

Government Banking

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*New Perspectives on Sustainable Development and Social
Inclusion From Europe and South America*

Kurt von Mettenheim & Maria Antonietta Del Tedesco Lins

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Introduction¹

Kurt von Mettenheim

This volume makes available to a wider academic and policy making public the proceedings of an international seminar on government banking at the São Paulo Business School of the Getulio Vargas Foundation (Escola de Administração de Empresas de São Paulo, FGV-EAESP) in August 2006. Scholars, policy makers, bank executives, and representatives from multilateral financial institutions from Europe, North America, and Latin America gathered to reassess the role of government banks, especially in terms of their capacity to accelerate sustainable development and social inclusion. Scholars included economists, political scientists, financial economists, and financial statisticians, all sharing interest in better understanding the role of government banks in comparative perspective. In April 2006 the conference conveners circulated a discussion paper that reviewed research then underway on Brazilian federal government banks and presented a variety of themes for exploration at the seminar in August. The following questions were posed to authors:

- 1) What regional and national traditions of public banking can contribute to sustainable development and social inclusion?
- 2) Are there “varieties of financial capitalism”?
- 3) Does the debate in financial economics about bank-centered and market-centered financial systems supply new perspectives on varieties of capitalism and broader concerns about development?
- 4) What reforms are most effective in bank-centered financial systems?
- 5) Are critics right? Do public banks cause financial repression?

These questions inspired different foci by participants. Some chose to focus empirically on developments within specific countries. Some chose to focus on the historical trajectory and current policies of specific government banks. Some chose to pursue comparative analysis of small number of countries. Some chose to

¹ Parts of this introduction are based on or taken from the manuscript “Commanding Heights: Statecrafting Federal Government Banks in Brazil” in review at the Penn State University Press.

compare across national and regional experiences. Although several participants were unable to complete or permit publication of materials presented, additional contributions from scholars in Europe and Brazil working on issues of public banking expanded the scope of the volume.

The differences between seminar proceedings (on government banking generally) and this volume (a focus on savings banks in Europe and South America) reflect our attempt to follow the rapid evolution of thinking about finance and development during the last years. In a broader sense, the volume remains as it started: a search for new perspectives on domestic banking in the 21st century that is “post-Washington Consensus.” During the 1980s and 1990s, international financial institutions and policy circles advocated liberalization and privatization as the preferred means to accelerate growth.² Since 2000, it has become increasingly clear that domestic banking systems have taken a variety of different paths with government and savings banks retaining important roles. Across Continental Europe, savings banks, cooperative banks, and other non-profit and government owned and controlled financial institutions have reformed and modernized during European integration and the opening of domestic banking systems to competition. In Latin America, government savings banks remain important domestic actors that have modernized and retained or expanded market share of domestic banking. These trends suggest that coordinated capitalist systems in advanced economies and neo-developmental states in Latin America share important features exemplified by government banks. This volume explores the policies and experiences of savings banks and other government banks toward financial inclusion and sustainable development.

This volume is controversial because it taps deep differences about government banks in the disciplines of finance, economics, politics, sociology, management, and public policy. Despite these differences, recent research suggests that banks (setting aside the question of *government* banks for the moment), far from being doomed to being replaced by financial markets, appear instead still to be central agents of growth. As Studart notes: “The supply of finance is causally determined by banks: it is banks, and not savers, who hold a key position in the process of growth.”³ The question raised in this volume is whether growth can be channeled by government banks toward sustainable development and social inclusion. This implies dealing with complex and deeply contested theories and concepts about banking and finance, government intervention, public policies, and development. The chapters presented herein are therefore cautious in the sense of providing case

2 From John Williamson’s *Latin American Adjustment: How Much Has Happened*. (Institute for International Economics, 1990), through the World Bank Policy Research Report, *Bureaucrats in Business*, and including policy analyses from the Inter-American Development Bank such as *Unlocking Credit: The Quest for Deep and Stable Bank Lending* (Johns Hopkins University Press, 2004) and Caprio, Gerard (et al) eds. *The Future of State Owned Financial Institutions* (Brookings Institutions, 2004), consensus remained that privatization is preferred policy.

3 Studart, R. *Investment Finance in Economic Development* (Routledge, 1995). p. 1

studies and empirical evidence, often on the micro and organizational level of analysis. This empirical focus is warranted given the deeply contested views about these institutions.

Government banks are banks in the core sense of accepting deposits and making loans. As such they are managed as banks and remain subject to domestic banking regulations and monetary authorities, as well as international guidelines set by the Bank for International Settlements as well as rating agencies, media coverage, and legislative oversight. However, because they are governmental entities, government banks also cut to classic concerns of political development and democratization. Democratization and political development imply social inclusion within political institutions. And rather than a permanent gain, questions just a generation ago subsumed under modernization and development theory appear to haunt social scientists and policy makers once again. The stark increase in inequality across many nations during the last decades implies a return to questions about social inclusion and exclusion. Scholars of political development (exemplified by the Social Science Research Council series on political development published in the 1960s and 1970s) described a moving equilibrium between social mobilization caused by economic development and the incorporation of citizens within political institutions that remained open and determined by political action. Today is different. Domestic political actors and policy communities currently struggle to maintain domestic income distribution amidst international capital flows and other forces that tend to exclude many citizens from wealth and political influence. This volume suggests that savings banks and microfinance policies are capable of steering domestic financial systems toward better income distribution, social inclusion, political development, and democratization. This is not to disregard critics of government banking; if public banks are abused they may undercut policies of social inclusion and become agents of crony credit, rent seeking, and manipulation of elections. Notwithstanding these risks, the chapters presented in this volume suggest that government banks, and especially savings banks, provide considerable comparative advantage over private commercial banks for policy and development.

Government banking also appears at the center of debates about differences between varieties of capitalism in contemporary comparative political economy. The difference is marked: Most coordinated market economies retain substantial public banking sectors, while liberal market economies tend to have none. Both historical experiences and recent experiments suggest that different varieties of *financial* capitalism, as well as transfer policies, greater social equality, and political control over the allocation of resources, have to do with public banking. The history of government banking across Continental Europe involves utopian liberalism and socialism, Christian democracy, collectivism, and other social and political movements today such as Islamic banking that have sustained a wide

variety of socially oriented development policies and traditions. A central idea behind this volume, notably published by the Konrad Adenauer Foundation, is that these longstanding traditions of savings banks in sustaining social capital, small businesses, local communities and more equitable political economies across Europe serve as important paradigms for reassessing finance and development in Latin America. Savings banks have a long history. Europeans have founded, modernized, reformed, and integrated domestic savings banks since the enlightenment. And rather than doomed to be replaced by more competitive private banks and equity markets, savings banks, along with other types of non-profit banks, appear to have flourished during the liberalization and modernization of domestic banking across Europe amidst new forces of globalization, integration, and increased competition. This volume explores recent policies and trends in Europe and Latin America that reflect this tradition of government savings banks.

Evidence about government banking, social inclusion, and the search for sustainable development in Continental Europe and South America stands in stark contrast to the concerns about increasing inequality that have come to haunt countries that liberalized and privatized their financial systems in excess and now rely exclusively on private banking and capital markets for the allocation of resources. In the US and UK (paradigmatic market-centered financial systems and liberal market economies according to Hall & Soskice, 2001), recent debates focus on how finance and banking exacerbate inequality, while unethical practices of predatory lending have led to new legislation to protect borrowers. Non-governmental organizations and a select number of policy experiments have attempted to reverse financial exclusion. However, the impact of these measures has been limited, in part, because liberal market economies do not have the policy levers provided by government banks that are common in coordinated market economies and neo-developmental states.

In this respect, this volume about public banking may indeed be relevant to countries without government banks. In the UK, the financial system has been brought under critical analysis for its impact on increasing inequality and social exclusion, while initiatives with credit unions and micro-credit have attempted to redress financial exclusion.⁴ In 1998, the UK Small is Bankable movement attempted to increase access to banking, an initiative endorsed by the British Bankers Association. Debates in the US also focus on the impact of banking and finance on social exclusion and inequality. Since Stiglitz's Nobel Prize winning work on credit markets, a variety of scholars have examined trends in US banking

4 Guine, Christophe & Edward Mayo. (eds) *Banking and Social Cohesion: Alternative Responses to a Global Market*. Charlesbury, UK: Jon Carpenter, 2001, Mosley, Paul & D. Hulme. *Finance Against Poverty*. London: Routledge, 1995, Ferguson, E. & C. Whyley. *Kept out or Opted Out: Understanding and Combating Financial Exclusion*. London: John Wiley, 1997, Jones, P.A. *Towards Sustainable Credit Union Development*. Manchester, 1999.

and credit that have reinforced and indeed caused further social bifurcation and exclusion. The Community Reinvestment Act (1977) attempted to subsidize finance toward excluded urban neighborhoods, while a variety of experiences with capital access programs were reviewed by the US Department of Treasury.⁵ In sum, given the problems with social exclusion in market centered financial systems, a closer look at government banking and sustainable development is in order.

Government banking nonetheless cuts to both fundamental theoretical differences across a variety of disciplines and inspire often polar opposite policy recommendations. In terms of theory, financial deepening approaches and (government) bank-centered finance strategies often see the same phenomena from profoundly different perspectives. And these differences cut to core, essentially contested concepts of markets, government intervention, and banking. Liberal market-economies are driven by equity markets, thrive on public information, and spurn coordination. Coordinated market-economies are driven by bank credit, thrive on concealing (limited sharing) of firm strategy with financiers, and spurn markets for their excessive volatility that produce bad equilibria. From a market-centered perspective, neo-institutionalism is nothing but neo-protectionism. From the perspective of coordinated capitalism and neo-developmental states, excessive financial liberalization and privatization would simply throw babies -- cherished institutions of social policy and domestic control -- out with the bathwater. For Dimsky, market approaches insist that policies should free agents to “get prices right,” while bank-centered approaches insist that enough credit be directed to accelerate innovation and “get planning right.”⁶ The portfolio approach of Gurley & Shaw inspired many policy makers to adopt financial liberalization during the 1980s and 1990s. Some economists warned all along that financial liberalization should be considered carefully.⁷ However, the series of financial crises during the 1990s and early 2000s suggests that the causal forces of financial repression and deepening are more complex, leading to reconsideration of policies among economists in the international financial community.

To better frame government and savings banks within these issues and introduce the chapters presented herein, the following sections provide a brief review of research and raise questions about government banking, first in Europe and then in developing, transition, and emerging economies.

5 US Department of Treasury. Capital Access Programs: A Summary of Nationwide Performance, October 1998

6 Dimsky, Gary A. *Bank Merger Wave: The Economic Causes and Social Consequences of Financial Consolidation in the United States*. M.E. Sharpe, Inc., Armonk NY. June 1999

7 Diaz-Alejandro, C. “Good-Bye financial repression, hello financial crash.” *Journal of Development Economics* 19 (1985): 1-24.

Government Banking in Europe

The central argument of this volume is that government banking in Continental Europe provides important comparative references for Latin American development. While premature and/or excessive liberalization and privatization of banks contributed to increasing inequality during the last decades in Latin America, new policies in the 21st century pursued by government banks appear to present new opportunities for sustainable development, social inclusion, and faster economic growth levels. Understanding bank change in Europe and South America therefore may provide new, alternative approaches to the single model of liberalization and privatization that predominated during the 1980s and 1990s. On the level of policy, this implies a return to traditional ideas from Europe about savings banks and local communities. Instead of radically reforming public banking sectors through privatization and liberalization, the experiences reported herein from Europe and South America involve the reform, modernization, and integration of traditional public banking institutions such as savings banks.

These questions about banking and development have largely remained off the agendas of scholarship and public policy debate. Indeed, since US Treasury Secretary Douglas' testimony to Congress in 1941,⁸ or Gabriel Ardant's overview of finance in Western European states published in 1975,⁹ leading social science journals lack compelling discussion of government banking and development. Moreover, Ardant's landmark synthesis of finance and state building in European history concludes by warning that policies pursued in Europe are not applicable to developing countries because "numerous bottlenecks intervene between demand and any response of agriculture or industry" and that "solutions must be sought in different forms."¹⁰ This volume begs to differ, somewhat, and attempts to specify these different forms through discussion of savings banks and the financial dimensions of coordinated capitalism in Europe and neo-developmental states in Latin America. This implies a broad reassessment of development paradigms.

We are not alone in this reassessment of market-centered paradigms. For example, Bresser-Pereira & Nakano have criticized the assumption of economists that domestic and foreign savings are substitutes, and argue that volatile foreign capital flows and excessive premia on foreign debt drag economic growth levels

8 Douglas, William O. *Democracy and finance: the addresses and public statements of William O. Douglas as member and chairman of the Securities and Exchange Commission*. New Haven: Yale University Press, 1941

9 Ardant, Gabriel. "Financial Policy and Economic Infrastructure of Modern States and Nations." in Tilly, Charles (ed). *The Formation of National States in Western Europe*. Princeton, NJ: Princeton University Press, 1975, pp. 164-242

10 *ibid*, p. 241

in Brazil.¹¹ Pinheiro argues that the series of financial crises in emerging markets during the 1990s have encouraged economists and policy makers to create an alternative “post-liberal” agenda for development.¹² Amsden broadens debates by arguing for a return to classic themes about production and government policies in late development.¹³ Evans and Chang also argue that most states embed and underpin economic policies and development, and that the market-centrism of recent social science has lost this fundamental insight.¹⁴ And Stallings & Studart review financial policies to reassess their role in sustainable development across Latin America and other developing regions.¹⁵ This volume reports new research from Europe and South America about institutions and policies able to deepen financial systems, accelerate economic growth, improve income distribution, social inclusion, and citizenship.

Before turning to the contributions of chapters, brief discussion of development banking and savings banks is in order to distinguish these different types of government banks and explain the focus of this volume on the latter. Savings banks provide the core of this volume for reasons of theory, policy, and historical sequence. On the level of theory, our focus on savings banks is based on dissatisfaction with large scale lending and centralized decision making. The large loans and often closed networks across the public and private sector typical of development banks suggest that these institutions remain commanding heights at the apex of domestic economies, polities, and societies. In contrast, savings banks, at least in the European context, retain a decentralized structure and bottom up dynamic that implies fundamentally different questions about markets, government, local communities, and bank performance. On the level of policy, these differences also imply that centralization versus decentralization, top-down versus bottom-up, large scale versus small scale, local versus national sum to describe fundamentally different types of government banking.

