy. Therefore, the application of the Basle rules to these institutions does not make sense.

However, this does not mean that these institutions should not deal appropriately with the risks to which they are exposed, but rather that Basle does not represent an appropriate set of recommendations for how these institutions should deal with their risks, whether because the proposed form of dealing with risks is inadequate, or because other relevant risks for these institutions are not covered by Basle I and II.

In relation to the rest of this text Section 2 will discuss an appropriate concept of development banks, showing that there does not exist a general theory of development banks, but highlighting some important differences between banks in general. Section 3 presents some of the essential elements of Basle I and, more especially, Basle II. Section 4 discusses how appropriate the implementation of Basle II is for development banks. Section 5 presents the conclusions.

2. Development banks: some concepts

Development banks are by definition institutions concerned with national economic development. Unlike multiple and commercial banks, however, there is no theory capable of precisely defining what a development bank is.

Therefore, by associating the figure of the development bank with its functionality for national development, it is not possible for us to identify a single model or a typical form of a national development bank (Diamond, 1957)

The reason why it is practically impossible to create an economic theory of development banks lies in the fact that the national development process in countries is different and has different matrices.

We can thus state that development banks are by nature financial institutions designed to meet specific demands, related to the economic development process, where, to what extent and in the way that society defines. Therefore, they are hybrid financial institutions that reflect, as well as the objective conditions of national economic development, the socio-economic profile of the countries where they operate.

In order to try to reach a concept of development banks, it is necessary to first advance in the understanding of the nature of development banks on three fronts: historical, conceptual and theoretical.

2.1. Origins of development banks: first experiences

As Diamond noted (idem, p. 20), at the beginning of the nineteenth century in Europe, and especially in Great Britain, there was no need to create an institution that would provide long term funding for investments. This was a result of the capacity that companies had at that time of raising their own funds to finance investment, as

well as the reduced amount of long term capital required at the beginning of the industrial revolution for industrial ventures.

This scenario was not observed in the European countries that followed Great Britain in the industrial revolution (Diamond, idem; Gerschenkron, 1962). In these cases, “[t]he capital required to make the critical jump from a small to a large enterprise or to create a new enterprise on a large scale was greater than the banks could provide, even when they were willing to provide long-term finance.” (Diamond, idem, p. 21).

The resolution found was the creation of a capital market, through which companies could issue shares and bonds to finance their investment needs. In this environment commercial banks came to perform a central role, since they began to actively invest in activities that required a large investment of capital. These banks began to act as investors. As noted by Diamond (idem p. 23):

“The novelty of these institutions lay in their combination of joint-stock organization, emphasis on long-term investment, power to mobilize resources through the issuance of bonds and promissory notes and (...) vigorous promotional activity.”

According to this model, the banks were responsible for launching and financing commercial and industrial companies. For these institutions deposits were of secondary importance. They kept close contacts with the investor public, both directly and through commercial banks.

Thus, between the end of the nineteenth century and the First World War the development banks created in Europe were largely owned by private capital and concentrated their resources in large companies. It is important to note that the French model of the development bank – based principally on *Crédit Mobilier* – generated a series of its own institutions in the capital market to stimulate the development of the economy.

After the Second World War various development banks were created whose principal characteristic was the important role governments played in them. As once again noted by Diamond (ibid., p. 39):

“[T]hese institutions have specialized in one particular field of activity, have usually (and, as time has gone by, increasingly) been sponsored by governments, have generally had government aid in the form of share capital or low interest or interest-free loans or guaranteed bond issues, and have often been under government direction or have had government representation on their policy-making bodies.”

As a result the institutions created in this period maintained a strong relationship with national development plans for industry and agriculture. Therefore, despite the role played by the government, the institutions were created obeying a basic rule, which was that the allocation of long term resources should be made through financial institutions guided by a logic of private operation³ instead of the direct allocation of these resources by the government.

This period also saw the emergence of a series of development banks in developing countries, notably in Asia.

From the moment when the principal development banks created during the twentieth century became institutions that depended on public funding, it can be said that they intermediated fiscal resources for the projects chosen, in other words, these institutions could not be openly seen as banks, either because the funding was hegemonically public or because the choices made involve criteria other than the pure and simple search for profit. In fact these institutions sought to obtain positive externalities since projects were chosen on the basis of broader criteria than profit alone.

