REVIEW OF STATE-OWNED BANKS
IN BELARUS

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EXECUTIVE SUMMARY

The financial sector in Belarus is dominated by four public banks – the Belarusbank, Belagroprombank, Belinvestbank, and Paritetbank. These banks (the public banks) account for 65% of total assets in the banking system. They also account for two-thirds of total deposits and provide 60 percent of total credit. Their dominance is particularly higher in sectors targeted by government programs, including agriculture, housing, and manufacturing.

The public banks play an important role in Belarus through lending under government programs (LGP). LGP is a well-established practice through which the government directs subsidized credit to some sectors, groups, and projects. LGP is attractive for the public banks because it is often 100 percent guaranteed by the central and local governments. Currently, LGP accounts for more than 60 percent of total bank lending.

However, LGP has imposed some challenges to the public banks and the economy. These include liquidity pressures, crowding out of private banks, macroeconomic instability due to excessive credit growth, and moral hazard. LGP also represent a significant fiscal cost in the form of settlement of credit guarantee claims and constant recapitalizations of the public banks. Furthermore, LGP has made the public banks highly dependent on government funding.

Weaker corporate governance imposes additional challenges. Supervisory boards of state-owned banks are dominated by public officials who at same exercise ownership functions; typically, these board members lack bank experience and are not independent. Appointed board members are not vetted by the central bank. The ownership function appears to be fragmented, with various government institutions playing ownership function in state-owned banks. This leads to weaker accountability for the performance of the public banks and raises the possibility of conflicting policy priorities.

In order to address some of the above challenges, the government of Belarus has taken steps to reform the funding structure of LGP and the role of the public banks in their implementation. But there are many questions surrounding the future of the public banks including their role in the implementation of government programs, funding, and willingness/incentives to transfer their LGP portfolios to the newly established Development Bank of Belarus (DBB).

There also questions about the mandate/role of the new development bank. It appears that – contrary to original goal of using the development to contain excessive growth by limiting its available resources to above the line budget allocations – the government is considering granting

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1 This note was prepared by Carlos Leonardo Vicente, Jose De Luna Martinez (both FPD –FFSDR), and Nataliya Lutsenko, ECSF1.
the development bank a broader mandate (including enough flexibility in terms of funding and product offer). This would practically make the DBB another universal bank.

Moreover, there are unanswered questions regarding the regulation and supervision framework that will apply to the development bank, its lending model, corporate governance structure, policy mandate, funding structure, etc. These are critical issues that require an urgent answer. Otherwise, the DBB the sustainability of the DBB is likely to be jeopardized.

The following are the recommendations to strengthen state-owned banks in Belarus:

For all state-owned banks:

- Strengthen corporate governance. Appoint independent board members with solid banking expertise; limit the number of government officials in supervisory boards; give powers to the NBRB to vet all appointments to the supervisory boards of state-owned banks.

- Strengthen the ownership function by empowering the State Property Committee to act as the sole shareholder representative.

- Set performance targets and hold supervisor y and management boards accountable for the achievement of targets

For the DBB:

- Narrow down the policy mandate, outlining the specific market gaps that the DBB is expected to fill.

- Require the DBB to cooperate with private sector, achieve self-sustainability, and undergo periodic review of its mandate.

- Adopt a wholesale model. The DBB should lend indirectly by wholesaling funds to both public and private banks. This would level the playing field, lessen possible funding constraints on the public banks, and minimize the risk of competition between the DBB and existing banks.

- Adjust current LGP practices: make participation in LGP voluntary; require banks to take full credit risk; use partial credit guarantees to encourage riskier LGP and price the guarantees at market prices
• Empower the DBB to fund itself from the market. In parallel, discontinue direct, LGP-related government funding to the public banks

• Clarify the procedures for the transfers of LGP portfolios from the public banks to the DBB. Make the procedures flexible and market-friendly, allowing the public banks and the DBB to keep/acquire only the portfolios they want.

• Place the DBB under the supervision of the NBRB
I. INTRODUCTION

1. This note reviews state-owned banks in Belarus and offers recommendations on how to strengthen them. It covers the Belarusbank, Belagroprombank, Belinvestbank, and Paritetbank (the public banks), and the recently established Development Bank of Belarus (DBB). Recommendations focus on corporate governance, funding, ownership function, mandate, lending models, and regulation and supervision.

2. The note is based on information provided by the public banks, the Ministry of Finance, and the NBRB. However, due to their unavailability, the team did not hold meetings with the DBB and the Ministry of Economy. Thus, the analyses concerning the DBB are based on the review of its law as well as on discussions with the Ministry of Finance and the NBRB.

3. The note is organized as follows: after this introduction, Section II presents an overview of the public banks in Belarus and the role that they play in the local economy; Section III discusses the details of Lending under Government Programs (LGP) and the importance for the public banks of the funding attached to these programs; Section IV analyzes the key features of the DBB, offering recommendations on how strengthen it; and Section V concludes.