Finally, in terms of sequence, development banks and savings banks also differ. The original intent of development banks was to finance rapid industrialization. Once industrialized, the development of capital markets can be seen as an important passage in terms of modernization of corporate governance and political economy

11 Bresser-Pereira, Luis C. & Yoshiaki Nakano, “Crescimento Econômico com Poupança Externa?” *Brazilian Journal of Political Economy*. (2003), Vol. 23, no. 2/90, pp. 3-27.

12 Pinheiro, Armando C. “Uma Agenda Pós-Liberal de Desenvolvimento para o Brasil,” IPEA Discussion Paper 989, October 2003

13 Amsden, Alice. “Editorial: Bringing Production Back In: Understanding Government’s Economic Role in Late Industrialization,” *World Development*, (2003), Vol. 25, no. 4, pp. 469-480 and Amsden, Alice. *The Rise of the Rest: Challenges to the West from Late Industrializing Economies*. Oxford: Oxford University Press, 2001

14 Chang, H.J. *Kicking Away the Ladder? Policies and Institutions for Economic Development in Historical Perspective*. London: Anthem Press, 2002; Evans, Peter. *Embedded Autonomy: States and Industrial Transformation*. Princeton, NJ: Princeton University Press, 1995

15 Stallings & Studart, *Finance for Development*. op. cit.

of finance. The liberalization of coordinated market economies and developmental states thus implies recasting the role of large development banks. In contrast, in terms of sequence, savings banks have an entirely different story. Savings banks were founded across Europe since the enlightenment and grew as responses to the social question. And rather than a phase replaceable by modern financial markets, the dismantling of Welfare States and pressures of competition and globalization that tend to increase inequalities suggest that savings banks may remain permanent features of domestic financial systems rather than backward institutions to be dismantled through privatization. A closer look at development banking and savings banks is in order.

Development Banking

Development banking was essential for industrialization during late development across Continental Europe, Asia, Latin America, and other developing nations.¹⁶ The core justification of government development banks remains that of providing finance and credit on terms beyond which private banks or markets are willing to provide. The inability of private banks to measure and unwillingness to bear long-term risks associated with infrastructure investments led Continental European governments to found industrial development banks in the early 19th century.¹⁷ As the ability of the French government to finance railroads and accelerate industrialization became widely acknowledged, the *Crédit Mobilier* soon became a model abroad and shareholder in other European development banks.¹⁸ Diamond notes that the *Crédit Mobilier* also became a model for banks in Asia, such as the Industrial Bank of Japan and India.¹⁹ Development banks were also founded after World War I for European

16 On development banks, see: Aghion, Beatriz. "Development Banking." *Journal of Development Economics*, (1999), Vol. 58, pp. 83–100. In Latin America, see: Romy Calderón Alcas. "La banca de desarrollo en América Latina y el Caribe," United Nations Economic comisión on Latin America, Development Finance Series, (LC/L.2330-P), 2005.

17 See: Sylla, Richard. "The Role of Banks." in Sylla, Richard & Toniolo, Gianni (eds). *Patterns of European Industrialization in the 19th Century*. London: Routledge, 1991, pp. 45–63. Aghion notes: "The oldest government-sponsored institution for industrial development is the *Société Generale pour Favoriser l'Industrie Nationale* which was created in the Netherlands in 1822. However, it was in France that some of the most significant developments in long-term state-sponsored finance occurred. In this respect, the creation in 1848–1852 of institutions such as the *Crédit Foncier*, the *Comptoir d'Escompte*, and the *Crédit Mobilier*, was particularly important." Aghion, op. cit. p. 3

18 Cameron notes: "Of even greater importance than the outcome of the operations of the *Credit Mobilier* were the intangible benefits such as the imitated skills of the engineers and technicians which it sent abroad, the efficiency of its administrators, and the organizational banking techniques which were so widely copied." Cameron, E., "The credit mobilier and the economic development of Europe." *The Journal of Political Economy*, (1953), Vol. 53, no. 6, p. 486 (cited in Aghion, p. 86) and Schneider: "Many BNDE técnicos left the bank (they were often in great demand) and took its institutionalization, professionalization, and developmental nationalism to other parts of the bureaucracy." Schneider, op. cit. p. 35

19 Diamond, W. *Development Banks*. Baltimore, MD: Johns Hopkins University Press, 1957

governments to infuse cash, subsidized loans, and guarantees for bank bonds to capitalize industrial reconstruction.²⁰ After World War II, the Kreditanstalt für Weidaraufbau (Reconstruction Credit Agency, KfW) and Japan Development Bank were created to channel foreign funds for post-war reconstruction, but continued to evolve thereafter adopting new policies and strategies within new contexts. Many newly independent developing countries also created development banks after World War II to channel World Bank loans and foreign aid. Gerschenkron, Myrdal, Lewis, and other economists argued that banking and government intervention were essential to accelerate industrialization in late development. Johnson's study of the Japanese Ministry of Technology and Industry (MITI) also remains a classic account of finance, late development, and government intervention.²¹ Hirschman also argued that economic development in Latin America required inducement mechanisms and policy coordination to effectively channel foreign assistance, public, and private investments. State development banks and agencies have also been cited as critical agents for accelerated growth in developing countries of Asia.²²

However, the different character of manufacturing, information technology, financial markets, and banking in the 21st century suggest that more complex tradeoffs between markets and government intervention now inform policies. Critics such as Woo-Cummings emphasize three problems with development banks.²³ First, because development banks tend to deeply leverage large industrial groups with bank credit, private enterprises avoid going public through the issue of equities. Second, given the scale and scope of political and economic interests involved, development banks often increase moral hazard and require costly bailouts. Development banks can thereby impede innovation, adjustment, and reproduce bad equilibria through inflationary finance or infusions of equity that transfer losses to government accounts. The Asian financial crisis of 1997-1998 reinforced the view, among critics, that development banking and government intervention in finance places domestic political economies at greater risk.²⁴

We have examined the Brazilian development bank, BNDES, elsewhere.²⁵ The trajectory of the BNDES suggests that critics of state development banks do indeed

20 Aghion cites: Societe National de Credit a l'Industrie (Belgium, 1919), Credit National (France, 1919), 1928, National Bank, Poland, 1928), 1928, Industrial Mortgage Bank (Finland, 1928), Industrial Mortgage Institute (Hungary, 1928), 1933, Instituto Mobiliare Italiano (Italy, 1933), Instituto per la Reconstructione Industriale (Italy, 1933).

21 Johnson, Chalmers. *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*. Stanford, CA: Stanford University Press, 1982

22 Woo, Jung-En. *Race to the Swift: State and Finance in Korean Industrialization*. New York: Columbia University Press, 1991

23 Woo-Cummings, Meredith (ed). *The Developmental State*. Ithaca, NY: Cornell University Press, 1999

24 However, for Hall, competing paradigms dispute causal interpretations of the Asian financial crisis. See: Hall, Rodney Bruce, 'The Discursive Demolition of the Asian Development Model', *International Studies Quarterly*, 47,1, (2003).

25 Von Mettenheim, Kurt *Commanding Heights*, chapter 6 (manuscript under review, Penn State Press)

describe abuses of the type that occurred under military rule and during the political vacuum of prolonged transition in Brazil. However, since democratization amidst the financial crises that wracked emerging markets economies during the 1990s and early 2000s, this traditional development bank came, once again, to the center of policy prerogatives and capacities. Since creation in 1952, the BNDE(S) remained at the center of developmentalist policies until the breakdown of democracy in 1964; was recast under military government to channel world liquidity and forced domestic savings through financial markets to private and state owned enterprises; and shifted to market-centered policies as the fiscal crisis of the Brazilian state deepened during the 1980s. After 1990, the BNDES became primary agent for privatization of state enterprises and the channel for new strategies to maximize the gains of liberalization and market forces. The BNDES also provided critical counter-cyclical credits to the Brazilian economy during the sudden stop of foreign capital flows into Brazil (2001-2004).

The combination of financial repression and political repression under military rule in Brazil suggests that democratization may improve the corporate governance of public banks – even centralized development banks involved in large scale transactions. In this respect, critics of development banking underestimate the importance of transparency, accountability, legislative oversight, and judicial review for averting risks of government banking. Since return to civilian rule in 1985, the BNDES became primary agent of both privatizations and involved in further financial, fiscal, and administrative reforms. These policies during the 1990s endowed the first PT coalition government under President Lula (2003-2006) with a very large development bank able to pursue policies despite capital flight, perceptions of political risk among foreign investors, and lack of confidence in private finance and banking. Recovery of confidence, capital flows, and the BOVESPA stock market during President Lula's second term (2007-) has reinforced the BNDES as a central part of Brazilian political economy. In this respect, the BNDES has returned to its origins: in search of collaboration between the public and private sectors, and domestic and foreign capital, to overcome constraints on economic growth and social inclusion. Since 1952, the BNDES has responded with credit and finance when markets collapse, capital flees, and private banks refuse to lend. Suggesting that the BNDES reproduces financial repression misrepresents reality.

Two further grounds for criticism of development banks exist. The first is based on the impact of large scale projects on the environment and the difficulty of bringing sustainable development criteria to lending at large public banks. Manfred Nitsch's chapter on the trend away from development banking toward microfinance provides an overview of finance and development policies in Latin America that reflect this shift "downmarket", i.e. one away from large loans and projects that tend to involve large externalities and impact the environment, toward micro savings, loans, and finance that reach those most in need. The second criticism also has to

do with the difficulty of centralized development banks reaching small enterprises and introducing popular credit programs. The centralized organizational structure of development banks remains distant from the bottom up forces of firms and individuals as potential borrowers.

Savings Banks

“That all persons in the time of their health and youth, while they are able to work and spare it, should lay up some small inconsiderable part of their earnings as a deposit in save hands, to lie as a store in a bank, to relieve them, if by age or accident they should come to be disabled or incapacitated to provide for themselves; and that if God bless them, that neither they nor theirs come to need it, the surplus may be employed to relieve such as shall.” Daniel Defoe, *Essays on Projects*, London, 1697, p. 45

Since Daniel Defoe wrote in 1697, Europeans have proposed, created, reformed, and modernized government savings banks. These institutions retain large market shares in most European banking systems in the 21st century. Savings banks were largely disregarded by classical economists favoring laissez faire policies during the 19th century. Savings banks were also ridiculed as utopian liberalism by Marxists. Nonetheless, ideas about savings banks first developed in the late 18th and early 19th century still remain timely.²⁶ Savings banks and providence associations were designed to avert workers becoming a burden on public services and taxpayers, to provide assistance to those in need (especially after the 1832 Poor Law proscribed charity), and to contribute to the independence of workers and their families. Gosden estimates that membership in UK friendly societies reached over 5.5 million by 1875. The policies, organizational form, and evolution of savings banks differed widely across Europe, but local and regional government savings banks were founded in most countries. However, Italy privatized savings banks most European savings banks modernized and integrated into national networks to compete with private commercial banks as European Community policies opened the industry and integrated finance. Most government savings banks in Europe have increased their market shares of domestic banking since.²⁷

Savings banks are often very old institutions. Review of recent savings bank performance, market share, social policies, and regulatory frameworks in advanced and developing countries suggests that these financial institutions remain competitive financial institutions at the center of many banking systems.

26 Price, Richard. *Proposal for Establishing Life Annuities in Parished for the benefit of the Industrial Poor*. London, 1773; Acland, John. *A Plan for rendering the Poor independent of public contributions*. Exeter, 1786; Eden, Frederick. *Observations on friendly societies for the maintenance of the industrious classes during sickness, old age, and other exigencies*. London, 1801; Coloquhoun, Patrick. *A Treatise on Indigence*. London, 1806

27 Gosden, P.H.J.H. *The Friendly Societies in England, 1815-1875*. Manchester: University of Manchester Press, “1961”

European experiences are of special interest because of the vitality of government owned banks during the liberalization of banking and monetary unification that placed domestic banking systems under new competitive pressures. Major developments in European savings banks and their political, social, regulatory, and economic context are summarized in Table 1.

Table 1 – Major Developments in European Savings Banks, 1945–2000

Austria	1991: Wiener Zentralsparkasse amalgamation with Landerbank becoming Bank Austria, acquires Creditanstalt 1997. 1992: Central Giro merger with joint stock bank Osterreichisches Credit-Institut 1997: Giro-Credit amalgamation with Erste Osterreichische Spar-Casse Bank (ex-Vereinsparkasse) to become ERSTE Bank AG listed on stock market.
Belgium	1942: Association of Belgian Mortgage, Savings, and Capitalization 1959: Private Savings Bank Group, 1986 renamed Belgian Savings Bank Group
Denmark	1960s–1970s: 486 local savings bank mergers into two national savings banks (SDS and Sparkekassen Danmark), five regional savings banks, and 140 smaller savings banks (merged to total of 188 savings banks by 1991).
France	1950 Minjoz Act frees lending 1958 583 savings banks in seven regional associations 1965 Savings for Home Act 1968 Racine Commission report on modernization of savings banks 1973 Checking Services 1979 Nice Conference report → 1983 Savings Bank Reform Act defining social representation and bank status 1980s–1990s Amalgamation into regional units and closing of regional finance companies
Germany	1947 Union of German savings banks, giro, and giro-central associations, in 1953 renamed Deutsche Sparkassen- un Giroverband e. V. 1992 723 savings banks in 13 regional savings bank and giro-bank associations
Great Britain	1945–1976 Three groups: Trustee Savings Banks (deposits 2022 million pounds 1965, Post Office Savings Banks (deposits 1822 million pounds, 1965), Building Societies (total assets 5532 billion pounds, 1965) 1972–3 Report of the Committee to review National Savings (Page Committee Report) 1976 Legislation to merge savings banks into 17 regional banks with central board 1986 Trustee Savings Bank, TSB, floated as public company on London Stock Exchange
Greece	1956–1990 PSB, Postal Savings Bank number of accounts increases from 138,186 to 4,320,531 (over 40 percent of population), with 12,8 percent savings deposit market share, 11.4 percent credit market share, and 8.7 percent total bank assets in 1990.
Ireland	1923–1965 Regulations limiting savings banks to receive deposits at fixed return set by finance ministry. 1964 Association of Trustee Savings Banks in Ireland lobby formed. 1989 Trustee Savings Bank Act liberalizes savings bank operations to compete with commercial banks 1986–1992 Amalgamation of nine savings banks into The Trustee Savings Bank, TSB 1990 Post Office Savings Banks & Trustee Savings Banks deposits = 1,167 million pounds, Building Societies = 3,929 million pounds, Government savings/financial institutions deposits = 1,407 million pounds)
Italy	1953 Convergence in interest rates paid on treasury certificates at postal banks and savings banks. 1960 79 savings banks with 2465 branches (up from 240 in 1940, 506 in 1950) 1963 bank deposit market share 22.6 percent increases to 28.4 percent in 1990. 1990 Amato Law liberalization of bank system culminating European legislation 1990s Privatization of major savings banks

