

Comment

Should government leave banking to the bankers?

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Introduction

A specific policy-related issue that keeps rearing its head, both domestically and internationally, is the debate around the need for and/or the role of government-owned financial institutions, particularly government-owned banks. This is particularly true in South Africa where there have been numerous calls for the introduction of a state-owned bank or, in more extreme cases, calls for the nationalisation of existing commercial banks.

In recent months, the domestic debate around public banking has picked up both in frequency and intensity. Adverse rulings against the private banking sector, including the Competition Commission's finding that several domestic and foreign banks colluded in global foreign exchange markets, as well as the latest judgement by the public protector that ABSA irregularly benefited from an apartheid-era bailout, have given renewed impetus to those who rail against private capital and its alleged excesses. In the same ruling, the public protector fired another salvo, in effect giving her blessing for the creation of a new "people's bank". Additionally, there have been repeated calls from the more extreme reaches of the political spectrum for the nationalisation of private sector banks to facilitate the creation of a government-owned bank. Finally, the discussion around the possible nationalisation of the Reserve Bank at this week's ANC five-yearly policy conference further muddled the waters.

Although the ANC has on numerous occasions stressed that the nationalisation of existing banks isn't its (or the government's) policy, the feasibility of a separate formal state-owned bank came under the spotlight again at the ANC policy conference. In fact, ANC delegates have given the government an ultimatum to ensure that a state bank, in the form of the Post Bank, is up and running within the next six months. The Postbank has filed its application for a commercial banking licence with the Reserve Bank and the resolution at the ANC policy conference suggests that the granting of said license is an urgent priority for the ANC (and by extension the government).

In light of this resolution, this comment briefly unpacks the motivation for and case against the creation of a state-owned bank.

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Please refer to the [glossary on the BER's website](#) for explanations of technical terms.

Why a state bank?

The Global Financial Crisis (GFC) reignited the debate on the ownership structure of the banking sector and its consequences for financial intermediation. Some argue that it was the presence of foreign-owned banks in developing economies that helped transmit the 2008/09 crisis from advanced to developing countries. Simultaneously, developing economies such as Brazil, China and India, where state-owned banks are systemically important, recovered quickly from the crisis, generating interest in the mitigating role that these banks can play during periods of financial volatility.

Advocates of public banking base their arguments on two views. The social view holds that by helping to overcome market failures, state-owned banks can promote socially desirable, welfare-enhancing investments, including broadening access to financial services. The developmental view is that a state-run bank is able to play a key role in allocating capital (on affordable terms) to strategically important sectors/industries which the private sector considers too risky to lend to. In doing so, such banks would help jump-start economic development.

Both these views are prevalent in the domestic discourse. A 2016 survey by Finscope found that about 11% of the adult population were “financially excluded” or unbanked, amounting to 4.3 million individuals. This notable “market failure” is often cited as the result of the concentrated nature of South Africa’s private banking sector, where the level of competition is considered inadequate and fees too high. This market failure also serves as the main motivation for the establishment of a commercial state bank in the form of the Postbank, with the apparent goal of promoting access to finance for the unbanked.

While these constraints still exist, what is not always fully appreciated is the substantial progress which has already been made in accelerating financial inclusion, even in the absence of a state-owned bank. Thanks to existing government initiatives, as well as private banks’ persistent efforts to improve credit access and social engagement, the number of the unbanked today is about a third of what it was six years ago - more than a million individuals have thus come into the formal banking net every year since 2010. Although this penetration rate is still not high enough, with further progress highly likely one has to question whether a formal, separate state-owned bank is absolutely necessary.

As for the developmental view, it is worth remembering that there are already a host of state-controlled finance institutions which are mandated to specifically cater for the apparent undersupply of loans to SMMEs and start-ups. These institutions include, among others, the National Empowerment Fund, the Industrial Development Corporation, the Small Business Development Fund, the Small Enterprise Development Fund, the various sectoral Skills Education Training Authorities, the Land Bank and the Housing Bank, not to mention the Department of Trade and Industry with its various incentive and grant programmes.