II. THE BELARUSIAN ECONOMY AND THE BANKING SYSTEM

A. Overview

4. During 2011, the Republic of Belarus faced serious macroeconomic challenges. The ruble-dollar exchange rate depreciated by 178 percent between January and December 2011 and year-on-year inflation reached 110 percent in January 2010. Real GDP growth declined to 5.3 percent from 7.7 percent in 2010. This unstable macroeconomic scenario affected the banking system, eroding the capital of banks, profitability ratios, and the quality of banks’ assets.

5. The banking sector in Belarus is dominated by the public banks. At the end of 2011, there were 32 banks including 26 with foreign participation and 5 owned by the State. State-owned banks accounted for 65 percent of the banking sector assets in 2011 (Figure 1), down from 71 percent in 2010. They also accounted for 84 percent of total capital, up from 73 percent in 2010. This increase in capital share is a result of a BYR14.5 trillion capital injection by the government of Belarus into state-owned banks in December 2011.

6. Financial deepening has increased and access to finance by firms compares to regional average. Private credit to GDP rose from 8 percent in 2001 to 54 percent in 2011,
mostly due to a rapid expansion of LGP in 2010-11. Total bank credit stood at BYR150 trillion (US$18 billion) after growing at an annual rate of 167 percent in ruble terms (but contracting by 40 percent in dollar terms). In 2008, 33 percent of all firms and SMEs reported having a line of credit from a formal bank – this was the average level of access for the ECA region.

7. **The banking system remains sound – but there are uncertainties with regard to quality of loan portfolios.** The system-wide capital adequacy ratio stood at 24.7 percent in end-2011 after falling from 20.4 percent in end-2010 to 14.9 percent in end-November 2011. The NBRB plans to increase the minimum capital of non-bank financial institutions to €25 million – the same minimum for banks. This will likely boost capitalization levels across the system. Non-performing loans (NPLs) fell marginally to 3.6 percent in the first quarter of 2012 after increasing to 42.2 percent in end-2011. However, the loan classification in Belarus does not follow international standards, raising doubts about the true level of NPLs. Finally, the percentage of loans that are classified as “under watch” has risen from 3.6 in 2010 to 13.6 percent in the first quarter of 2012, indicating a worsening of credit quality.

**B. Role of the public banks**

8. **There are four public banks in Belarus, including the Belarusbank, Belagroprombank, Belinvestbank, and Paritetbank.** These are universal commercial banks established under the banking code and with no explicit policy mandates. In practice, however, these banks have been entrusted with the implementation of government programs. They offer a wide range of banking services and products, including deposits, credit, payment services, foreign exchange transactions, securities trading, etc. All are first-tier institutions, meaning that they deal directly with the general public.

- **Belarusbank** was established in 1995 as a result of the merger between the Savings Bank of the Republic of Belarus and the Belarusbank Joint Stock Commercial Bank; the latter had been established in 1922. Belarusbank is the largest Belarusian bank in terms of assets and client base. In end-2011, it had US$ 12.6bn in assets or 40 percent of the banking system’s assets. It also had 1789 branches and 135 regional offices. The bank is active in LGP, particularly in the residential construction sector.

- **Belagroprombank** is the second largest bank is Belarus and it had US$ 5.9bn in assets or 24 percent of market share in end-2011. The bank was established in 1991 through the conversion of the Belarusian branch of the Agrobank of URSS. It participates in the implementation of government programs since 1996, focusing on the agricultural sector – particularly financing of agricultural equipment and construction of milk farms. Belagroprombank’s branch network includes 221 outlets, 56 local branches, and 7 regional branches.
• **Belinvestbank – Belarusian Bank for Development and Reconstruction** resulted from the merger in 2001 between the Belorussian Development Bank and Belbusinessbank. In 2011, it accounted for five percent of the total bank assets and was among the six largest banks in Belarus. In addition to the implementation of government programs, the bank acts as the agent of the government for the servicing of foreign loans, including those from the World Bank. 68 percent of Belivenstbank’s loans are allocated to large corporate in the industrial sector.

• **Paritetbank** is the successor of Bank Poisk which had been established in 1991. In 1999, the NBRB became the major shareholder of the bank. It is very small bank, with less than one percent of the system’s assets, loan portfolio, deposits, and capital. It does not participate in governments government programs and its privatization is in advanced stage.

9. **The public banks play a critical role in the economy due to their dominance of the banking system.** For instance, the four banks above account for two-thirds of total deposits (Figure 1), although their share has reduced by 6 percentage points from 2010 to 2011. They also provide 60 percent of total credit. In fact, their role is particularly important in sectors targeted by government programs, including agriculture, housing, and manufacturing.

**Figure 1. Share of the public banks in the banking system**

![Graph showing the share of the public banks in the banking system](source: NBRB; Bank staff calculations)
III. SALIENT FEATURES OF THE PUBLIC BANKS IN BELARUS

A. Lending under Government Programs

10. **Bank lending is highly influenced by the government through its lending programs.** LGP is a well-established practice through which the government directs subsidized credit to some sectors, groups, and projects. LGP targets are set in presidential and ministerial decrees. In theory, LGP is “recommended” but the public banks have no sufficient autonomy to disregard a decree from the President or the Council of Ministers. But some LGP is attractive for banks because it is often 100 percent guaranteed by the central and local governments. Currently, LGP accounts for more than 60 percent of total bank lending.