Netherlands	<p>1950s-1960s "Family" savings bank model expands to consumer credit and insurance brokerage.</p> <p>1960s Formation of network across savings banks to compete with commercial banks.</p> <p>1980s Merger between Post Office Giro, Post Office Savings Bank, Nederlandsche Middenstandsbank.</p>
Norway	<p>1945-1961 Savings bank deposits remain at 50 percent of market share (commercial banks decline from 48.8 percent in 1947 to 39.9 percent in 1970).</p> <p>1950 Post Office Savings Bank and Post Office Giro created.</p> <p>1970s-1980s Commercial banks regain market share</p> <p>1987 Savings Bank Act permits capitalization through PCCs, primary capital certificates, by 1996 PCCs of 15 savings banks reach NOK 10.4 billion.</p> <p>1959-1996 Consolidation from 600 to 132 savings banks</p> <p>1996 Savings bank market share 29 percent of domestic credit, 45.5 percent of deposits.</p>
Spain	<p>1947 regulation of social welfare policies of savings banks (24.65% profits 1947-1992).</p> <p>1962 Bank Sector Legislation and creation of ICCA Instituto de Credito de las Cajas de Ahorros supervisory body created, transferred to central bank in 1971</p> <p>1939-1962 number of savings banks declines 98-84 (29 acquired, 15 created)</p> <p>1950 branches increase to 1000, reach 2000 in 1956, 3000 in 1962, and 14,414 in 1992.</p> <p>1985 Savings Bank Act to democratize, professionalize, and reform savings banks.</p>
Sweden	<p>1955 Savings Bank Act sets trustee representation half local government appointees half depositors.</p> <p>1962 Limitation Committee standardizes bank regulations</p> <p>1969 Savings Bank Act liberalization of savings bank policies and practices</p> <p>1989-1991 Formation of single Savings Bank Group uniting two savings bank associations.</p> <p>1992-3 Banking crisis leads to creation of SwedBank (Sparbanken Sverige AB) uniting various bank units under Savings Bank Group.</p> <p>1995 Savings banks retain 26.6 percent market share of deposits and 25.4 percent of private credit.</p>
Switzerland	<p>1970-1980s Adjustment to dual depressions reduces number of savings banks.</p> <p>1971 Association of 248 Swiss Regional Banks formed, but market share of domestic declines from 25 percent in 1945 to 12 percent in 1975 to 5 percent in 1995.</p> <p>1994 RBA Holding created to consolidate regional banks.</p> <p>1990-1995 Cantonal banks maintain 35 percent of savings market.</p> <p>1995 Regional banks and savings banks (n=127) retain balance sheet of 72.2 million francs, compared to 730.5 million francs at big four private banks and 262.5 million francs of cantonal banks.</p>

Source: Mura, Jürgen (ed). *History of European Savings Banks*, Sparkassen Verlag, Vol I, 1996, Vol II, 2000.

Several common patterns emerge from these experiences. First, in comparative perspective, savings banks appear to provide a "European Advantage" over the US and other countries without these institutions. Unlike the fiasco of widespread savings and loan bankruptcies in the US during the 1980s, in Europe local, regional, and national savings banks appeared to have modernized to remain at the center of domestic banking systems and political economy. Second, far from being destined to failure under pressure from increased competition from commercial and foreign banks, savings banks have instead reformed, modernized, consolidated, and adopted new strategies to compete during the liberalization of European banking and markets. Third, Canevalli argues that savings banks retained a significant comparative advantage in terms of organizational network and lending discretion that was critical for ushering small and medium enterprises through economic downturns. Fourth, the corporate social responsibility policies and contributions of savings banks have provided critical social and cultural investments above

and beyond the practices of private firms. For example, French savings banks reserve half of dividends to fund social responsibility programs run by bank staff and local or regional social and political representatives. Spanish savings banks also are mandated to contribute a share of profits to social welfare programs, on average 24.9 percent of profits during the last decades.

Savings banks also remain important in developing and emerging countries. Indeed, savings banks and postal banks appear to provide an important legacy from European colonial rule in developing countries after independence. Sher and Yoshino provide an overview of postal savings institutions in Asia, while Hugue reviews the history and current policies and institutions of postal banking in Africa.²⁸ The number of savings accounts and percent of domestic population with savings deposits by region and country reported in a UN survey conducted in the late 1990s is reported in Table 2.

Table 2 – Regional and National Distribution of Postal Savings Accounts, c1998

	Postal Savings Accounts	Percent Population
Sub-Saharan Africa		
Benin	330,000	5.4
Burkina Faso	323,924	2.8
Central African Rep.	68,099	1.9
Gabon	159,884	13.7
Ivory Coast	708,000	4.6
Mauritius	210,296	18.3
Niger	115,000	1.4
Tanzania	1,000,224	2.9
South Africa	1,700,000	4.0
Middle East / North Africa		
Egypt	7,500,000	11.2
Syria	565,000	3.6
Morocco	1,029,905	3.6
Tunisia	1,871,500	20.2
East Asia		
China	104,000,000	8.2
Japan	113,690,000	89.9
Korea	18,164,000	82.2

²⁸ On postal savings banks in Asia, see: Sher, Mark J & Naoyuki Yoshino (eds). *Small Savings Mobilization and Asian Economic Development: The Role of Postal Financial Services*. London: M.E. Sharpe, 2004

	Postal Savings Accounts	Percent Population
South Asia		
India	116,000,000	11.7
Sri Lanka	9,007,530	47.6
Western Europe		
Austria	2,300,000	28.4
Belgium	310,639	3.0
Finland	2,392,913	9.7
France	20,000,000	34.1
Germany	19,670,000	24.0
Greece	4,500,000	42.6
Italy	15,000,000	26.1
Sweden	2,226,000	25.2
Eastern Europe		
Czech Republic	830,000	8.1
Slovenia	160,000	35.8
Croatia	126,502	2.7

Source: Scher & Yoshino, *Small Savings Mobilization and Asian Economic Development: The Role of Postal Financial Services* 2004, p. 37, from UN Department of Economic and Social Affairs survey.

In sum, coordinated market economies, bank-centered financial systems, and developmental states retain government (and savings) banks at the center of their financial systems, political institutions, social organizations, and government policies.

Savings banks have also proved critical agents for social inclusion throughout South America. Further study of these institutions is required. However, case studies of the Brazilian Caixa Econômica Federal and Chilean BancoEstado suggest that these institutions provide significant comparative advantage for public policies toward social inclusion. The European and World Savings Bank groups have been particularly active in promoting savings bank and postal bank modernization in developing and transition countries. Indeed, research and publications by the World Savings Bank Institute provide a variety of new programs underway in these countries. However, like development banks described above, it should also be noted that savings banks also have their critics: The proposed privatization of the Japanese Postal Bank system provides an important example of how political coalitions can sustain financial liberalization and use privatization against entrenched interests.²⁹ Chapter three by Olivier Butzbach further reviews the advances and challenges of savings bank modernization in several Continental European countries, while Turner & Grossle describe how the German Sparkasse

²⁹ See papers presented at the session entitled "The Politics of Postal System Reform in Japan." Special Session 1029, International Political Science Association World Congress, Fukuoka, Japan, July 2006

system has been critical in ensuring access to banking services and reverse forces of social exclusion. Salquin also reviews the corporate social responsibility policies of the Caisse d'Épargne savings bank group in comparative and theoretical perspective. In sum, this volume focuses on savings banks as a major actor in both coordinated market economies across Continental Europe and neo-developmental states in Latin America.

Varieties of *Financial Capitalism*: Saving Banks and Coordinated Market Economies

Many of the differences between Continental European and other advanced economies have to do with how savings banks and financial markets work in different varieties of capitalism. Since publication of Hall & Soskice's *Varieties of Capitalism* in 2001, scholars have focused on matters of classification,³⁰ corporate governance,³¹ policy complementarity,³² regulatory convergence,³³ and the applicability of concepts to Latin America.³⁴ These works make it clear that theories and policies from capital market-centered financial systems and liberal-market economies such as the US and UK are often amiss or out of place in Latin America and other developing countries and regions. Instead, bank-centered financial systems and government banking have several advantages that are especially relevant to the Latin American context of late development, shallow markets, dismal income distribution, and volatile business cycles. Banks provide more patient capital than equity markets to help firms through adjustment to shocks typical of a large developing country. Banks can monitor firms and the economy better where shallow markets lack information and efficient pricing. And government banks still provide longer time

30 Sellers, Jeffrey M. "National Local Political Economies and Varieties of Capitalism: A Classification and Analysis of Twenty-One OECD Countries." Paper presented to the American Political Science Association Meeting, Philadelphia, PA, 2003, Hopkin, Jonathan. "How Many Varieties of Capitalism? Structural Reform and Inequality in Western Europe." Paper presented at the Annual Meeting of the American Political Science Association, Chicago, Illinois, September 1-5, 2004.

31 Tiberghien, Yves. "Global Forces, Political Mediation, and the Fragmentation of Corporate Governance Patterns: The Cases of France, Japan, and Korea." Paper presented to the American Political Science Association Meeting, Chicago, IL, 2004 and Tiberghien, Yves. "EU Mediation of Global Finance vs National Corporate-Labor Coalitions: The Mighty Battle over the Takeover Directive, 1989-2003." Paper presented to the American Political Science Association Meeting, Philadelphia, PA, 2003, Gourevitch, Peter & James Shinn. "Explaining Corporate Governance: the Role of Politics" Paper presented to the American Political Science Association Philadelphia, Pa. August 27-31, 2003, Jackson, Gregory. "Toward a comparative perspective on corporate governance and labour management." RIETI Discussion Paper Series 04-E-023

32 Deeg, Richard. "Measuring Institutional Complementarity and Change in Capitalist Systems." Paper Presented at the Annual Meeting of the American Political Science Association, Chicago, IL, 2004

33 Lütz, Susanne. "Convergence within national diversity – a comparative perspective on the regulatory state in finance." Paper presented at the Annual Meeting of the American Political Science Association, Chicago, Illinois, September 1-5, 2004.

34 Schneider, Benn R. "Varieties of Semi-Articulated Capitalism in Latin America." Paper presented to the American Political Science Association Philadelphia, Pa. August 27-31, 2003

horizons for infrastructure and social investments where private agents remain unwilling to put money.

Does the varieties of capitalism approach apply to Latin America? Hall & Soskice appear to respond in the affirmative.³⁵ However, their tendency to underestimate both the stark differences between developing and advanced economies and tensions between markets and institutions counsel caution. In Latin America, policy making involves fundamentally different realities of underdevelopment, social exclusion, and market volatility. And despite the record of recent transitions from authoritarian rule, Latin American economies remain far less settled and far less coordinated than Continental European experiences. Brazil and other Latin American countries also pale in terms of political development. A standard distinction about governments in political science turns on whether social classes have been included in political institutions. By the mid- twentieth century, this was largely the case in Europe. Scholars of advanced capitalism therefore assume many fixed parameters in terms of income distribution, rule of law, government agencies, and political institutions. In Latin America, disputes over bank credit and finance differ because the stakes are higher, the number of those excluded is greater, and the parameters for policy constantly shift.

These differences are not simply of degree. Advanced economies have consolidated institutions and deeply embedded more stable markets. Firms and governments in Brazil and Latin America face more volatile business cycles and shallow markets. Conaghan & Malloy noted over a decade ago that transitions from authoritarian rule in Latin America demonstrated remarkable political creativity. However, another observation of Conaghan & Malloy still rings true: Democracy in the region is neither based on underlying social pacts, nor on class compromises along the lines of European experiences with Keynesian policies and welfare states. Nor are new and often embattled democracies in Latin America based on inclusionary regimes and policies comparable to past experiences in the region involving national-populism, state-led development, and import substitution industrialization. Latin American politics therefore often reveals fundamental disagreements about markets, institutions, government, law, and competing perceptions of social justice. In short, Latin American policy-making involves decisions during volatility, crisis, and even catastrophe that sum to a different type of unsettling statecraft.³⁶

35 "We concentrate here on economies at relatively high levels of development because we know them best and think the framework applies well to many problems there. However, the basic approach should also have relevance for understanding developing economies as well. (cf Bates, 97)." Hall & Soskice, p. 2

36 Conaghan, Catharine M. and Molloy, James. *Unsettling Statecraft: democracy and Neo-Liberalism in the Central Andes*. Pittsburg: University of Pittsburg Press, 1994. Nelson, Joan (ed). *A Precarious Balance: Democracy and Economic Reforms in Latin America*. Washington, DC: Overseas Development Council, 1994 and Sola, Lourdes (ed). *Estado, Mercado e Democracia: Política e Economia Comparadas*. São Paulo: Paz e Terra, 1993.

Notwithstanding these differences, this volume compares government banking in Europe and South America. A brief review of concepts from comparative financial economics helps clarify the grounds for this cross-regional comparison. Allen & Gale argue that markets, banks, and corporate governance vary across the largest economies in ways that confirm the core distinction between bank-centered and market-centered financial systems. On the left side is the paradigmatic market-centered economy of the US that retains deeply leveraged liquid financial markets, a large number of banks that compete in terms of financial services and credit markets, and where hostile takeovers and liquid equity shares reinforce financial markets and competition as mechanisms for allocation of resources. On the right hand of the figure is Germany, with comparatively small financial markets, the concentration of domestic banking in a few large institutions,³⁷ and long-term relationships between banks and firms at the heart of politics and government policy. Allen & Gale arrange the UK, Japan, and France as intermediate financial systems along these three dimensions, suggesting that their financial markets, banks, and traditions of corporate governance tend to approximate the attributes more clearly embodied by the polar opposites of the US and Germany.

Table 3 – Banks in Financial Systems: Comparative Categories of Allen & Gale

	US	UK	Japan	France	Germany
Financial Markets	Hi	Hi	Mod	Mod	Low
Banks	Competition		←→	Concentration	
Corporate Governance	Hostile Takeover	--	Main Bank	--	Hausbank

Source: Allen & Gale, 2000, p. 4

These concepts and categories from Allen & Gale provide the point of departure for reassessment of government banks presented in this volume. In a broader sense, Allen & Gale concur with the varieties of capitalism approach in political economy. Contemporary theories of relational banking suggest that banks are not necessarily culprits of bad equilibria and slow growth. Because banks can provide effective monitoring of firms, longer term finance, and use local knowledge and information better than liquid equity markets, it follows that bank-centered financial systems may produce stronger, more sustainable growth than economies based exclusively on equity markets.