Since the 1980s a greater diversification of operations has been observed among these institutions, as they moved away from being simply lenders to industry (Bruck, 2001, p. 131). Changes also occurred in the way that banks were financed, although government funding continued being extremely important in the cases in question (Bruck, idem, p. 132).

³ By the logic of private operation, we want to refer not simply to the search for profit, but to the quest for efficiency that characterizes the concession of credit by a financial institution in comparison with loans made directly by the government.

Another aspect that needs to be mentioned is that in the post-war period development banks became more important institutions in developing countries, in contrast with the role they performed in the central countries. Also noted was a gradual move of emphasis from base industries to technological modernization. This fact reflects, without a doubt, a characteristic of these institutions, which is that they are accessories to the development process. This is the reason why they have been losing importance in central countries and are still essential in developing countries.

2.2. Development banks and the role of the state in the financial market

The analysis of the historical experiences of development banks becomes confused with the discussion about the role of the state and public banks in the financial market. The emergence of these institutions, thus, starts with the consensus that some type of government intervention in the financial market should exist, in order to increase its efficiency in the allocation of resources and to reduce the level of risk to which financial institutions are exposed and in the ultimate instance to favor economic development.

As a result, the constitution of public banks – including development banks – is seen as one of the ways that the state can act in financial markets, but not the only one. Other alternatives are market supervision; the contracting of private services by the government; the formulation of financial policies with specific objectives aimed at the financial market or for selected productive sectors, or a combination of these forms.

The principal justification of the state's actions in the financial market is based on two distinct approaches: (a) the market failure model; and the (b) Post-Keynesian model.

The market failure approach starts with the criticism of the hypothesis that markets – whether financial or not – are efficient. Market failures are seen as transitory or permanent conditions that prevent the efficient operation of some markets and, thus, prevent the prices and volumes traded from reflecting the relevant set of information about the benefits, costs and risks that guide the behavior of supply and demand.

In this approach financial markets are characterized as markets where asymmetrical information exists and in which imperfect competition rules, amongst other market failures. In this environment risk evaluation and compensation difficulties will exist, especially in the case of the capital market, regarding long term credit in general and credit for small and mid-sized companies, as well as for the financing of R&D and investment in innovation. It is as a form of supplanting these problems that the need emerges for the state to intervene in these markets (Sobreira, 2005).

According to this approach it is possible to implement proposals with a more interventionist nature, basically in the form of directed credit policies, supported by public resources and the creation of development banks and public banks in general. Nevertheless, also according to this approach, development banks in particular do not figure as explicitly recommended forms of action (Stiglitz, 1998, p. 9). Even so it is possible to justify the actions of public banks based on the credit rationing model – which results from the assistance of asymmetrical information and the limited risk propensity of banks. Under these conditions credit incentive policies for groups suffering from rationing can be implemented through public banks.

The Post-Keynesian focus is similar in part to the market failure approach, but by emphasizing uncertainty in the trading of rights over future income – and, therefore, emphasizing the fact that at the moment when the financial decision has to be taken some relevant information simply does not exist and what is in play is not a problem of the cost of or access to information – it affirms that there is no guarantee of the efficient allocation of resources (Kregel, 1980).

As a result the resources developed by dealing with uncertainty and its effects on the financial market have limited effectiveness, maintaining the condition of the inefficiency of the financial market from the micro-economic point of view. In this way individual attempts at protection become the source of macroeconomic inefficiency.

According to this focus this fact justifies the regular actions of the government in the financial market in order to reduce macroeconomic instability, thereby reducing the level of uncertainty that affects the financial market,

and controlling the financial fragility of the system and finally by containing the short-term tendency of the financial market (Carvalho, 1996; Studart, 1996). Also justified is the regular action of public and development banks as forms of expanding the macroeconomic efficiency of the financial market.

This is due to the fact that the government is subject to the same information limitations associated with uncertainty that hinder the calculation of the probability of the success of certain ventures by the private sector. In these cases the only form of compensating the incompleteness of the financial market in the sectors most affected by uncertainty is for the government to directly assume the risk that the private sector prefers not to.