11. **The public banks finance government programs using three sources:** (i) resources allocated in the State budget, which are placed with them as low cost deposits; (ii) NBRB’s funding; and (iii) own resources (mostly deposits from customers and capital injections). Banks are entitled to interest rate compensation if they grant loans using their own resources. But no compensation is provided if they use government deposits. In some cases, the interest rate compensation is provided directly to the borrower by the Treasury. When this is the case, the compensation is calculated as the difference between the market interest rate charged by the bank and the one established under the government program.

12. **The two largest state-owned banks, Belarusbank and Belagrompombank, are the main implementers of government programs.** In 2011, LGP accounted for 74 and 30 percent of Belarusbank and Belagroprombank’s total credit to clients, respectively; this is down from 80 and 39 in 2010. Compensated loans make the bulk of LGP, particularly at Belarusbank which intermediates most of the LGP to residential construction.

13. **LGP is often guaranteed by the central and local governments.** According to the NBRB, the outstanding amount of guarantees stood at BYR 37.3 trillion in end-2011. This is equivalent to 50 percent of the total LGP. Local governments contributed with BYR23 trillion and the central government with the remaining BYR14.3 trillion. The NBRB monitors the allocation of guarantees in nine banks and under some government programs. Figure 2, panel 1, shows that the total value of outstanding guarantees increased fivefold over the last five years, from BYR 3.2 trillion in 2006 to BYR 20.2 trillion in 2011. This increase was due to a rapid growth of LGP. Belagropombank has the largest value of outstanding guarantees. Its share stood at 45 percent in 2011, down from 61 percent in 2008 (panel 2). Over the same period, Belarusbank’s share remained constant at around 35 percent while Belinvestbank’s increased from 3 to 14 percent.
Figure 2. Government guarantees and bank’s claims under LGPs

Panel 1. Outstanding and claimed guarantees
In BYR bn

Outstanding guarantees at the end of the year
Guarantees executed during the year
Claims as % of outstanding guarantees (right)

Panel 2. Evolution of the share of outstanding guarantees by bank

Belarusbank
Belagroprombank
Belinvestbank
Other banks

Source: NBRB

14. **LGP has imposed challenges on the public banks.** Firstly, banks have recorded losses due to high levels of NPLs in their non-guaranteed portfolios. Secondly, there have been liquidity shortages because the volume of government-stipulated lending targets did not match available resources. Thirdly, liquidity shortages were often addressed through monetary financing by the NBRB, fuelling excessive aggregate demand with negative consequences on price stability and current account balance.

15. **Moreover, LGP imposes significant costs on the economy of Belarus.** These include the settlement of guarantee claims, constant recapitalizations of the public banks, and distortion of the competitive environment in the financial sector.

- **Calls of guarantees have been on the rise since 2009 mainly due to the deterioration of the macroeconomic environment.** As Figure 2 (panel 1) shows, banks claimed BYR 1.9 trillion in 2011. Out of this amount, local governments paid BYR 1.3 trillion and the central government paid the remaining BYR 0.6 trillion. The claim rate – the claimed guarantees as percentage of outstanding guarantees – increased from 3 percent in 2009 to 9 percent in 2011. Belagroprombank has the highest claim rate, followed by Belarusbank.

- **In 2011, bank recapitalization totaled BYR 14.5 trillion or 5.3 percent of GDP.** And according to the IMF, bank recapitalizations averaged 1 percent of GDP during 2007-10.

- **Distortions of the competitive environment are significant.** So far, private banks have been kept out of the LGP. This means that, unlike their state-owned competitors, they
cannot access cheaper sources of funding and as result they can only do limited business with state-owned enterprises (SOEs) and households that are eligible to LGP. Moreover, the subsidization of interest rates and the issuance of full, cost-free, guarantees under LGP distort incentives for prudent risk management and undermine the credit culture.

16. **Going forward, the government intends to reduce LGP and streamline the implementation mechanism.** For the first time, the government published the ex-ante allocation of LGP per bank for 2012. As Figure 3 shows, the total volume of LGP is estimated at BYR 15.5 trillion². A bulk of the money will come from the repayment of existing LGP-funded loans. Sector-wise, residential housing construction received the highest allocation (48 percent), followed by agriculture (31 percent). With 54 percent, Belarusbank will continue to be the largest recipient of LGP allocated funding; the Development Bank and Belagroprombank come in second place with 23 percent each. As discussed below, the Development Bank will take over the LGP over time.