These findings and theories are at odds with recent expectations about financial convergence. Since Ricardo and Smith, free trade, comparative advantage, and technical progress were to cause the wealth of nations to converge.³⁸

³⁷ Note that this description of banking in Germany differs from the importance of a large number of small credit institutions emphasized below in chapter two.

³⁸ Estimates for the time necessary to bridge differences between the global north and south remain between one and several generations. Barro, Robert & Sala-i-Martin, Xavier. "Convergence." *Journal of Political Economy*, (1992), Vol. 100, no. 2, pp. 223-251.

Understanding why global capital has not flowed to underdeveloped countries is beyond the scope of this volume.³⁹ Instead, a more specific expectation about convergence frames inquiry: That financial liberalization and privatization would cause domestic economies to converge toward private banking and equity markets. Political scientists and economists such as Keohane & Milner, Cerny, Loriaux, and Story & Walter argue that domestic financial industries would converge because they have been most exposed to new forces of globalization.⁴⁰ Studies of European financial systems provide substantial evidence to the contrary: bank credit still drives most advanced economies. Meanwhile, stock markets remain at the center of the important but notably exceptional experiences of the US, UK, and a very few number of other countries; most small countries that serve as offshore finance centers. Butzbach, Vitols, and Schmidt suggest that financial systems in Italy, France, and Germany have retained or increased their differences during financial liberalization and monetary integration.

The studies presented in this volume suggest that savings banks, cooperative banks, and other traditional credit and savings institutions have thrived during the last decades marked by liberalization and consolidation of banking activities. The importance of traditional credit institutions such as savings banks, cooperative credit societies, credit unions, and mortgage associations, many owned or controlled by (usually local) governments has been reported by scholars of advanced and developing countries. Concerns about big private banks and capital markets overshadow another critical dimension of change. Considered individually, local and regional credit institutions are often very small. However, as a whole they sum to a very large part of the total volume of domestic credit and finance in many advanced countries. And contrary to the expectation about the comparative advantage of large private banks, the market share of local and regional government and non-profit credit institutions appear to have remained stable or increased. Despite the pressures from financial integration and the launching of the euro in 2000, scholars of Germany, France, Italy, and Spain suggest that a wide variety of local, regional, cooperative, non-profit, and savings banks continue to play essential parts in domestic politics and policies.

The theory of comparative *institutional* advantage emphasized in the varieties of capitalism approach appears to provide a powerful explanation for this persistence of traditional local and regional credit institutions. Instead of convergence toward market-based financial systems, differences appear instead

39 Tornell, Aron & Velasco, Andres. "The Tragedy of the Commons and Economic Growth: Why Does Capital Flow from Poor to Rich Countries?" *Journal of Political Economy*. (1992), pp. 1208-31 and Edwards, Sabastian (ed). *Capital Flows and the Emerging Economies: Theory, Evidence, and Controversies*. Chicago: University of Chicago Press, 2000

40 Story, Jonathan & Ingo, Walter. *The Political Economy of Financial Integration in Europe*. Manchester: Manchester University Press, 1997.

to have been reinforced. Patterns of bank change suggest that path dependence, local and regional institutions, traditional banking practices, and other differences remain critical. European financial systems reflect long historical trajectories that have accumulated large amounts of capital in deeply embedded local markets and institutions. Far from being condemned to the dustbin of history in favor of more efficient financial markets or big banks with greater economies of scale, local banking, credit, and finance still appear important. Understanding how policies reshaped domestic bank systems during financial liberalization in Europe provides essential comparative references for study of government banks elsewhere.

This volume explores evidence from advanced economies about financial policies that appear able to sustain comparative advantage, smooth adjustment to shocks, increase economic growth, and promote better income distribution. This implies a theory about the varieties of *financial* capitalism. As noted, the varieties of capitalism approach raises profound questions about creating and sustaining comparative advantage, the ability of governments to control business cycles, and the importance of different domestic policy traditions. The theory of comparative *institutional* advantage suggests that the domestic impact of globalization has differed. Nations appear not to be converging toward a single model based on free trade, equity markets, and privatization. Domestic economic policies, the governance of firms, the content of social policies, and the shape of political institutions across countries are based on strategies that involve collaboration as much as market competition. Hall & Soskice, Scharpf, and Ostrom stress how the limited exchange of information, the monitoring of behavior, and sanctions against those who would defect from cooperation pervade policymaking across continental Europe.⁴¹ Continental European policy traditions involve powerful business associations and trade unions, extensive networks of cross-shareholding, and legal or regulatory systems all designed to promote collaboration as much as competition. But the argument of Hall & Soskice is about firms, profits, and competitive advantage, not politics. They argue that coordinated market economies let firms coordinate strategies to which they would not have been led by market relations alone.

In any case, the empirical assertion by Allen & Gale appears *not* to be supported by recent studies. Allen & Gale are unequivocal: “The current trend is toward market based systems.”⁴² They emphasize the impact of financial liberalization in France, “big-bang” liberalization of the domestic financial sector in Japan, and comment that: “Latin American countries such as Brazil are implementing changes to create US style financial systems.”⁴³ This claim reflects expectations during the 1990s that economies across the globe would converge toward private banking

41 Scharpf, Fritz W. *Governing in Europe*. Oxford: Oxford University Press, 1995 and Ostrom, Elinor. *Governing the Commons*. Cambridge: Cambridge University Press, 1990.

42 Allen & Gale, *op. cit.*, p. 5

43 *ibid.* p. 5

and market-centered financial systems through privatization and liberalization. Policy-makers in several state- and bank-centered systems have indeed pursued liberalization and privatization strategies to great benefit, both in advanced and emerging economies. The privatization of the Japanese Postal Bank system provides an important comparative reference for political coalitions that sustain financial liberalization.⁴⁴ However, governments and banks remain important parts of domestic financial landscapes and the record of liberalization and privatization is far from clear. This complexity reinforces the methodological imperative to go beyond easy generalizations from apparent trends in aggregate data, and focus the analytic lens closer through case studies and specific comparisons.

Debates about bank change often turn on how deregulation, financial globalization, and new information technologies have deepened capital markets. Continental European experiences remain different. European banks have faced additional pressures from financial integration and adoption of a single currency. However, the intensification of competition and the adoption of new bank strategies appear to have reinforced and accentuated “those fundamental functional principles that are idiosyncratic to the respective financial system.”⁴⁵ Financial liberalization appears to have reinforced bank-centered systems and refashioned traditional institutions across Continental Europe.⁴⁶ This outcome differs from the US and UK where banks have tended to abandon the traditional business of accepting deposits and extending credit in favor of new financial products and services. Schmidt summarizes the different past and contemporary paths of domestic financial systems across Continental Europe in the following terms:⁴⁷

- 1) banks play a strong role in their respective financial systems
- 2) universal banking is prevalent
- 3) not strictly profit-oriented banks play a significant role
- 4) there are considerable differences between national banking systems.

These differences involve a series of questions about banking, finance, and development beyond the scope of this study.⁴⁸ However, one outcome seems clear: Instead of convergence, Schmidt concludes that the world’s largest five domestic economies appear to not only have maintained their differences but indeed have diverged further in terms of domestic banking and finance.⁴⁹

44 See papers presented at the session entitled “The Politics of Postal System Reform in Japan.” Special Session 1029, International Political Science Association World Congress, Fukuoka, Japan, July 2006

45 Hackethal, op. cit. p. 32

46 See: Kurzer, Paulette. *Business and Banking: Political and Economic Integration in Western Europe*. Ithaca, NY: Cornell University Press, 1993

47 Schmidt, Reinhard H. “The Future of Banking in Europe,” Goethe-University, Frankfurt, Germany. Working Paper Series in Finance and Accounting, No.72, March 2001

48 On regulatory regimes in European finance, see: Lütz, Susanne. “Convergence within national diversity – a comparative perspective on the regulatory state in finance.” Paper presented at the 2004 Annual Meeting of the American Political Science Association, Chicago, IL, September 2004

49 Hackethal notes that Boot & Thakor (1996) reach a similar conclusion: “In bank-based financial

In a broader sense, the persistence of differences suggests that various development paths can lock in comparative advantage. Indeed, for Allen & Gale, current differences across financial sectors reflect different national trajectories of crisis, recovery, and growth over long periods of time.⁵⁰ In sum, contrary to expectations about a global convergence toward policies of liberalization and privatization to free market forces, comparative financial economics suggests a variety of financial capitalisms and the continued viability of government banking. The persistence of differences and the reform and modernization of government banks during the last decades suggest reassessment of public banking is needed. The chapters presented in this volume report new research on savings banks from Europe and Latin America to better understand new prospects for social inclusion and sustainable development.

Government Banking in Developing, Emerging, and Transition Countries

Financial liberalization and banking in emerging, transition, and developing economies since 1980 also appear to have taken several different paths.⁵¹ One involves radical reforms and the internationalization of domestic financial system. These experiences are largely found in Eastern Europe after transitions from Stalinist regimes and command economies. A second path appears to have been taken across Latin America involving policies of privatization and liberalization that led to substantial but not wholesale internationalization of domestic financial systems. A third path appears among the very largest emerging nations that have liberalized their financial sectors selectively, strategically, or very little at all. A fourth path is embodied by the persistence of underdevelopment, experiences found in many African countries. Finally, financial systems across Asian developing countries seem too diverse to be classified as a single path, but their substantially

systems the functions of information collection, risk allocation, financing and monitoring are performed well by banks, so that the demand for financial innovations and for the respective markets is relatively low.” p. 32

50 Allen & Gale: “In the UK, the South Sea Bubble in the 18th century led to regulation of the stock market, which was subsequently repealed, and banking crises in the 18th century led to the development of effective central bank policies. In the US continual banking crises eventually led to a centralized Federal Reserve. The Great Depression led to the formation of the Securities and Exchange Commission and the development of a regulatory framework, much of it still in place. In Continental Europe the Mississippi Bubble, which occurred about the same time as the South Sea Bubble, created extreme scepticism about the role of markets. In the long-run, financial systems were developed that relied primarily on banks rather than a combination of financial markets and banks as in the Anglo Saxon countries.” op. cit p. (chapter 9). See: Caprio Jr., G. & Vittas, D. (eds.) *Reforming Financial Systems: Historical Implications for Policy*. New York: Cambridge University Press, 1997, Mitchell, W. *Business Cycles and their Causes*. Berkeley, CA: University of California Press, 1941, von Thadden, E. “The Term Structure of Investment and the Bank’s Insurance Function,” *European Economic Review*, (1997), Vol. 41 pp. 1355-1374

51 On financial policies in developing countries, see: Haggard, Stephan et al (eds). *The Politics of Finance in Developing Countries*. Ithaca, NY: Cornell University Press, 1993.

deeper credit markets and financial systems are marked in comparison to other developing regions. This section briefly explores these regional experiences.

Given the debates reviewed above, perhaps the most important inference about bank change is that little evidence suggests convergence toward private banking and stock market driven domestic economies. Instead, credit, bond issues, and government and domestic ownership still remain at the center of financial systems in developing, transition, and emerging nations, especially the largest ones. For example, data reported by the Bank for International Settlements (BIS) suggest that the financial systems of most developing nations remain bank-centered *with a bias toward national and government control* in the largest emerging nations, most markedly in China, India, and Russia.⁵² Furthermore, the data on bank change from the BIS also suggests that the efficiency, profitability, operating costs, and counter-cyclical credit allocation of banks are distributed in important ways across private, government owned, and foreign banks in emerging and developing countries. The division of financial labor in developing countries therefore appears to combine the comparative advantages (and shortcomings) of domestic, foreign, and government financial institutions in a variety of settings.

Government bank ownership remains widespread in most emerging economies, especially the largest ones. In 2000, a full 99.0 percent of domestic bank assets remained under government control in China, while 80.0 percent and 68.0 percent of domestic bank assets in India and Russia remained government owned. These levels represent considerable change, given that governments in India owned 91 percent of domestic bank assets in 1980, while state ownership of banks in 1980 under communist government in Russia and China was presumably complete. Although data on the average return on assets and Basel Accord capital reserve index were not reported for Russia and China, the 11.2 Basel Index and 0.4 percent return on assets (1998) reported for government banks in India suggest that government ownership is not necessarily the kind of financial black hole often portrayed by critics.

Eastern European nations reported in the BIS study include experiences with privatizations in the Czech Republic and Poland that decreased government ownership of domestic bank assets from 78 and 80 percent in 1990 to 28 and 23 percent in 2000 respectively. Nonetheless, government ownership of banks in Hungary increased from 81 percent in 1990 to 92 percent in 2000. And while government banks in the Czech Republic and Hungary reported significant losses during 1998 (returns on assets of -0.4 percent and -27.1 percent), government banks in Poland reported a 1.0 percent return on assets. These results were reported for 1998; the year Russia declared a moratorium on foreign debt that produced currency crises and financial losses throughout neighboring Eastern

52 Hawkins, John & Dubravko Mihaljek. "The banking industry in the emerging market economies: competition, consolidation and systemic stability - an overview." Bank For International Settlements, BIS Papers, No. 4, 2001

European countries. Again, the Basel Index reported to the BIS for government banks in Eastern Europe suggest that these institutions are soundly capitalized with sufficient reserves against bad credit and other shocks.

The Asian emerging economies reported in the BIS study also retain considerable levels of government bank ownership, albeit at lower levels than in the three largest emerging economies. Philippine government ownership of banks did fall from 37 percent in 1980 to 12 percent in 2000, but Korea increased government ownership of domestic banks during this period from 25 to 30 percent. Meanwhile, government bank ownership in Indonesian remained above 55 percent from 1980-2000. And while significant losses were declared by government banks in Asia during 1998 (a year after financial crisis) the only case of serious deterioration of capital according to the Basel Index was Indonesia. Once again, government banks are far from financial black holes and indeed appear to remain at the center of political economies in Asia.