While it is at this stage unclear what role the new Postbank will play in providing developmental finance, an alternative option to creating a separate state-run bank would be to tackle the remaining obstacles that hinder existing government-controlled finance institutions from spreading the credit net even wider. Addressing shortages in areas such as skills, expertise, innovation and technology would make a notable

difference in helping such institutions to optimise their mandates of accelerating access to loans, bridging finance and other financial needs.

Potential for graft derails case for state bank

Even when the government has the best of intentions, international evidence clearly shows that state-owned banks mostly end up being dragged down by inefficiencies and resource misallocation. The conflict of interest between the government and the bureaucrats designated to manage government-owned banks can give rise to resource misallocation, while state-owned banks are often seen as a mechanism for politicians to pursue their own goals (i.e. re-election, personal profit, etc.). As capital continues to flow to politically connected sectors and firms, those real businesses and SMEs which are ready to invest, employ and expand, will continue to be short-changed in the process.

Proponents of state-owned banks often point to India as an example of how to run government-backed financial institutions. However, inefficiencies, misallocation of resources and the mispricing of risk has seen non-performing loans balloon over recent years. India's banking sector is saddled with bad loans amounting to around \$120 billion, of which around \$90 billion is accounted for by the 21 state-owned banks currently in operation.

Another darling of state bank proponents, the Brazilian National Social and Economic Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social*, BNDES), is currently part of a police investigation into government fraud and white collar crime. A political insider is alleged to have paid huge bribes in return for access to the subsidised, easy money loans of BNDES, loans which otherwise could have been put to good use elsewhere to boost real economic activity.

In South Africa, rumours and allegations of politically connected individuals interfering in the running of government and strategic state-owned enterprises (SOEs) abound. Continued concerns over "state capture" have led to increased political and economic uncertainty which, in turn, contributed to the recent sovereign credit rating downgrades and underperformance of the economy. Importantly, financial institutions are only as healthy as the faith that customers, lenders and investors have in them. But public trust in SOEs is at an all-time low. This, combined with the government's poor track record in successfully running and overseeing major enterprises, increases the chances that a formal stand-alone state-owned bank could become a vehicle for enriching politically connected individuals and firms (at the taxpayer's expense), thereby failing in its apparent core role of promoting financial inclusion and broader economic development.

Conclusion

In the 1970s, state-owned banks controlled around 65% of assets in developing economies. Yet, as it became clear over time that public banking was increasingly associated with gross inefficiencies, credit misallocation, ballooning non-performing loans, and ultimately lower economic growth, so government ownership of banking assets in developing countries has collapsed. The few successful state-controlled banks still in existence have some key characteristics in common: suitably qualified and experienced

management boards; strong governance structures; little or no political interference; strong independent audit and risk committees; and robust transparency. The crisis in several strategic South African SOEs inspires little confidence in the government's ability to meet such basic, yet essential criteria.

On the other hand, private sector banks face very real risk limits which prohibit the unbridled expansion of financial services. If existing government institutions can get their acts together, an alternative working model would be one of co-financing and risk sharing between the government and the private sector. Such a model would broaden access to finance and go some way in achieving government's social and developmental goals, all without running the risk of creating another vehicle for state-capture and the enrichment of the few.

In all, there is little international evidence that government bank ownership provides substantial benefits to the banking sector, the real economy, or the users of banking services (particularly in developing economies). There is some evidence to show that government ownership might result in lower interest rates and slightly better access to financial services, but the benefits are probably outweighed by the costs associated with increased inefficiencies and political patronage.

While the South Africa Post Office is under new management and appears to be set on sustainable organisational renewal to deal with the challenges posed by the new economy, the burning question is whether the Postbank can remain independent and maintain good governance structures in the face of political pressure. The question of governance, competence and independence will become central should the Postbank ever become the custodian of the social grant payment system as has been mooted. Given the importance of the social transfers to the broader society, it is of national importance that the system operates as efficiently and robustly as possible. International experience with state-owned banks seems to point to more risks than benefits and consequently South Africa should proceed with great caution.

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