**Figure 3. Allocation of LGP by sector and by bank in 2012**

Panel 1. Allocation of LGP by sector

2012: BYR 15,509bn

Panel 2. Allocation of LGP by bank

2012: BYR 15,509bn

Source: Cabinet Ministers of Belarus,Resolution 385, April 23 2012; Bank staff calculations

**B. Funding structure**

17. **The funding structure of the public banks has been changing but deposits remain the main source of funds.** Deposits account for more than 50 percent of the funding of Belinvestbank, BelarusBank, and Paritetbank (Figure 4). Owner’s equity is the second largest source. At Belarusbank, its share has increased from 10 percent in end-2010 to 18 percent in end-

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² Banks will certainly allocate own resources to LGP; hence, the total LGP will exceed this amount.
2011 following last year’s capital injection. In line with the NBRB’s decision to discontinue its non-market lending to the public banks, the share of subsidized funding from the NBRB has decreased in all banks (except at Paritetbank). On the contrary, the share of debt securities has increased, apparently supporting IMF’s assessment that the NBRB replaced non-market operations with the buying of public banks’ securities in order to meet their funding needs.

**Figure 4. Sources of funds of the public banks**

Panel 1. **Belarusbank’s sources of funds** (April-12: BYR 109,956bn)

Panel 2. **Belagroprombank’s sources of funds** (April-12: BYR 49,961bn)

Panel 3. **Belinvestbank’s sources of funds** (April-12: BYR 15,486bn)

Panel 4. **Paritetbank’s sources of funds** (April-12: BYR 1,051bn)

Source: NBRB; Bank staff calculations

18. However, a significant share of deposits of the public banks is from the government and state-owned companies. This is not surprising given the structure of the Belarusian
economy and public bank’s reliance of government funding. For instance, in 2011 government deposits accounted for 21 and 28 percent of Belarusbank and Belagroprombank’s total deposits, respectively. Corporate deposits – which the majority belongs to state-owned enterprises – accounted for 21 percent of Belarusbank’s deposits and 28 percent of Belagroprombank’s. In both banks, the share of government deposits fell significantly from 2010 to 2011 (from 27 percent at Belarusbank and 48 percent at Belagroprombank).

19. **Capital injections have been a key source of funding for the public banks.** The government has injected capital into the public banks for several years, effectively allowing them to remain in business and to play their role in LGP. In 2011 alone, the government injected BYR14.5 trillion of new capital in three state-owned banks. This amount was distributed as follows: Belarusbank – BYR 12.9 trillion; Belagroprombank – BYR 1.6 trillion; and Belinvestbank – BYR 11.9 billion. Compared to previous year (2010), these capital increases correspond to 392 percent for Belarusbank, 36 percent for Belagroprombank, and 3 percent for Belinvestbank. However, the aggregated capital of the three banks has decreased in dollar terms.

20. **All in all, the public banks are highly dependent on government deposits, capital injections, and funding from the NBRB.** Given NBRB’s commitment to discontinue non-standard liquidity support and the expected transfer of LGP to the DBB, the public banks are likely to face funding strains. This calls for a reform of the public banks (including possible attraction of private capital) and for a wholesale development bank that can channel LGP-related funding through public and private banks.

C. **Corporate governance, supervision, and oversight**

21. **Weaker corporate governance is a key challenge facing the banking system (especially state-owned banks) in Belarus.** The supervisory boards of the public banks are dominated by government officials who include ministers and top leadership of regional executive committees. Appointed board members are not subjected to fit and proper tests by the NBRB, which has no vetting powers. As a result, the boards tend to be less active and less professional. There is a need to develop corporate governance standards for the banking system which among other things, should enhance the independence of directors and strengthen their role in strategic planning, risk management, etc.
Table 1. Composition of the Boards of Directors (Supervisory Board)

<table>
<thead>
<tr>
<th>Total board members</th>
<th>Belarusbank</th>
<th>Belagroprombank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government officials</td>
<td>11</td>
<td>?</td>
</tr>
<tr>
<td>Independent members</td>
<td>1</td>
<td>?</td>
</tr>
<tr>
<td>Institutional affiliation of the chairman</td>
<td>Minister of Finance</td>
<td>Deputy Prime Minister</td>
</tr>
</tbody>
</table>

Source: Bank’s annual reports and websites

22. The predominance of government officials in the boards of the public banks raises concerns about board independence and effectiveness. Board members are expected to act in the best interest of the public banks, sometimes by holding contrary views to those of the owners (government). In addition, they should be accountable to the owners for the performance of the public banks. This is only possible if the state ownership function does not overlap with the board stewardship function. However, the presence of high ranking government officials in the boards blurs the line between the two functions. High-ranking government officials would play more useful role by acting exclusively as owners, setting policy priorities and demanding results from boards that enjoy freedom in their decisions. Moreover, by virtue of their careers as public servants, public officials often lack bank-related skills and experience necessary to be effective board members. Hence, in order to foster transparency and accountability, the government should revisit the composition of the public banks’ boards with the aim to bring more independent board members with adequate banking skills and experience.

23. The Association of Banks has been working with the NBRB to address governance weaknesses. A new banking law has been developed and is pending approval by the parliament. This law contains provisions on corporate governance; including making NBRB’s guidelines on corporate governance and risk management binding on all banks that are subject to prudential supervision.