The BIS data confirm that privatizations have decreased the level of government banking across Latin America. Government bank ownership declined substantially in Chile and Colombia, while Mexico first nationalized (in 1982) then sold all government ownership of banks. However, the experiences of Argentina, Brazil, and Venezuela suggest that bank change in Latin America has differed from the wholesale liberalizations and privatizations in Eastern Europe noted above. In 2000, governments in Venezuela, Brasil, and Argentina still retained control of 52, 43, and 30 percent of domestic bank assets respectively. Although government banks in Brazil and Colombia reported returns on assets of -0.1 and -10.0 percent for 1998, all other government banking sectors included in the BIS study reported positive returns, despite significant external shocks to their economies during that year. Furthermore, Basel Indexes reported by the BIS for government banks in Latin America suggest that all except Colombia (6.9) remain well above the 8.0 suggested by the Bank for International Settlements. This implies that government banks retained sufficient reserves against capital losses due to bad credit and economic shocks at the turn of the century.

Data from the BIS also suggest that foreign ownership of banks in large emerging political economies has increased since 1980. However, the different paces of change and continued prevalence of domestic ownership are consistent with the different regional and national development paths emphasized above. Again, the three largest emerging nations have changed the least. In 2000, foreign banks still owned less than one percent of domestic bank assets in China, while foreign banks increased ownership of bank assets in India from 4 percent in 1980 to 8 percent in 2000, and from 6 percent to 9 percent in Russia. In comparison, foreign bank ownership in other emerging economies of Asia included in the BIS study varied between a low of 7 percent for Indonesia and a high of 32 percent in Korea. Foreign ownership of bank assets in Latin America reflects considerably

higher levels of liberalization, varying from a low of 23 percent in Brazil to a high of 54 percent in Chile. Finally, the impact of liberalization on banking in Eastern Europe is confirmed by the comparatively higher levels of foreign ownership, ranging from 66 percent in the Czech Republic to 70 percent in Poland.

In sum, high levels of government bank ownership in emerging and developing nations suggests that policies of privatizations and liberalization have not been unilaterally adopted. Data on the number, size, concentration, efficiency, profitability, and capitalization of banks suggest not only that government ownership remains important in emerging political economies, but also that state owned financial institutions may remain viable and competitive after financial liberalization. Comparison of domestic and foreign banks (and bond markets) as sources of domestic finance and counter-cyclical agents during recessions suggest that the division of financial labor in emerging and developing economies still involve the virtues and vices of government, foreign, and domestic private banks. This volume attempts to improve understanding of government banks as agents capable of increasing social inclusion and sustainable development.

Summary of Seminar Presentations and Discussion

Review of the August 2006 seminar proceedings helps clarify the intent and evolution of this volume. The August 2006 seminar was organized in three parts, the first dealing with government banking experiences in advanced economies, the second dealing with the policies of international financial institutions toward government banks, and the third dealing with government banking in developing countries. Part I reviewed public banking in Germany, France, Italy, and Spain. Presentations differed in terms of cognate discipline, theoretical tradition, and methodology. Andreas Hackethal's presentation on public banking in Germany focused on debates in comparative financial economics, banking theory, and the German banking system. Frédéric Boccara adopted a macro-historical review of development in France from a more critical theoretical tradition in the social sciences that attempted to identify new policy opportunities for social inclusion and citizenship. Olivier Butzbach reviewed savings banks in France, Italy, and Spain from the perspective of political economy, focusing on empirical trends and policies that suggest the continued importance and increased role of government savings banks in Southern Europe.

A closer look at each of these presentations is in order. Hackethal's research on public banking in Germany taps a larger set of deeply contested questions about whether the German financial system is becoming market-based. For Hackethal, the political class in Germany values government banks (savings banks and provincial government banks) for their ability to invest longer term and focus on public rather than private returns. However, international financial institutions

argue that development banks such as the KfW make this unnecessary. Politicians also value public banks because they are seen to ensure widespread access to financial services. However, international financial institutions argue that the German postal bank and private banks provide access more efficiently and without political interference. Policy makers and politicians also argue that the longer-term, *relational* view of finance in government banks helps markets overcome information asymmetries. In opposition, international financial institutions argue that cooperative banks also provide longer term finance while averting the politicization of credit. Politicians argue that public savings banks ensure competition, while international financial institutions insist that their market share and competitive advantages impede competition and increase the cost of credit and finance.

After reviewing these debates about government banking in Germany, Hackethal also summarized critical features of the German financial system. Hackethal noted that the structure of German banking involves three pillars (private banks=pillar 1; government banks=pillar 2; cooperative banks=pillar 3), with a strong role of public financial institutions, many small banks with wide branch network, and a limited role of foreign banks. Since the 1970s, German savings banks have retained roughly forty percent of total loans and deposits, while private banks have provided roughly twenty percent and cooperative banks roughly fifteen percent. In terms of returns, Hackethal notes the continued importance of stable interest rate returns in bank balances. In a broader sense, the German financial sector is a relatively large part of the domestic GDP, and remains critical for household investments, external financing of firms, and German corporate governance practices.

Again, Hackethal emphasized the reality that private banks in Germany play a much smaller role than in other countries. And while the number of banks and branches is high, competition nonetheless occurs largely within the three “pillars” (private commercial vs investment banks in pillar 1; savings vs *Länder* banks in pillar 2; among cooperative banks in pillar 3). Furthermore, comparatively low bank profits in Germany are due to receipts still being based on (low) interest spreads between deposits and loans rather than financial services. Declining profits are thus due to increased competition rather than inefficiencies as emphasized by international financial institutions. In sum, Hackethal provides a variety of empirical evidence consistent with other studies of German banking and finance to suggest that traditional patterns have remained largely in place during the last decades. Description of Germany as a bank-centered financial system and political economy still holds. However, one important development is reported by Hackethal with reference to the research of Höpner & Krempel: The traditional dense cross-ownership patterns that placed large German banks at the center of corporatist

networks have apparently declined.⁵³ Nonetheless, on average, the proxy voting rights of German banks in DAX shareholdings remain at roughly 50 percent, very high in comparative perspective.

Hackethal also argued that views about change in the German financial system have so far polarized between the modernization tradition that see the traditional bank-centered system inevitably giving way to a more efficient market-centered financial system, while the “banks vs markets” view argues that reforms (designed to transform the German system toward a market centered financial system) will incur problems of incompatibility. Hackethal also reviewed debates about the *Sparkasse* group that deal with complex matters of savings, investment, resource allocation, profitability, organizational design, politics, and traditional social policies of solidarity. Hackethal concluded noting that further research into the Sparkasse group and the German financial system will be needed to understand development since the 1990s.

Boccarda explored the French experience with government banking, corporate relations, and globalization to present a broader argument about the need to develop new criteria for credit selection and public bank change. Boccarda introduced these challenges for theory and policy with a historical overview of public banking in France. For Boccarda, five phases characterize the evolution and formation of the current role of public banks in France: The 1944-45 nationalizations; the over-accumulation crisis that provided a turning point during 1967-73; the 1982 nationalizations amidst increasing financial globalization; the subsequent series of privatizations, bank restructurings, and creation of new financial markets during transition toward the euro and, finally; the new dynamics of public banking since the adoption of the euro. Boccarda’s historical overview clarified the broader questions he posed about the contemporary role of a public and semi-public bank sector, the impact of the information revolution, and the relation between social actors and public banking.

Boccarda reminded participants that the three largest private French banks (BNP, Société Générale, Crédit Lyonnais) and the Banque de France were nationalized after liberation in 1945, and that these government banks played a decisive role in reconstruction and reindustrialization through the FDES (Treasury). Boccarda confirms Shonfield’s classic account of directed credit through networks and specialized public agencies for economic sectors that averted market failures and secured unprecedented economic growth in France in the post-WWII era. However, Boccarda argues that the globalization of French firms and labor productivity were not accompanied by adequate value added arising from these transactions, and that over investment and over accumulation produced imbalances that became

53 See: Höpner, Martin/ Krempel, Lothar (2003): Ein Netzwerk in Auflösung: Wie die Deutschland AG zerfällt, in: MPIfG-Jahrbuch 2003/04, Köln 2004, S. 9-14.

increasingly severe during the 1970s. Furthermore, according to Boccara, public banking in France became caught up in an “escape ahead” syndrome whereby capital exports to developing countries, financial investments, and inflation sustained growth but exacerbated imbalances and reduced profits and the value added to the domestic French economy. Meanwhile, directed credits and creation of the European Monetary System increased the scale and scope of government financial policies. For Boccara, the consequences were increased unemployment, accelerating inflation, declining capital efficiency, and increased debt burdens in developing countries from French export-led growth.

For Boccara, the 1982 election of Mitterand and subsequent balance of payment and currency crises provide another fundamental turning point for public banking in France. Further nationalization of banks and enterprises led to another round of outward expansion towards the US and new attempts to modernize industry, reduce unemployment, and secure increased profits to subsidize directed credit policies. However, these policies deepened macroeconomic disequilibria and set the context for a turn to liberalization policies in the late 1980s. Thereafter, the increasing importance of financial markets, the securization of assets, the influx of US bonds, and the increased importance of central bank interest rate and money management changed the context for government banking in France. Subsequent privatizations, wage deflation, deficit financing via bond markets, and further capital exports during the 1990s reproduced higher inflation and reduced investments in human capital. Transfer of prerogatives to the European Central Bank and launch of the euro in 2000 also reinforced these domestic tendencies of financialization and declining human capital investments, while government policies shifted toward “second generation” reforms such as directed finance for SMEs, corporate innovation, and human capital formation.

Boccara also raised several broader questions about the impact of the information technology revolution on credit markets, public policies, and government banking. For Boccara, the near-zero cost of information, an increased burden of research and development, and the critical role of human capabilities sum to require reassessment of core ideas about money, markets, credit, corporate strategies, and public banking. This implies further transdisciplinary research to understand new links between monetary policy, central banking, domestic banks, financial markets, and credit policies. Boccara also explored the idea of a new type of credit selectivity, one able to shift public banking toward sustainable growth and human capabilities development. This “new monetary paradigm” implies relations between banks and firms on bases other than profitability. Specifically, this implies creation and adoption of new concepts and measures for value added, employment security, and new approaches through international organizations such as the Basel Accord that could develop and implement new criteria for bank accounting and reporting requirements for balance sheets in financial markets. These issues

raise a series of new questions about social forces, institutions, markets, regulation, and relations between international financial institutions, central banks, domestic policies, social organizations, and politics. Boccara thus explored the impact of new developments in credit, banking, and information technology on the political economy of government banking in the 21st century.

Butzbach presented further evidence from his research on savings banks in Italy, France, and Spain, adopting an empirical approach to understand recent developments. Butzbach focused on two critical matters; the public nature of savings banks' corporate governance (e.g. inclusion of stakeholders, cooperative status in the French case, links with local governments in the German case) and, second; the public nature of savings banks' business: business targets on the one hand (households, SMEs, local governments) and savings banks' non-profit objectives on the other. Butzbach's comparative analysis of government policies, bank strategies, and institutional context of savings banks in Germany, France, Italy, and Spain suggest significant differences across these national experiences. This confirms recent work in comparative political economy about varieties of capitalism, the specific configuration of domestic policies, and the institutional foundations of comparative advantage in banking. The counterintuitive findings reported by Butzbach include the increased market share of savings banks, credit collectives, and other non-profit, public, and semi-public financial institutions in these countries during the last decades characterized by financial liberalization and monetary unification.

The second part of the August 2006 seminar focused on policies at international financial institutions involving government banks, with special focus on Brazil and Latin America. Rogerio Studart, then at the Inter-American Development Bank (IADB), presented an overview of core theories about finance and development that inform IADB policies in general and the place of government banking in these policies. Studart and other recent studies suggest that the Inter-American Development Bank and World Bank have shifted away from the Washington Consensus that predominated during the 1980s and 1990s that favored privatization and financial liberalization. Instead, a variety of new development strategies now inform IADB and World Bank policies such as micro-credit, new development strategies, infrastructure finance, public-private partnerships, and a other innovations designed to shift finance toward sustainable development and social inclusion. Although Studart was unable to complete a chapter for publication in this volume, the new chapter prepared by Manfred Nitsch returns to these themes of international financial policies for cooperation and development.

The third part of the August 2006 seminar reviewed experiences with government banking in developing countries. Barbara Stallings provided a review of theoretical debates about financial policies in developing countries and a comparative overview of financial systems and patterns of change in Asia and Latin

America. In terms of theory, Stallings reviewed the new literature in economics critical of government banking as well as the traditional theories and policies of government banking associated with developmentalism in Latin America and Asia. Stallings also explored several empirical comparisons of government banking in Latin America and Asian developing nations. In comparative perspective, the shallowness of financial markets in Latin America and the more complex relations between ownership, performance, and institutions emerge as the most important observation about government banking in the two regions. Stallings thereby emphasized the financial dimension of underdevelopment in Latin America involving shallow markets for credit, bonds, and equities, the crowding out of the private sector, and problems related to international capital flows.

For Stallings, authors such as La Porta, Lopez-de-Silanes, and Shleifer argue that inefficient public banks cause financial repression and reproduce underdevelopment, while authors such as Barth, Caprio, and Levine argue that excessive regulation and government supervision impedes credit market efficiency. Finally, economists such as de la Torre and Schmuckler argue that domestic markets in most developing countries lack sufficient scale for efficient capital markets. The policy recommendations that flow from these empirical and theoretical claims often involve the privatization of government banks (preferably to more efficient foreign banks to increase competition) to replace direct government regulation, supervision, and intervention with more effective private monitoring and decision making and, finally, to liberalize and integrate domestic markets with global finance. Stallings also emphasized the reality that these policy recommendations often run directly against traditional policies and perceptions in Latin America and East Asian. Because private banks and financial agents have traditionally been unwilling to finance long-term investments, and foreign banks tended to extract capital rather than sustain inflows and investments, economists and policy makers in these developing regions have traditionally sought to protect domestic and government banks.

These issues set the context for Stallings's empirical comparisons of private, public and foreign banking in East Asia and Latin America. Stallings classified Latin American and East Asian banking systems according to the dominance of 1) foreign banks, 2) private domestic banks, 3) public banks, or 4) banking systems where mixed ownership prevails. Cross-regional comparisons reported by Stallings suggest that, in terms of ownership and performance, East Asian experiences support the new economics literature critical of government banking. The evidence suggests that East Asian banking systems dominated by foreign banks perform best, while banking systems dominated by private domestic banks outperform those dominated by government banks. However, Stallings also suggested that national experiences in Latin America provide a more complex picture, with domestic banking systems dominated by government banks performing best, while

banks characterized by mixed ownership patterns outperforming Latin American banking systems dominated by private banks.