One of the principal functions of development banks in this focus is the assumption of risks in sectors with important positive externalities for economic development.

This function implies two important differences between development banks and private financial institutions in relation to the administration of risks. First, development banks need to develop risk control strategies distinct from those used in the private sector, since the nature of these risks is different in the two types of institution. Second, development banks should be submitted to distinct rules of prudential risk control.

It is also worth noting that more indirect forms of state action in the financial market are advocated by a group of theories that suggest market freedom (financial liberalization theories), according to which the state should act to reduce market failures and the level of uncertainty that affect financial markets to inoffensive levels. This is the case of prudential regulation policies aimed at the reduction of systemic risk.

2.3. Development banks: some concepts

Based on the elements presented in the two previous sections, it is possible to advance a concept of development banks. As has already been noted, this is not intended to be a general theory, but rather is necessary to allow a discussion of the risks associated with the operations of these institutions and the adequacy of implementing the rules of Basle II by these banks.

Development banks can be classified as one of two types: in the first type the development bank is merely seen as a financial institution. In the second it is seen as a hybrid institution, with multiple functions associated with the development process.

According to the more restricted focus the development bank assumes a passive posture in relation to the development process, acting as a bank whose function is to meet the demand for funds spontaneously generated by ongoing investment and not met in any satisfactory form by the existing financial system. This is typically the focus of market failures as presented above. In this case the financing of repressed demand by long term credit is the principal function of a development bank.

In the broader focus (Bruck, 2001 e 2002; Pena, 2001; UN-Desa, 2005), development banks participate more actively in the development process. These institutions anticipate demand, identifying new sectors, activities, products and/or strategic productive processes for national development and generating programs (whether or not they are prepared by the bank) for investment in these areas.

Furthermore, in the more restricted focus, the development bank – despite the fact that it complies with the requirement of functionality for economic development – ends up acting in a pro-cyclical form with the same dynamics as a private bank. Therefore, its operations expand during expansive phases of the economic cycle and contract during recessive phases.

According to this focus the functionality of development banks during contracting phases is seriously compromised. It is in this phase when the estimated risk of new investments is elevated, at the same time that the incentive for the assumption of risks falls. Therefore, the role of a development bank becomes of extreme importance.

What is desirable is that the development bank plays an anti-cyclical role, i.e., that it is capable of counterbalancing the loss of dynamism of private investment, notably the most innovative investment. In other words, it is up to development banks not only to meet the already existing demand for long term funds not met

by the financial system, but also to stimulate new demand through the implementation of investment stimulation programs in sectors considered to be strategic.

In these cases the development bank acts simultaneously as a bank that provides credit and as an agent that promotes development, also assuming functions of a macroeconomic nature – planning, the formulation and/or implementation of national policy. These functions are difficult, if not impossible, for private financial institutions to implement, thus the predominance of government capital is naturally imposed in this case.

Therefore, it is not only the focus on long-term financing, or the financing of important sectors for economic development in a determined period, that distinguishes a development bank from other types of financial institutions. It is the commitment of financial aid to the national economic development process that differentiates it from other institutions which might come to exercise this function. As a result the predominance of the public sector in the structure of capital and, consequently, in the management of development banks is not a mere historical detail, but is something that has to be considered as one of the defining aspects of this type of institution.

3. Basle II

When prudential regulation behavior is analyzed it can be noted that this fundamentally applies to commercial banks, in other words to those institutions that operate the payment system.

The Basle Agreement (Basle I) was a response to a belief that the principal threat to the stability of the banking system came from credit risks accepted especially, but not exclusively, by US banks. The focus of Basle I was precisely credit risks and its main form of action was imposing the creation of a minimum level of owned capital proportional to the exposure of the bank to credit risks.

Basle I functioned in an adequate manner if we consider that its aim was to equalize the competitive conditions of internationally active banks in relation to the costs of obedience to the regulations. Any other lens through which Basle I is analyzed shows an agreement that is quite unsatisfactory in its terms. Both as the codifier of prudential practices and as the inducer of advances in the risk administration methods used by banks, Basle I did not reach a minimum level of efficiency.