24. The public banks are supervised by the NBRB and are required to comply with the same standards as the rest of commercial banks. For example, as private banks, they are required to maintain a minimum capital of €25 million, a minimum capital adequacy ratio of 8 percent, and to observe a maximum exposure to a single borrower of 25 percent of capital. Moreover, when public banks violated some of these requirements due to the financial crisis, they were given the same timeframe as private banks to regain compliance.

25. The ownership function appears to be fragmented. Various government institutions – including the Presidency, the Council of Ministers, the Ministry of Finance, and the State Property Committee (within the Ministry of Economy) –play some sort of ownership function in state-owned banks. This leads to weaker accountability for the performance of the public banks and raises the possibility of conflicting policy priorities. The government should empower the
State Property Committee to act as a sole shareholder representative. Among other responsibilities, the shareholder representative would be in charge of improving communication between the state-owned banks and the owners; leading the review of mandates; setting quantitative and qualitative policy targets; and strengthening policy oversight, corporate governance, reporting, and performance monitoring. It should also act as the single point of contact between the state-owned banks and the owners.

F. The future of the public banks

26. **Plans to privatize smaller public banks are underway, but progress has been undermined by the financial crisis.** Paritetbank is in the final stage of privatization. Belinvesbank was close to be acquired by a reputable international banking group but the transaction did not proceed after the home supervisor urged the investor not proceed in the midst of the financial crisis.

27. The government has reportedly indicated in its five-year that it intends to retain the ownership of the Belarusbank and the Belagroprombank.

IV. THE DEVELOPMENT BANK OF BELARUS (DBB)

A. Origin of the DBB

28. **The DBB was established in 2011 by a Presidential decree, following a recommendation of the 2010 Financial Sector Assessment Program (FSAP).** The FSAP argued that LGP had undermined competition, crowded private sector lending, distorted incentives for effective risk management, and exacerbated the public banks’ dependence on government deposits. It recommended the establishment of a development agency which would receive all existing guaranteed loans and associated state funding from the public banks. This agency was envisaged as the exclusive source of funding for state development programs and its operations would be reflected in the state budget.

29. **Although the DBB has started to receive LGP-related assets from the public banks, key details about its role and business model are still being debated.** For instance, there is no definitive word on its mandate, organization, funding structure, pricing policies, lending model, and regulatory arrangements. Policymakers in the Ministry of Finance, the NBRB, and the Office of the Prime Minister are still debating the key features and functions of the DBB.

30. **This section presents some recommendations for the establishment and proper functioning of the new DBB.** These recommendations are based on the analysis of the law of the development bank as well as on discussions with the public banks, the Ministry of Finance,
and the NBRB. It is expected that these recommendations will help the authorities put in place a development bank that is financially self-sustainable, well administered, and able to contribute to Belarus’ long term economic development by financing only viable projects on a market basis.

### B. Current policy mandate

31. **Clear and narrow policy mandate is a key requirement for the success of a development bank.** However, it appears that the DBB has been established to address multiple and apparently conflicting policy objectives, namely:

- Resolution of bad assets of the public banks
- Containment of credit growth, and
- Access to finance at favorable terms by certain sectors while reducing the cost for the government

32. **In practice, the implementation of the three objectives above can become problematic:**

- *For instance, burdening the DBB with bad loans is likely to undermine its performance and bring it to insolvency status* unless the government is willing to write off these loans and inject sufficient amount of capital into the bank. Moreover, according to private banks, the removal of bad loans from the balance sheets of the public banks would unfairly strengthen the public banks’ competitive position unless they were no longer funded at very benevolent terms by the government.

- *Giving the DBB the dual role of a debt collection agency and lender might create institutional conflicts and distract staff and management from core lending activities.* A debt collection agency is an entity that specializes in managing and maximizing the recovery value of non-performing loans. Its functions, policies and procedures are completely different from an institution that specializes in originating new loans. According to the Ministry of Finance, the employees working for the DBB has so far devoted significant part of their time monitoring and trying to recover problems loans. As a result, the development of strategies and procedures for the DBB has been negatively impacted.

- *If allowed to operate as a universal bank, the DBB has a potential to engineer excessive credit growth and therefore contradict its “reason for existence”.* The government appears to be considering extending the mandate of the DBB beyond the primary objective of containing credit growth. As a universal bank, the DBB would be effectively an additional public commercial bank, offering the same range of products
and services as the Belarusbank, Belagroprombank, Belinvestment, and Paritiet. If this happens, this would not only increase the number of state banks but also their share in the economy.

- **Finally, the objective of maintaining access to finance at favorable terms while reducing the cost for the government may not be sustainable.** The government expects the DBB to reduce the cost of LGP because the bank will not be entitled to compensation when lending at below market rates. But this is only true if the DBB acts as an extension of Treasury (simply managing the funds allocated in the budget) and if all its costs are covered by the state budget. Otherwise, the DBB may run into financial problems since its income may not be enough to cover its operational costs. Thus, requiring the DBB to earn a sustainable profit by compensating it whenever it has to lend below its "sustainable interest rate" would be the only way to ensure its sustainability.