Furthermore, Stallings suggested that the quality of domestic institutions is the most important explanation for these differences in the performance of domestic banking systems, not the type of bank ownership. This implies that case studies and small n comparisons may provide better understanding of the political economy of government banking in developing countries. Stallings also noted that popular and political support for government ownership of banks is often widespread. Finally, instead of favoring either traditional developmentalist views in favor of government banking, or unilaterally adopting policies of privatization as advocated by the new economic literature, Stallings suggested that pragmatism, transparency, and the establishment of clear mandates for government banks may best maximize the contributions of domestic institutions, public-private collaboration, and international assistance and investment in developing countries.

Mena and Errázuriz presented a case study of the BancoEstado, the Chilean government owned savings bank, an expanded version of which is presented in chapter five. Mena and Errázuriz review the history of the BancoEstado, present a variety of descriptive data about the scale, scope, and importance of this bank in Chilean, politics, economy, and society, and conclude with observations about recent accomplishments in terms of micro-credit and popular savings initiatives as well as the bank's plans for the future. Mena and Errázuriz emphasize over 150 years of public savings bank history in Chile as well as the core functions of government savings banks today, those of promoting financial inclusion, increasing opportunities and equal access to banking and finance, to complement private markets and increase competition in the banking sector, and to mobilize household savings to finance sustainable economic and social development. BancoEstado also retains a mandate to promote entrepreneurship, invest in human capital and culture, lead infrastructure investment, finance social spending, and contribute to financial stability, public confidence and national development. With over US\$20.5 billion in assets, the largest network of bank branches, ATM machines, half of Chilean savings accounts, two-thirds of mortgages in Chile, 60 percent of payments, 45 percent of the micro-business bank market and 80 percent of public sector banking, this government savings bank retain a marked importance in Chilean development. Recent modernization of information technology, administrative reforms, and new micro-credit policies suggest the BancoEstado may become central to the goals of expanding social policies under President Bachelet to address inequality.

Four chapters were added to this volume published by the Konrad Adenauer Press to expand the geographical scope and substantive coverage. Turner & Grossle's chapter on community banking networks and financial exclusion focuses on savings banks in Germany. Their chapter provides both an important case study of savings banking and review of theoretical and policy problems about social inclusion and

sustainable development. Given the modernization and performance of savings banks in Germany during integration and liberalization of banking in Europe, their study suggests important lessons for bank change and the social impact of banking and access to finance. Another chapter was commissioned on the corporate social responsibility policies of the Caisse d'Épargne savings bank group in France by Jean-Yves Salquin. Salquin reviews the literature on corporate social responsibility policies, practices in private and government banks in France, and the different social responsibility policies of the French savings bank group during the recent period of bank modernization and integration in Europe.

Three chapters on government banking in Latin America were also added to complete the present volume. In chapter four, Manfred Nitsch provides an overview of international cooperation policies and finance during the last thirty years. This chapter provides a transition between part one and part two of this volume by linking discussion of recent policies and trends in Europe to questions about finance and development in Latin America. Nitsch argues that the fundamental shift in development finance is one away from large scale projects and development banking toward microfinance, savings, and credit. In this respect, new approaches in international development agencies and non-governmental organizations converge with local community approaches throughout Latin America. From this perspective, the deepening of domestic banking and credit in Latin America implies a concomitant deepening of democracy and social capital.

Two chapters on government banking in Brazil were also added. The first is an overview of government policies, programs, ideas, and their theoretical affinities by Carlos Augusto Vidotto. Vidotto's chapter reviews the place of the Banco do Brasil, Caixa Econômica Federal (Federal Government Savings Bank), Banco Nacional de Desenvolvimento Econômico e Social (Bank of National Economic and Social Development), Banco da Amazônia (Bank of the Amazon), and Banco do Nordeste do Brasil (Bank of the Northeast Brazil) in Brazilian political economy. Instead of privatizing these government banks, the Brazilian government injected capital into these institutions and challenged executives to pursue new development policies. Vidotto explores the ideas behind policies toward government banks during the transition from military rule and reforms designed to maintain price stability. Finally, a case study of the Brazilian Federal Government Savings Bank (Caixa) completes the volume by exploring general concerns about government banking, social inclusion, and democracy. Review of government savings banks in Brazilian history suggests that these institutions have been at the center of domestic political economy, expanding and contracting under a variety of political regimes and economic conditions. Since capitalization to meet central bank and Basel Accord guidelines in 2001, the Caixa has attempted to modernize, continue to serve as agent for government policies, and expand both popular credit and savings and investment banking activities.

PART I

Government Banking in Europe

Chapter 1

Community Banking Networks and Financial Exclusion: How Savings Banks and Cooperative Banks Contribute to Financial Inclusion in Germany

Anke Turner and Ingrid Gröbl

Like any other good, financial services enhance individual welfare. For example the availability of a current account allows a household or firm to participate in cashless payment transactions thus saving time and money. Access to credit enables economic agents to compensate for the impact of sudden and unexpected falls in income on consumption. Likewise by shifting purchasing power from the future into the present, borrowing allows people to respond to intertemporal differences in utility. Savings and their investment in interest-bearing assets, too, can be used to bridge unexpected income gaps or enable agents to finance unexpected expenditures for example due to illness, death of a family member, unemployment, injury on the job etc. Savings also serve to accumulate wealth thus preventing household exposure to old age poverty. In OECD countries people have become used to the benefits of public welfare networks offering social insurance against illness, unemployment, income security in old age and guaranteed income in emergency cases. However, a persistent high level of unemployment as well as demographic developments have significantly contributed to rising gaps between expenditures and revenues with tremendous fiscal deficits as a consequence, casting serious doubts on the sustainability of the Welfare State. Privatizations of social security schemes are high on the political agenda and in this respect the role of financial markets is being put into the centre of debate.

Since the Welfare State offers income security in particular to low- income groups, the question whether financial markets can be a good substitute will of course depend on whether they are indeed able to offer financial services which suit the needs of all income groups and which can easily be understood by their potential buyers. Differently put, the quality of financial markets as a supplier

of income security will crucially depend on their capability to avoid financial exclusion, which in a broad sense encompasses self-exclusion as well, following from people's inability to understand risk-return patterns of various financial products. Indeed if financial markets were complete, then they would qualify as an excellent candidate offer complete insurance against idiosyncratic risks and would allow consumption-smoothing and consumption-tilting according to household preferences and all that at the lowest cost possible. In a world of incomplete financial markets, providers as well as buyers of financial funds will be left with manifold risks with unforeseen future contingencies as well as information asymmetries as major origins. To explain the limited ability of financial markets to meet financial needs of households and firms with information deficits, however, does not tell the whole story. A further problem is related to distributional aspects which so far have been largely ignored in financial economics. Financial exclusion in this respect is both a consequence of information deficiencies and a skewed income distribution that allows financial intermediaries to focus on raisin-picking.

This chapter examines whether financial exclusion can be overcome or at least mitigated by community banks or networks of community banks. We take Germany as an example in which savings banks ("Sparkassen") and cooperative banks ("Kreditgenossenschaften") have achieved significant market shares. Both sectors depart from profit maximization but still have so far successfully defied competitive pressures coming from profit maximizing banks. In this respect Sparkassen and Kreditgenossenschaften provide evidence that competitiveness and sacrificing instead of maximization can be compatible thus confirming the Integrative Business Ethics point of view. Indeed German banking has been characterized by a mixture of competition between profit-maximizing and satisficing banks and a specialization in particular financial services which limit to competition and i.e. provide allow Sparkassen and Kreditgenossenschaften to keep financial exclusion at a comparatively low level. Since current restructurings in the German banking system appear to foster profit maximization, these achievements are at stake.

Ethical and Social Aspects of Financial Exclusion

Financial exclusion affects in particular below average income groups, inhabitants of neglected living areas, and immigrants. Senior citizen and disabled people present another financially excluded group with respect to their physical constraints loan conditions. As will be elaborated in more detail below, financial intermediaries may have good microeconomic reasons to restrict access to financial services. From an ethical perspective, however, this is highly controversial because every human being does not only possess the same right to freedom and thus choice, but following the principle of impartialness, individual decision-makers have to take into account how their actions affect others and, more precisely,

they have to avoid decisions which harm others. However, what that means, for example, for a bank that denies a loan to a lower income household because screening costs are too high compared to expected revenues, has been the subject of rather controversial discussions. Following lines of thought which are based on utilitarianism, profit maximization is accepted as an ethical action as such because by avoiding the waste of resources it enhances the scope of choice for all other members in the society. Implicit in this argument is of course the assumption that profit maximization is not achieved by using monopoly power or by opportunistic behaviour but, for example, by choosing the best technology¹. Likewise (perfect) competition is considered as a mechanism of social interaction which is ethical as such because it enhances solidarity in a society.

As a consequence it is not the bank which should depart from its profit maximizing objective thus impairing its competitiveness, rather, following for example Homann, Blome-Drees (1992) and Wagner (1999), the bank should be released from a moral responsibility in this respect. As an alternative, Wagner (1999) suggests appropriate institutions which “correct” the decision to deny a household credit. By contrast, lines of thought which are based on Habermas’ discourse ethics like Peter Ulrich’s “Integrative Business Ethics”² criticize utilitarianism for its equalization of freedom with economic freedom, which would result in the primacy of efficiency over equity. According to Ulrich managers should not be released from ethical responsibility in cases when competition claims profit-maximizing behaviour. Rather, he turns the table by stating that if managers would include distributive aspects of their actions (thus deviating from profit-maximization), competition would honour this in the same way it honours profit-maximizing behaviour in a world in which this is the accepted guideline of firm behaviour. Ulrich, acknowledges the necessity of appropriate institutions but contrary to, for example, Wagner (1999), he does not accept institutions as a prerequisite for corporate ethical decisions. Rather, institutions as rules of collective behaviour have to be developed by involved business elites themselves.

From a social point of view, poverty and social exclusion jeopardize social cohesion. The acceptance of social cohesion as a desirable state is a result of social and ethical values, but it also affects macroeconomic outcomes. From an ethical point of view it follows from the universal principle of acknowledging that every human being has the same right to freedom and thus choice. From an economic point of view, the level of social cohesion influences public safety and the quality of the business environment. A lack of social cohesion can hamper investment activities with adverse effects on economic growth.³

1 See Wagner (1999).

2 See Ulrich (1993, 1997)

3 See e.g. Aghion, Bolton (1997).

Following Amartya Sen's capabilities approach,⁴ social exclusion can be understood as the typical type of poverty in advanced economies which in his understanding is primarily the result of lacking access to resources as well as a result of barriers to participation in economic and social life.⁵ Whereas financial exclusion refers to financial services, social exclusion is usually a result of the simultaneous exclusion from a broad range of markets offering employment, housing, health, education with financial services being just one component. In 2006, the Joint Report on Social Protection and Social Inclusion issued by the Council of the European Union stressed "the concentration of multiple disadvantages in certain urban and rural communities and among some groups."⁶ Therefore, in most cases financial exclusion is associated with other social problems. For instance, having no basic banking account can entail problems with employment and housing. Persons with low educational achievement may have problems to select appropriate old age provision products thus fuelling the likelihood of old age poverty.

Explanations for Financial Exclusion

One explanation for financial exclusion is information asymmetries between contracting parties. Financial exclusion results whenever the contracting parties do not find ways to overcome information asymmetry or to negotiate protective measures which implies that the contract will not be concluded at all. A well-known example in this respect is credit rationing which may affect not only bad but also good borrowers.⁷ In the same vein, insurance companies might be forced to offer only restricted insurance coverage at fair prices to some customers, leaving them without the desired and needed extent of risk protection.⁸ Both examples relate to situations in which the supplier of financial services is less informed than the household or firm. By contrast in the case of assets (potential) buyers of these products are regularly less well informed than the bank or insurance company. For instance, bank runs are linked to the uncertainty due to non-observable or unknown characteristics or behaviour of the investment provider.⁹ This information asymmetry can lead to financial exclusion in the sense of self-exclusion if the potential investor refrains from buying investment services at all, because he doubts that the bank or investment company is sufficiently reliable. This behaviour is known about immigrants from countries with underdeveloped financial systems as well as from particular customer groups in the aftermath of a bank bankruptcy or a

4 See e.g. Sen (1999), p. 360.

5 See e.g. Bundesministerium für Arbeit und Sozialordnung (2005), p. 9.

6 Council of the European Union (2006), p. 10.

7 See Stiglitz, Weiss (1981).

8 Rothschild and Stiglitz (1976).

9 Diamond, Dybvig (1983/2000).

stock market crash. This type of financial (self-) exclusion is especially relevant for private old age provision investments because not saving for retirement increases the risk of poverty.

A second explanation is linked to high risks coupled with small volumes and high costs. For a bank, high risk is usually nothing to worry about as long as a risk premium can be secured and the risk can be diversified. In other words, from an economic perspective, a bank will charge high prices from high risk customers. As a result, low income/high risk households are often offered financial services which they cannot afford. These groups typically need small amounts of credit, are only able to save small amounts and can only cover their basic risks. This makes it difficult for financial intermediaries to achieve the necessary economies of scale and scope. Moreover, these groups have a strong need for financial advice thus increasing the underlying costs without a promise for future earnings that would justify these costs.

A third explanation is related to the strategy which is seen as optimal in the eyes of a financial intermediary. Providers of financial services design and target their products towards their defined markets. The product design can be suitable for the target customers, but financially exclusive for other customers if it doesn't fit their needs. Pricing practices may exclude some customers when they cannot afford the product. Marketing activities may exclude some customers if they have the impression that they are not permitted to use the product. The choice of a distribution strategy can exclude some customers if, for example, the provider decides not to offer a point-of-sale in certain areas.

A final explanation establishes an immediate link between exclusion and self-exclusion. The decision to buy a financial product is complex. First, a customer needs to be able to manage a household budget. Second, he needs to be able to understand his own needs, to clarify his risk preference and assess his future income development. Third, a customer needs to understand how financial services help him to manage his risks. Fourth, he needs to be able to make an informed selection from a variety of services and providers. Behavioural economics suggests that people use heuristics to make decisions. If this is combined with psychological phenomena such as over-confidence, framing and the disposition effect, a decision based on heuristics can cause self-exclusion because people buy a product that doesn't fit their abilities. From an educational perspective, financial self-exclusion is also a result of a lack of financial literacy.

