



# International Experience with Policy Lending

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# Outline

- What is policy lending and who lends?
- Performance of state-owned banks in other countries
- How to manage policy lending
- Dealing with the quasi-fiscal risks
- Two cases: Turkey and Uruguay
- Extent of policy lending in China



# What is policy based lending?

- Directed credit: banks required to lend to specific borrowers with low credit ratings (e.g., farmers) or to risky activities.
- Subsidized lending: lending at below market interest rates
- Guarantees: governments may provide explicit or implicit guarantees for lending



# Who extends policy loans?

- Its not just policy banks
- Commercial banks with state ownership are often used for policy lending
- Often difficult to distinguish extent of policy loans if commercial banks are involved



# Why use policy lending rather than direct budget support?

- Gaining political support for explicit lending from the budget is more difficult than providing funds through the banks, where the costs are hidden
- Banks may be able to raise funds at a lower cost than the government
- Some foreign lenders have a preference for lending to state-owned banks rather than directly to government, as it involves less red-tape



# How have state-owned banks performed in other countries?

- Poorly
- 1/3 made losses over 3 years to 2003 based on IMF survey of state-owned banks in 25 countries covering 100 institutions
- 1/3 had NPLs > 10 percent of loans
- Capital injections were common, with banking crises having the potential to lead to fiscal crises



# How to manage policy lending?

- Poor performance of state-owned banks suggests it's better to limit the extent of policy lending
- But if governments decide to continue to use policy banks, they need to be managed well to ensure objectives are achieved and the costs are transparent.
- Key measures in managing the policy banks include
  - well-defined mandates for policy banks
  - independent and strong supervisor
  - new activities should require pre-approval by supervisor
  - minimum capital requirements
  - adequate credit policy and internal controls
  - greater fiscal transparency



# #1. Well-Defined Mandate and Budget

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- Policy Banks are vulnerable to “mission creep”
  - Lack constraints imposed by market discipline
  - Often unlimited demand from constituents for credit services
  - Encourages rapid expansion; lowering of credit standards
  - May expand into areas beyond level of expertise
  - Avoid unintended weakening of private banking market



## #2. Supervisor Needs a Clear Mandate and Adequate Authority

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- supervisor needs operational independence
- Adequate budget and qualified staff
- Legal authority to obtain information and require periodic reports
- Authority to investigate and maintain confidentiality of sensitive information



## #3. New Activities Should Require Pre-approval by Supervisor

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- Scope of operations should be defined in authorizing legislation
- New activities and substantive changes in existing credit programs should be reviewed and approved in advance by supervisor



## #4: Minimum Capital Requirements

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- Helps prevent rapid credit expansion
- Measure of the “cost” of providing the credit services
- Provides basis for private sector comparison
- Cushions unexpected demands on fiscal resources



## #5 Adequacy of Credit Policies and Internal Controls

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- State financial institutions should have written policies and procedures governing credit extensions including:
  - Eligibility requirements for recipients of credit
  - Credit approval procedures and responsibilities
  - Internal loan review process
  - Periodic internal audits testing implementation



## #6 Improve fiscal transparency

- IMF Manual on Fiscal Transparency—“important to identify and where possible quantify and report information on quasi-fiscal activities”
- Policy lending is a key quasi-fiscal activity
- It should be reported in the budget as a fiscal risk
- But transparency is not an end in itself
- Transparency would help subject policy lending to the same scrutiny as on-budget fiscal activities
- Explicit provisions should be made in the budget for the full quasi-fiscal costs of policy lending, calculated on a forward looking basis



# Case study: Turkey

- Subsidized lending was the main quasi-fiscal activity conducted by two state-owned banks. One bank provided cheap loans to farmers, the other to SMEs
- High profits for all banks in the mid 1990s allowed them to cover losses incurred in their quasi-fiscal operations
- But in the late-1990s, higher real interest rates led to overall losses. The banks and debtors realized that all losses would be covered by the government budget, so bad loans rose rapidly.
- Subsidized lending was scaled back in 2000 and was allowed only if backed by allocations in the budget.
- Recapitalization of these banks cost 15 percent of GDP.
- This was combined with restructuring and downsizing to improve the financial position of the banks.



# Case Study: Uruguay

- Two state-owned banks accounted for  $\frac{1}{2}$  of total lending
- They provided subsidized loans to farmers and cheap mortgages to low-income earners
- Profitability of these banks was low and NPLs high relative to private banks, even before the 2002 crisis
- The quasi-fiscal activities had a significant macroeconomic impact.
- But calculating the quasi-fiscal costs is complicated and depends on assumptions about the recovery rate on private sector lending.
- On a flow basis, quasi-fiscal activities averaged 1 percent of GDP per year in 1996-2002, equivalent to  $\frac{1}{3}$  of the explicit budget deficit
- The loss of government equity in these two banks amounted to 12 percent of GDP in 2000-2002



# China's Policy Banks

- Three banks were set up to undertake policy lending—China Development Bank, Agricultural Development Bank and Ex-IM Bank
- Policy bank loans comprise 15 percent of GDP
- The quasi-fiscal risks of such lending are not transparent. Earlier analysis by Singh and others (2003) noted the difficulty of estimating the quasi-fiscal component of such lending.
- But they suggest including such lending in the fiscal accounts, given its policy purpose. They also suggest a broader approach by assessing the policy lending of other state-owned banks.
- Policy bank credit growth has been fast, in excess of 20 percent in 2005, 1½ times faster than for commercial banks.
- The rapid growth of credit suggests that the risks of policy lending may have increased
- This underlines the need for a more explicit assessment of the quasi-fiscal risks in the budget



# Closing comments

- Policy lending that benefits specific activities are nontransparent and have potentially hidden fiscal costs
- If they cannot be avoided, best practice would be to
  - Clarify the lending mandates of policy lenders
  - Strengthen supervision
  - Enforce minimum capital requirements for policy banks
  - disclose the policy lending for parliamentary approval
  - provision for costs in the budget