C. Desirable features of the DBB

33. **The goal of the DBB should be to promote sustainable access to finance by filling market gaps and crowding in private and public banks.** To achieve this objective, the design of the development bank in terms of its mandate, funding, lending model, regulatory and supervisory arrangements, and corporate governance, would have to be revisited as suggested in Table 2.
Table 2. Key features of the DBB

<table>
<thead>
<tr>
<th></th>
<th>Current – under the DBB Law</th>
<th>Desirable – team’s recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy Mandate</td>
<td>Multiple (and to some extent contradictory) objectives</td>
<td>Narrow objectives, complementing private and public banks by filling market gaps</td>
</tr>
<tr>
<td>Funding</td>
<td>Multiple sources of funding</td>
<td>Multiple sources of funding</td>
</tr>
<tr>
<td>Lending model</td>
<td>Retail (implicit), with potential competition with existing banks.</td>
<td>Wholesale-only institution, complementing existing banks</td>
</tr>
<tr>
<td>Pricing of loans and guarantees</td>
<td>Undefined</td>
<td>Market-based; if forced to lend at below market interest rates, compensation should be provided</td>
</tr>
<tr>
<td>Regulation and supervision</td>
<td>Undefined (not by the NBRB)</td>
<td>NBRB</td>
</tr>
<tr>
<td>Corporate governance (Board composition)</td>
<td>Government representatives</td>
<td>Include independent board members</td>
</tr>
<tr>
<td>Review of the mandate</td>
<td>Not foreseen</td>
<td>Review mandate periodically (e.g., every 10 years)</td>
</tr>
</tbody>
</table>

C-1. Mandate

34. **The mandate of the new DBB should be clear and narrow.** The law of the DBB should specify the target sectors or market segments that the new institution is expected to serve. Moreover, it should describe the intervention mode (lending instruments and financial products) that the new institution will use to achieve its goals. Finally, the new institution should be legally obliged to remain financially sustainable by achieving every year a minimum return on its capital or assets.

35. **The terms of the transfer of LGP portfolios from the public banks to the DBB need further clarification.** Although the government has issued guidance on transfer procedures, there appears to be different interpretations among the public banks and governments entities. Some public banks have transferred some loans (mostly those funded by government deposits) but there are generally reluctant to transfer more, arguing that most of the loans are of a good quality and therefore a reliable source of income for them. Moreover, the government will have to allocate additional resources to the DBB in order to allow it to acquire more portfolios.
36. **The transfer mechanism should be flexible and market-based.** The public banks should be allowed to keep the loans they want but they should take full credit risk unless the government decides to keep a 100 percent guarantee (as argued above, the guarantees should be partial). If the public banks decide to keep loans funded by government deposits, they should return a percentage of the loan amount or portion of the initial deposit to the DBB. The DBB should also be free to decide which loans it wants to keep in its balance sheet. The unwanted loans could be kept off-balance sheet, managed by the DBB (for fee) on behalf of the government.

C-2. **Funding**

37. **According to its decree, the DBB will be funded through government sources including shareholder’s capital, budget transfers, proceeds from client’s repayment of loans acquired from the public banks, and profits from its business operations.** The DBB will also take deposits from government entities but not from the general public. Debt funding from the market is restricted, perhaps in line with the need to avoid excessive credit growth that has so far characterized LGP. Moreover, the DBB will not receive interest rate compensation nor will it have its loans guaranteed by the government. Any temporary excess liquidity of the DBB will be deposited in other banks or in the NBRB; alternatively the liquidity must be invested in government and NBRB’s securities.

38. **The DBB should remain a non-deposit-taking institution, but it should enjoy government guarantee to borrow from the market in order to fund its lending operations.** This is the ideal funding model for most development banks around the world. It allows them to use their low-cost advantage to leverage long-term resources, especially from international financial institutions. However, this assumes that the government will no longer extend LGP funding directly to the public banks and that the NBRD will continue not to provide liquidity to the public banks in support of their LGP-related activities. Otherwise, allowing the DBB to borrow from the market might represent a risk to the objective of curbing excessive credit growth.

C-3. **Lending model**

39. **There are two lending models for development banks – retail lending (first tier) and wholesale lending (second-tier).** Under the retail model, development banks lend through other financial intermediaries; under the wholesale model, they lend directly to final borrowers using own branch network. The wholesale model is usually preferable because it allows development banks to complement rather than substitute the private sector. In fact, there are multiple examples of well-established wholesale institutions in Europe and around the world, including Kreditanstalt fuer Wiederaufbau (KfW) in Germany, Croatian Bank for Reconstruction and
Development (HBOR), and the National Bank for Agriculture and Rural Development (NABARD) in India. Generally, wholesale development banks tend to perform better than their retail counterparts because the highest credit risk (due to exposure to final borrowers) is borne by private financial institutions.