Financial Exclusion in Germany and the Role of Community Banking Networks

Community banks are small local banks. Usually, they offer all kinds of financial services to retail customers living in their region. Community banks are part of the regulated banking system. Of course, in order to survive in an otherwise

competitive environment, their business model has to be sustainable. To compensate for their smallness, community banks which share important similarities often cooperate in larger networks thus allowing them to take advantage of economies of scale and scope. In most cases community banks do not pursue profit maximization. Although they need to follow principles of economic efficiency in order to survive in the market, they also foster public interests, social interests or just the concerns of their members. Examples of community banks include cooperative banks, saving banks, credit unions and community banks.

The history of community banks in Europe dates back to 1431. However, most community banks were founded during the industrial revolution in the 18th and 19th century when mass unemployment and poverty led to self-organisation institutions for the poor. Today, their close link to communities puts them into a position to overcome financial exclusion. First of all, community banks have deeper local knowledge. Hence, they can overcome information asymmetries at lower costs than anonymous large banking groups. Their smallness also reduces the problems of large hierarchical organizations to store information and to make efficient decisions. Being rooted in a community has a reputation effect implying that customers have trust in their local bank managers. This encourages them to use financial services. Additionally, both sides are more keen to act in good conduct because a reputational loss has a much stronger impact in a local community. An improved capability to avoid financial exclusion is coupled with greater willingness due to business goals which include commitment towards public, social and member welfare. This is equivalent to saying that these goals permit lower financial returns as long as they are justified by higher social returns. This makes community banks more willing to take on customers with higher costs thus promoting financially inclusive strategies which adjust product conditions, prices, marketing, and distribution to all prospective customers.

The Scope of Financial Exclusion in Germany

A typical indicator of financial exclusion is branch penetration. It measures how easily financial services can be accessed. In a worldwide comparison (99 countries), Germany ranks sixth in terms of demographic branch penetration (branch/1.000 people) as well as geographic branch penetration (branch/1.000 m²). Only Spain stands out with an extraordinary high branch penetration. The demographic branch penetration in the other four countries with a higher penetration rate is only slightly better than the German one (see Table 1.1).

Table 1.1 – Bank Branch Penetration Across Countries

Country*	Demographic branch penetration (branch/1.000 people)	Geographic branch penetration (branch/1.000 m ²)
Spain	0.96 (1)	78.90 (9)
Austria	0.54 (2)	52.47 (14)
Belgium	0.53 (3)	181.65 (3)
Italy	0.52 (4)	102.05 (7)
Portugal	0.52 (5)	57.45 (13)
Germany	0.49 (6)	116.90 (6)
Canada	0.46 (7)	1.56 (74)
France	0.43 (8)	46.94 (18)
Switzerland	0.38 (9)	70.54 (11)
Denmark	0.38 (10)	47.77 (16)
Netherlands	0.34 (11)	163.81 (4)
United States	0.31 (12)	9.81 (39)
Greece	0.31 (13)	25.53 (22)
Malta	0.30 (14)	375.00 (2)
Australia	0.30 (15)	0.77 (83)
Hungary	0.28 (16)	31.04 (21)
New Zealand	0.28 (17)	4.19 (52)
Ireland	0.23 (18)	13.41 (31)
Croatia	0.23 (19)	18.62 (27)
Norway	0.23 (20)	3.41 (56)

* Selection of the 20 countries with the highest demographic branch penetration in 99 countries.

Among EU-15 members, Luxembourg was not included in the survey.

Source: Beck, Demirgüç-Kunt, Martínez Pería (2005), pp. 31 f.

Concerning the regional distribution of branches, a study by the Deutscher Sparkassen- und Giroverband (DSGV 2004) shows that even in economically weak regions, access to finance in Germany is not an issue. Anyone who wants to buy financial services in Germany has at least the physical possibility to do so. Another way to measure financial exclusion is to look at the use of the respective service itself. A basic banking account is a service everybody needs at some time. Moreover, people without a basic banking account usually are excluded from other financial services. Therefore, the fraction of people who do not own a basic banking account is also a good indicator of financial exclusion. In comparison to the EU-15, ownership of basic banking accounts in Germany is very high. In 2005, 92% of participants in an Eurobarometer survey had a basic banking account. Only in the Netherlands and in Belgium ownership was higher than in Germany (see Table 1.2). Despite the high ownership share, access problems still exist for some part of the population in Germany. The Federal Government has been discussing this issue with the industry for years now.¹⁰

¹⁰ See for example Bundesregierung (2006).

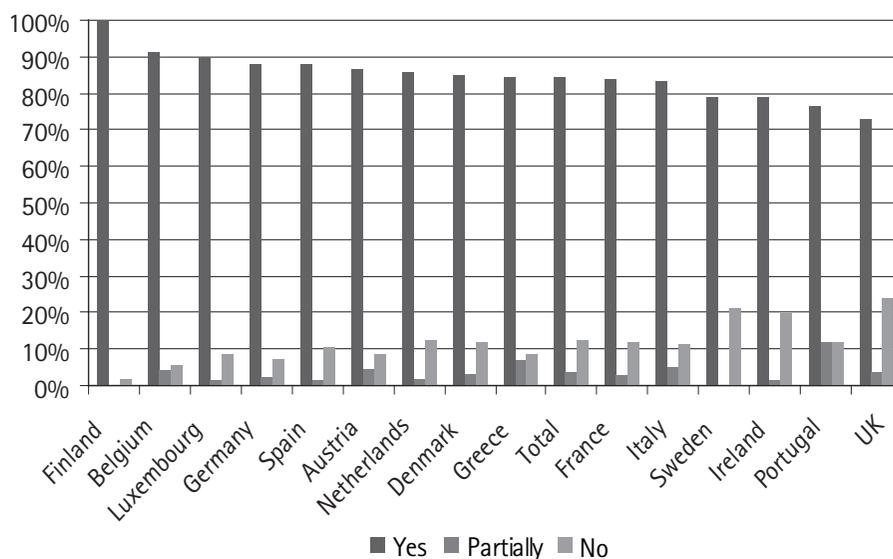
Table 1.2 – Access to Basic Banking Accounts in 2005

Country	Ownership of basic banking account
Netherlands	95%
Belgium	93%
Germany	92%
France	87%
Finland	82%
United Kingdom	76%
Sweden	75%
Luxembourg	74%
Portugal	74%
Austria	73%
Italy	62%
Ireland	57%
Spain	50%
Denmark	47%
Greece	10%

Source: European Commission (2006), p. 17.

In Germany, bank loans are the main source of financing for small and medium-sized enterprises (SME). In the 2002 ENSR Enterprise Survey conducted on behalf of the European Commission, 88% of SMEs in Germany did not have problems with accessing the necessary bank financing. Only 7% were denied financing at all; 2% received partial financing only. Access to SME finance was only better in Finland, Belgium and Luxembourg.

Figure 1.1 – Access to SME Finance in 2002 in the EU-15 (During the Last Three Years)



Source: Observatory of European SMEs of the European Commission (2002), own calculations.

The Three-Pillar Structure of the German Banking System

Elsewhere we have given a detailed description of the German banking system, the key characteristics of which will be therefore only briefly sketched here.¹¹ A basic property of the German banking system is “universal banking” which simply means that most banks offer all types of financial services though some specialization is observable. Thus, unlike in financial systems with separate banking, classification of the German banking system be based on criteria other than types of financial services. In Germany an observable difference in ownership structures has led to distinguishing between privately owned commercial banks, the cooperative banks network group (member owned) and the savings banks network groups (municipality/county-owned) making up the so-called three pillars of the banking system. The three pillars or groups differ concerning their numbers of employees with the savings bank network as the largest employer, by the size of their branches with Kreditgenossenschaften having the smallest number of local branches, and according to market shares in various business fields.

Table 1.3 – Key Metrics of the German Banking System in 2006

	Total*	Private commercial banks	Landesbanken and savings banks	Central cooperative banks and credit cooperatives
Number of banks	2,130	360	469	1,261
Number of branches	38,517	11,578	14,252	12,594
Employees	662,200	186,700**	296,500	166,100***
Loans to enterprises and consumers	2,242,233 m. €	586,679 m. €	839,562 m. €	371,178 m. €
Deposits from non-banks	2,704,663 m. €	815,453 m. €	1,006,004 m. €	466,222 m. €
Balance sheet total	7,187,714 m. €	2,046,592 m. €	2,467,299 m. €	850,543 m. €
Net interest received	89,133 m. €	34,586 m. €	32,485 m. €	14,729 m. €
Net commission received	29,850 m. €	16,504 m. €	8,058 m. €	4,285 m. €
Operating result before valuation	49,197 m. €	19,004 m. €	16,523 m. €	8,142 m. €
Profits before tax	27,575 m. €	10,152 m. €	10,441 m. €	3,960 m. €
Cost/income ratio	62.3 %	66.0 %	53.6 % and 65.8 %	62.2 % and 64.4 %
Return on capital before tax	9.34 %	11.24 %	11.40 % and 8.95 %	4.49 % and 10.93 %

Figures for the most recent year (here: 2006) should be regarded as provisional.

*Including mortgage banks, special purpose banks.

** Including employees in mortgage banks established under private law.

*** Only credit cooperatives employees whose primary occupation is in banking.

Source: Deutsche Bundesbank (2007), pp. 15-40; Deutsche Bundesbank Zeitreihendatenbank.

¹¹ Bressler, Gröbl, Turner, 2006, pp. 249ff.

Regarding loans to firms, Landesbanken and savings banks have the largest market share. The same is valid for loans to households and deposits. Concerning the size of their assets, again with total assets of 2.5 trillion €, the savings banks network is a leader closely followed by private commercial banks. The value of assets owned by the cooperative bank network is substantially lower, amounting to 851 billion €. Regarding profitability, private commercial banks and the Landesbanken (part of the savings bank network) ranked highest in 2006. It is noteworthy that the three pillars do not significantly differ with respect to the number of branches which might be a due to competition among the three groups.

Since reconstruction after World War II, the German banking system has proven to be highly stable. Indeed, banking crises like those in the US have not occurred. This has continued to be an outstanding feature even in the aftermath of financial market crashes in 2001 and a sustained depressed business environment. Comprehensive stress tests conducted by the Deutsche Bundesbank in summer 2004 did not indicate any signs of fragility. Moreover, the regulatory solvency ratios of German banks are in line with international standards.¹²

Key Facts of the Savings Bank Sector

The savings banks network is composed of the so-called “Landesbanken” (regional building and loan associations, “Landesbausparkassen”, the central investment service provider “DekaBank” and a few other financial services companies) as well as the local savings banks (“Sparkassen”). The members of the savings bank network constitute a two-tier-system with the Sparkassen forming the first tier offering all kinds of financial services to private customers, and the Landesbanken forming the second tier, entertaining both large-scale and international business, and acting as bankers of the public sector on the state government level. In spite of their specialization, the members of the savings banks network cooperate in various fields. In particular, Landesbanken provide a broad range of financial services to Sparkassen that would be too expensive for small local savings banks with liquidity management, foreign transactions as prominent examples: “Due to this subsidiary-like structure, which persists between all associated companies of the Sparkassen-Finanzgruppe, even the smallest local savings banks are able to offer their customers a vast range of universal banking services”.¹³

Traditionally, savings banks as well as Landesbanken were owned by local municipalities or state government with a state guarantee as a prominent characteristic. After the “Understanding” between the European Commission, the German Government and the Deutscher Sparkassen- und Giroverband on 7/17/2001,

¹² See Bresler, Gröbl, Turner (2006), pp. 249-251.

¹³ Bresler, Gröbl, Turner (2006), pp. 251-252.

the state guarantee has ceased to exist. However, the governance structure of savings banks is still marked by at least a significant formal representation of public owners which appoint the major part of supervisory boards which in turn appoint chief executive. Moreover, state representatives have a direct impact on credit decisions through their presence in the credit committee. Whether this still significant formal state presence implies factual high state influence is controversial.¹⁴

Due to a so called regional principle, each savings bank is more or less constrained to offer its services to the region of its public owner only. A further constraint concerns their business objectives which primarily have to serve public interests according to specific Savings Bank Acts. Public interests manifest themselves in the obligation of savings banks for an area-wide provision of financial services to the local population, to local businesses and to public authorities.¹⁵ Cultural and social aspects of the public mandate are not discussed here because they don't affect financial exclusion.

Key Facts of the Cooperative Banking Sector

In 2006, 1,255 local cooperative banks with about 14,000 branches were part of the cooperative banking network ("genossenschaftlicher Finanzverbund"). Local cooperative banks offer all kinds of financial services to their customers.¹⁶ WGZ Bank und DZ Bank offer centralized services to local cooperative banks. As with the Sparkassen-Finanzgruppe, numerous network companies produce financial services thus taking advantage of economies of scale which a single bank would not be able to exploit. DG HYP and Münchener Hypothekenbank focus on the mortgage business, Bausparkasse Schwäbisch Hall is a building society, R+V Versicherung offers insurance products, Union Investment Gruppe offers asset management, VR-Leasing-Gruppe offers leasing and TeamBank AG (easyCredit) specialises on consumer loans. Technical services are offered by CardProcess (bank account cards), DG Verlag (media), Fiducia IT (IT service), GAD (data processing), VR Kreditwerk (credit factory), VR Netze (telecommunication and network services) and VR-NetWorld (Internet service).¹⁷

Cooperative banks are owned by their members. In Germany, out of 30 million customers, 15.9 million are members of their cooperative bank as well. By the cooperative law, the business purpose of a cooperative enterprise is to foster the interests of their members. The corporate bodies are the general meeting, the management board and the supervisory board. Every member of the cooperative

14 Hackethal, Schmidt (2005).

15 Bessler, Größl, Turner (2006), p. 254ff.

16 See BVR (2007).

17 See BVR (2007).

bank has one vote giving him an opportunity to voice interests. Compared to other ownership structures, the member-customer of a cooperative bank has the strongest corporate governance rights to assert interest and be financially included. There is no legal entitlement for a regional principle as in savings banks legislation. However, in day-to-day business, local cooperative banks only offer services to customers living in their region.¹⁸

Since cooperative banks have to foster the business of their members, their strategies should be financially inclusive – at least vis à vis their members. However, to become a member requires customers to participate in the bank's equity. Even if the amount is modest, it might prohibit access for the poor. In fact cooperative banks do not only accept members as customers. For several reasons such as free capacities, improvement of their competitive position and the hiring of new members, they offer services to the general public. Some authors argue that there is no significant difference in the fees charged to members and to non-members. Hence aside from the interest received for the paid-in capital, there is no special advantage in becoming a member of a cooperative bank. This has cast doubt on a special interest of cooperative banks in including low profit and high risk customers.¹⁹ Nevertheless, German cooperative banks interpret their founding history (self-help) as an obligation for corporate social responsibility. Similar to savings banks, they see themselves in the role of providing financial services to the entire population.²⁰