As a piece of prudential regulation, the agreement is flawed, since the risk categories - 0%, 25%, 50% and 100% - are excessively broad. As an inducer of improvements in the methods of risk administration the agreement is, in the best of hypotheses, innocuous. This is because there is no stimulus for banks to invest resources in their own models of risk contention, since this will not result in any alteration in relation to the capital that the institution should accumulate, because the risk classification is given externally to the bank.

Basle II, in contrast, was designed with another philosophy, which was to encourage the regulated institutions to adopt more advanced methods of risk administration. For this reason it was decided that the new regulation system should operate through the creation of incentives for the adoption of more advanced methods of risk management, similar to those of the market. Therefore, for the three risks which Basle II is concerned with – credit, market and operational – alternative adjustment possibilities are defined depending on the investment each bank makes in its own measurement and risk control models. The expectation is that more sophisticated methods of measurement and risk control will lead to the creation of ever smaller coefficients of capital, allowing the most advanced institutions to save capital.

The main purpose of Basle II is not, however, the adoption of specific models of risk administration, but rather the creation of incentives that can induce banks, at their own decision, to seek continuous improvements in their methods of dealing with the problem. Basle II, thus proposes the objective of molding the operation of financial markets in such a way that banking institutions seek at their own initiative and interest to reduce their exposure to credit, market and operational risks.

4. Basle II and development banks

As noted in Section 2, development banks cannot be characterized in a satisfactory manner in a general definition. Nonetheless, it is possible to identify some of their characteristics that can be found with reasonable frequency.

The principal characteristic is the mission of providing long term loans to finance investment in companies. This mission is justified by the fact that many economies do not have long term financing channels for productive investment, as well as by the reluctance of private financial institutions to provide finance for investments that can generate positive externalities for the economy or for activities in which the presence of significant economies of scale require that investments be made on a large scale.

Since these are the principal activities of a typical development bank, the principal risks involved in its operations are credit and operational risks. For this reason Basle I and Basle II can in principle serve as guides for the formulation of risk administration policies by this type of institution.

Nonetheless, as has already been noted, Basle I did not have the intention of promoting the improvement of risk administration methods in financial institutions in general. Thus, development banks do not come under the definition of internationally active banks, the object of the 1988 agreement, nor do they operate in competition with these banks.

In relation to Basle II, development banks are not authorized to accept deposits and as such are not subject to systemic risks, a fact that makes Basle II in principle innocuous for these institutions. On the other hand, as a credit risk administration instrument, the provisions of Basle II are at the same time both complex and simplistic, since they do not propose alternatives for the measurement and administration of credit risk, validating only the existing models.

It should also be observed that the capital of the majority of development banks consists of funds with a public origin. As a result increasing capital is a fiscal problem, not a capital market one. The limits of these institutions are not a decline in the private evaluation of their perspectives, but a possible refusal by fiscal authorities to increase their capital, which can result from many factors that have nothing to do with the vulnerability of the institution, not only credit risks, but also market and operational ones.

Another aspect refers to the fact that Basle supposes that the administration of the bank can determine its asset policy, both in terms of the resources looked for and in terms of the risks incurred. Basle, by imposing limits, sought to operate precisely through these decisions. As a result, its application to development banks supposes that the directors of these institutions are capable of determining autonomously the profile of acquired assets in relation both to return and risk. This, however, is not the case for many development banks, whose asset policy is circumscribed by economic policy decisions taken at higher levels of power, or are contained in the statutes. In this case Basle II does not contribute to improving the risk administration of the institution.

5. Conclusion

The application of the rules of Basle II – or even Basle I – to development banks finds a serious obstacle in the particularity of the functions of these institutions.

Their operational logic is not the same as the private financial sector, nor are these institutions subject to the occurrence of systemic risk, therefore the application of the agreement rules to them is not relevant.

The limits applied to the activities of these institutions cannot be the same as applied to commercial banks. Furthermore, their nature as state bodies – and not as banks – suggests that more important than risks that can threaten to bankrupt the institution are events that compromise their capacity to exercise the functions for which they were designed.

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