40. **The DBB should operate as a wholesale bank, working with both private and public banks.** The law of the DBB is not clear as to which model the DBB will adopt. But, it is a fact that the DBB has neither the resources (staff) nor the infrastructure (branches) to reach out to all eligible borrowers in Belarus. It would be inappropriate and expensive for the DBB to attempt to develop such infrastructure. So far, existing banks have been able to serve the DBB’s target customers, and with the right incentives, they are likely to continue doing so. Hence, given the existing resources and branches of commercial banks, the DBB should not attempt to reach its end-customers directly. Instead, it should operate through existing banks – private and public.

41. **The wholesale model would have two main advantages in Belarus.** Firstly, it would ensure that the public banks continue to access part of the LGP funding, which is currently a major source of funding for them. Secondly, it would level the playing field by allowing the participation of both public and private banks in the intermediation of LGP funds.

42. **Finally, the proposed model implies some changes to the current LGP arrangements:**

- **The public banks would have to take credit risk.** Losses arising from participation in LGP should be fully borne by each participating bank (unless a guarantee is provided by the DBB).

- **Participation in LGP should be voluntary.**

- **Partial credit guarantees should be used to encourage banks to use own funds for LGP.** For riskier programs not attractive to banks, partial credit guarantees (with less than 100% loss coverage) could be provided. But unlike the current practice, participating banks should pay market prices for the credit guarantees they receive.

- **Under subsidized LGP where a fixed interest rate must be charged to final borrowers, the DBB should allow banks to bid for available funds.** In practice, each bank would set the cost at which is willing to borrow from the DBB in order to lend at a low interest rate to specific borrowers. If fixed lending rates are too low, there is a possibility that some banks would be willing to borrow at zero or even at a negative
interest rate\(^3\). The DBB could also use partial credit guarantees to make the programs attractive to banks. Overall, bidding would ensure a market pricing mechanism while allowing the DBB to adequately compensate banks for the risk that they are taking\(^4\). As pointed out above, banks would have to take credit risk.

\textbf{C-4. Regulation and supervision}

\textbf{43. Neither a supervisor nor prudential standards are assigned to the DBB.} According to the DBB law, existing regulatory standards governing banks and non-bank financial institutions should not apply to the DBB. The NBRB has no jurisdiction over the DBB and no other institution is identified as the DBB’s regulator and supervisor.

\textbf{44. The NBRB voiced concerns about a lack of a supervisory framework for the DBB.} The NBRB fears that if left unsupervised, the NBB is likely to pose a risk to financial stability and credit growth beyond the risk currently posed by the public banks. This fear is legitimate. The DBB should be supervised under the same standards as any other public or private banking institution operating in Belarus, particularly if it engages in the same types of transactions as other banks. Moreover, proper supervision embodies good practices – including standards and requirements on loan underwriting, classification, and provisioning; risk management; corporate governance; anti-money laundering – that can contribute to the efficiency and sustainability of the DBB.

\textbf{V. CONCLUSIONS AND RECOMMENDATIONS}

\textbf{45. The public banks play an important role in Belarus.} They account for 65% of the total assets and two-thirds of total deposits in the banking system. In addition, they provide a wide range of financial services to households, private enterprises, government, and other state-owned enterprises, including deposits, credit, payment services, foreign exchange transactions, securities trading, etc. Moreover, they constitute the main vehicle for the government to lend to priority sectors of the economy, such as agriculture, housing and manufacturing.

\textbf{46. The lending behavior of the public banks has been highly influenced by government programs.} Currently, LGP constitutes more than 60 percent of total bank lending. Some programs are highly attractive for banks because they not only offer cheap funding but also a 100 percent guarantee. Private banks have so far been kept out of the LGP.

\(^3\) The zero interest rate would be equivalent to free government deposits under the current system; And the negative interest rate would be equivalent to current interest rate compensation.

\(^4\) However, there would be a need to put in place a mechanism to prevent unfair competition from banks with poor risk management practices and unsound underwriting standards.
47. **LGP has imposed some challenges to the public banks and the economy.** These include liquidity pressures, crowding out of private banks, macroeconomic instability due to excessive credit growth, and moral hazard. LGP also represent a significant fiscal cost in the form of settlement of credit guarantee claims and constant recapitalizations of the public banks. Furthermore, LGP has made the public banks highly dependent on government funding.

48. **The governance of state-owned banks is weak.** Supervisory boards of state-owned banks are dominated by public officials who at same exercise ownership functions; typically, these board members lack bank experience and are not independent. Appointed board members are not vetted by the NBRB. The ownership appears to be fragmented. Various government institutions – including the Presidency, the Council of Ministers, the Ministry of Finance, and the State Property Committee (within the Ministry of Economy) – play some sort of ownership function in state-owned banks. This leads to weaker accountability for the performance of the public banks and raises the possibility of conflicting policy priorities.

49. **In 2011 the government established the Development Bank of Belarus (DBB).** The DBB is expected to centralize all new LGP and to contain excessive credit growth by limiting LGP growth to the resources allocated in the state budget (above the line). It is also expected to take over LGP-related portfolios from the public banks. However, it appears that the government is considering the expansion of the mandate of the DBB beyond the primary objective of containing credit growth.

50. **There are still many pending issues on the design and operation of the DBB,** including a clear definition of a specific policy mandate of the DBB, its funding mechanism, lending models, pricing of products, regulation and supervision, and corporate governance.

51. **The following are the recommendations to strengthen state-owned banks in Belarus:**

   For all state-owned banks:
   
   - Strengthen corporate governance. Appoint independent board members with solid banking expertise; limit the number of government officials in supervisory boards; give powers to the NBRB to vet all appointments to the supervisory boards of state-owned banks.
   
   - Strengthen the ownership function by empowering the State Property Committee to act as the sole shareholder representative.
• Set performance targets and hold supervisor y and management boards accountable for the achievement of targets

For the DBB:

• Narrow down the policy mandate, outlining the specific market gaps that the DBB is expected to fill.

• Require the DBB to cooperate with private sector, achieve self-sustainability, and undergo periodic review of its mandate.

• Adopt a wholesale model. The DBB should lend indirectly by wholesaling funds to both public and private banks. This would level the playing field, lessen possible funding constraints on the public banks, and minimize the risk of competition between the DBB and existing banks.

• Adjust current LGP practices: make participation in LGP voluntary; require banks to take full credit risk; use partial credit guarantees to encourage riskier LGP and price the guarantees at market prices

• Empower the DBB to fund itself from the market. In parallel, discontinue direct, LGP-related government funding to the public banks

• Clarify the procedures for the transfers of LGP portfolios from the public banks to the DBB. Make the procedures flexible and market-friendly, allowing the public banks and the DBB to keep/acquire only the portfolios they want.

• Place the DBB under the supervision of the NBRB
Appendix A.

Table A-1. Key Indicators of the Banking Sector in Belarus

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-owned banks</td>
<td>31</td>
<td>31</td>
<td>31</td>
<td>31</td>
</tr>
<tr>
<td>banks with &gt;50% in foreign capital</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Total assets (in BYRbn)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of state-owned banks in total assets (%)</td>
<td>78.0</td>
<td>72.5</td>
<td>71.2</td>
<td>65.2</td>
</tr>
<tr>
<td>Total authorized capital (in BYRbn)</td>
<td></td>
<td></td>
<td>12,023</td>
<td></td>
</tr>
<tr>
<td>State’s share of total authorized capital (%)</td>
<td>80.6</td>
<td>70.0</td>
<td>73.6</td>
<td>84.5</td>
</tr>
<tr>
<td>CAR (%)</td>
<td>19.8</td>
<td>20.5</td>
<td>20.4</td>
<td>24.7</td>
</tr>
<tr>
<td>ROE (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Source: NBRB</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Table A-2. Loan quality and provisioning (in percent)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012-Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>NPLs to gross loans</td>
<td>4.3</td>
<td>3.1</td>
<td>2.8</td>
<td>1.9</td>
<td>1.7</td>
<td>4.2</td>
<td>3.5</td>
<td>4.2</td>
<td>3.6</td>
</tr>
<tr>
<td>Watch</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>2.7</td>
<td>3.4</td>
<td>2.4</td>
<td>3.6</td>
<td>10.6</td>
<td>13.7</td>
</tr>
<tr>
<td>Substandard</td>
<td>2.1</td>
<td>1.7</td>
<td>1.8</td>
<td>1.4</td>
<td>1.3</td>
<td>2.4</td>
<td>2.9</td>
<td>3.5</td>
<td>2.7</td>
</tr>
<tr>
<td>Doubtful</td>
<td>0.8</td>
<td>0.3</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>1.2</td>
<td>0.5</td>
<td>0.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Loss (&gt;180 days past due)</td>
<td>1.4</td>
<td>1.1</td>
<td>0.8</td>
<td>0.5</td>
<td>0.2</td>
<td>0.6</td>
<td>0.1</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Provisions to total gross loans</td>
<td>1.4</td>
<td>1.5</td>
<td>1.5</td>
<td>1.2</td>
<td>1.2</td>
<td>1.9</td>
<td>2.2</td>
<td>3.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Provisions to NPLs</td>
<td>32.4</td>
<td>48.4</td>
<td>51.3</td>
<td>61.5</td>
<td>70.0</td>
<td>44.9</td>
<td>61.9</td>
<td>79.0</td>
<td>96.8</td>
</tr>
</tbody>
</table>

Source: NBRB
Table A- 3. Lending under Government Programs

<table>
<thead>
<tr>
<th>Year</th>
<th>Belarusbank</th>
<th>Belagroprombank</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>8,049</td>
<td>5,528</td>
</tr>
<tr>
<td>2009</td>
<td>15,536</td>
<td>7,627</td>
</tr>
<tr>
<td>2010</td>
<td>51,595</td>
<td>18,707</td>
</tr>
<tr>
<td>2011</td>
<td>30,395</td>
<td>9,894</td>
</tr>
</tbody>
</table>

Source: Audited annual reports