The Contribution of Savings Banks and Cooperative Banks to Improved Financial Inclusion: Nationwide Provision of Financial Services

Although Germany has an evenly distributed bank branch system, the contribution of each of the three banking sectors differs. Figure 1.2 shows that the branch network of the savings banks is the most balanced one manifesting no regional gaps. Cooperative bank branches can also be found everywhere. However, their network has clear regional focal points. Their network is especially dense in the South and in rural areas (see Figure 1.3). On the contrary, the four major private banks (Commerzbank, Deutsche Bank, Dresdner Bank, Hypovereinsbank) focus their retail outlets on economically attractive and highly populated areas, neglecting areas with less than 20 million inhabitants (see Figure 1.4).²¹

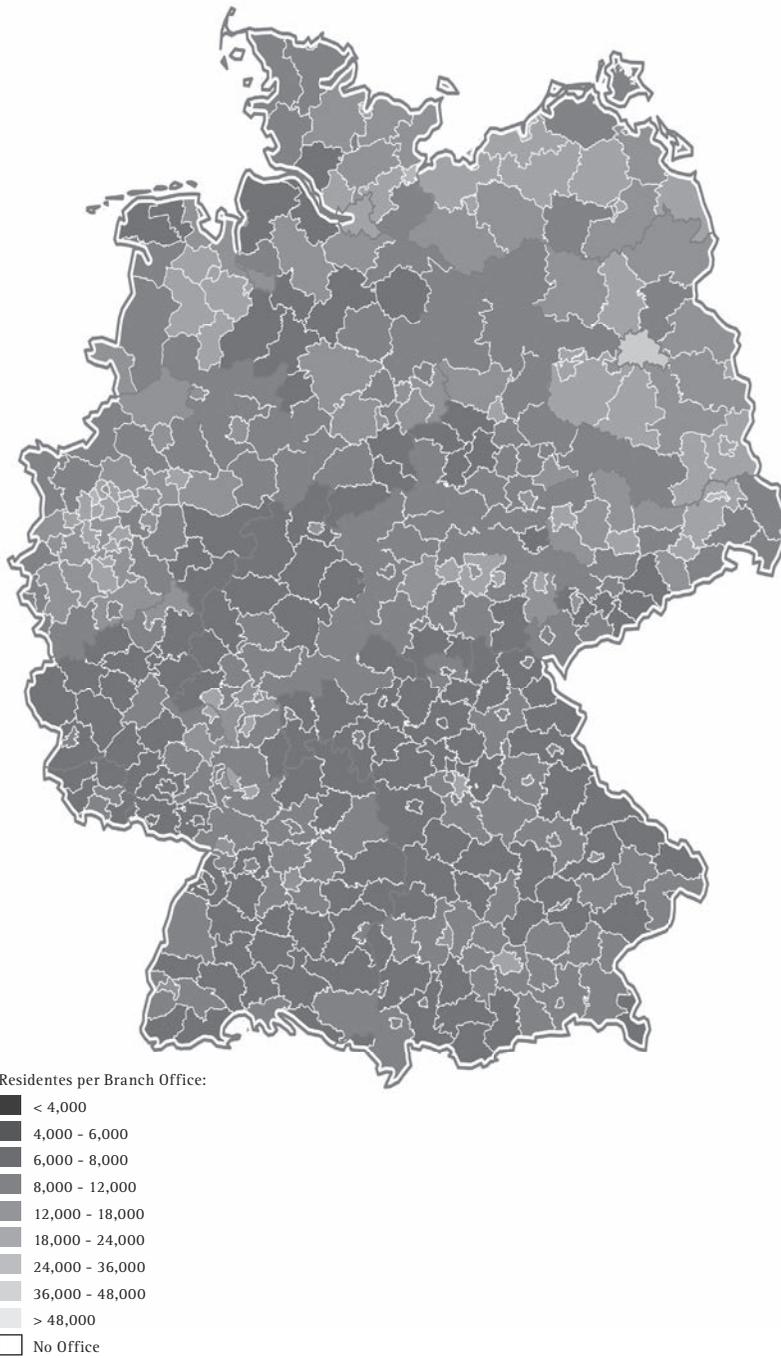
18 Sommer (1998), p. 105.

19 For a discussion of the issue see Dagott (2003), p. 130 ff and Boersch (1998), p. 77 ff.

20 See BVR (2006a), p. 4; Pleister (2002), p. 10; Boersch (1998), p. 79.

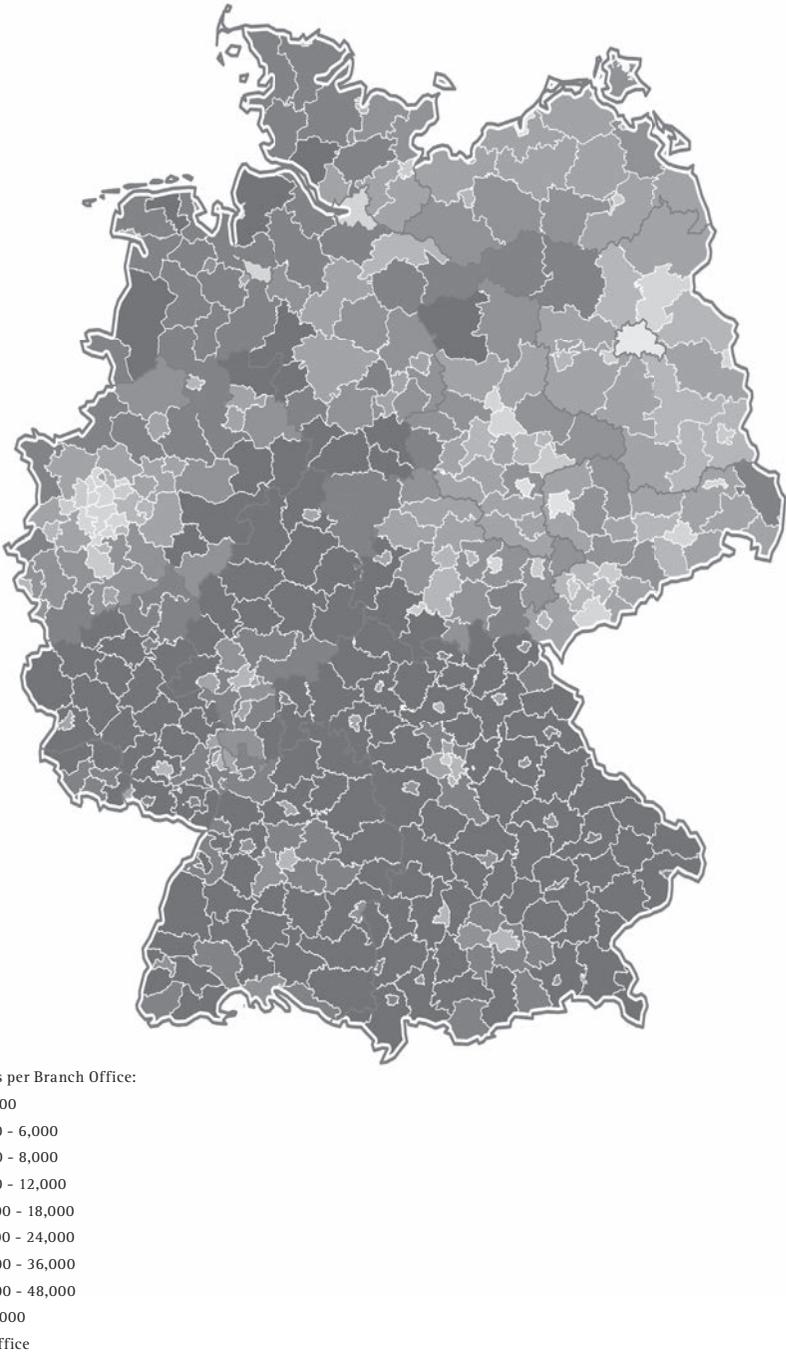
21 See DSGVO (2004).

Figure 1.2 – Regional Density of the Savings Banks Branch Network



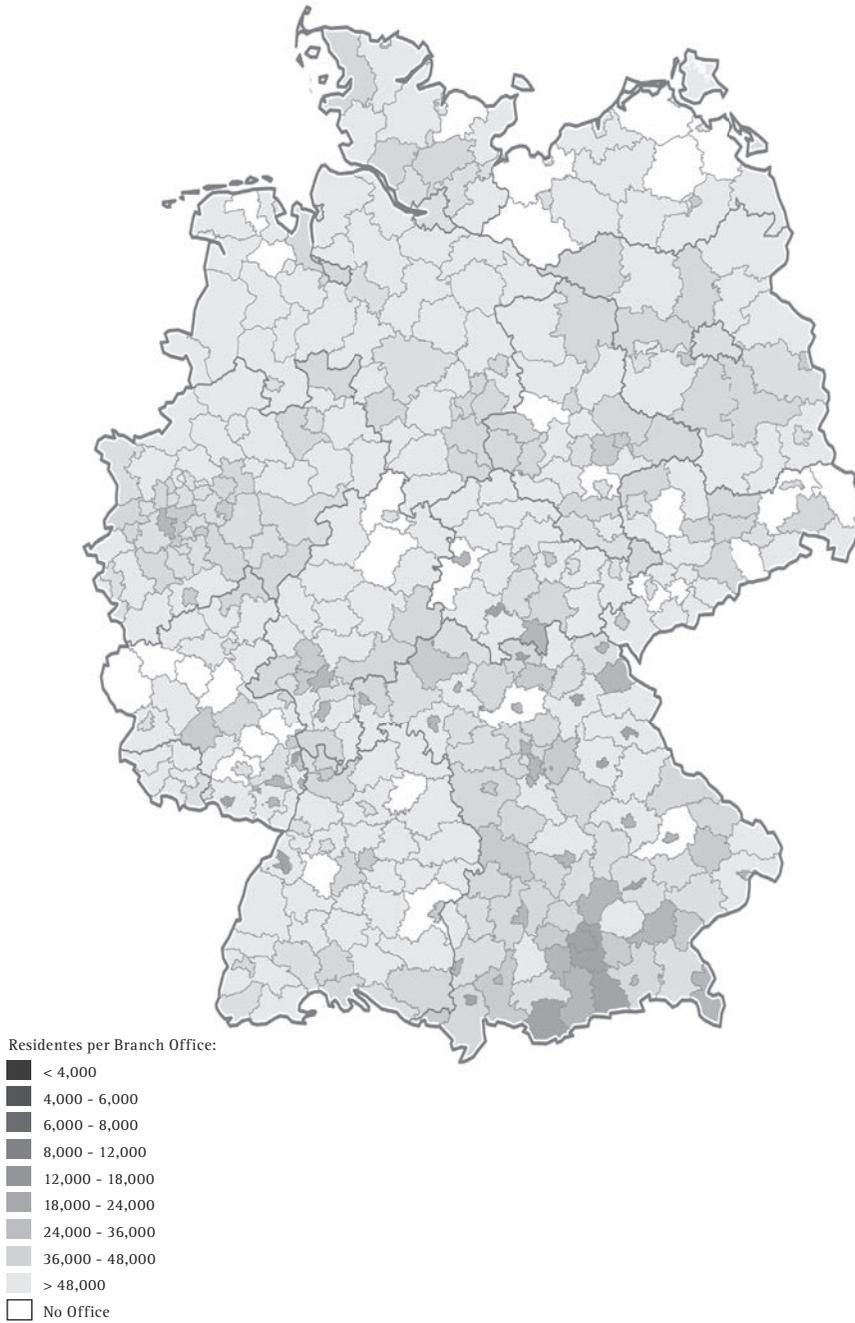
Source: DSGV (2004), p. 19.

Figure 1.3 – Regional Density of the Cooperative Banks Branch Network



Source: DSGV (2004), p. 15.

Figure 1.4 – Regional Density of the Four Major Private Bank Branch Network (Excluding Postbank)

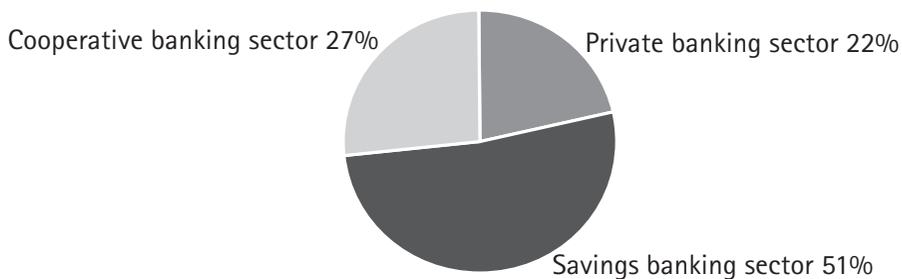


Source: DSGV (2004), p. 23.

Provision of Basic Banking Services

There are no official statistical data on the distribution of bank accounts among the different banking sectors. However, the number of bank account cards is a good proxy. Savings banks (including Landesbanken) have the largest market share: 51% of all bank account cards are issued in the savings banking sector. Cooperative banks have the second largest market share (27%), private banks the smallest (22%) (see Figure 1.5). The Federal Savings Banks Association reports that 80% of all welfare recipients – who are most likely to be financially excluded – hold a basic bank account with a savings bank.²²

Figure 1.5 – Distribution of Bank Account Cards Among the Three Banking Sectors



Source: Deutsche Bundesbank Bankenstatistik Februar 2007, p. 91.

Since 1995, savings banks have been recommended to offer a basic banking account to everybody irrespective of one's personal income status by the so-called "Zentraler Kreditausschuss" which represents a common organizations for all savings banks with the purpose to propose common strategies. Its recommendation also contains a sanctioning mechanism saying that denied customers have the right to file a complaint to one of the complaint offices ("Kundenbeschwerdestellen") of the four major banking associations. Whether savings banks have a legal obligation to offer a basic bank account to everybody is controversial. Advocates of such a legal obligation emphasize that the public mandate (to offer financial services) could be interpreted in that sense.²³

Since 1995, the number of "Girokonto für jedermann" type of accounts has continuously increased. The majority of new "Girokonto für jedermann" type of accounts were opened by savings and cooperative banks (see Table 1.4).

²² Deutscher Sparkassen- und Giroverband (2005), p. 6.

²³ See Bresler, Gröbl, Turner (2006), p. 256; Kaiser (2000).

Table 1.4 – Development of the Number of “Girokonto für jedermann”-Type of Accounts

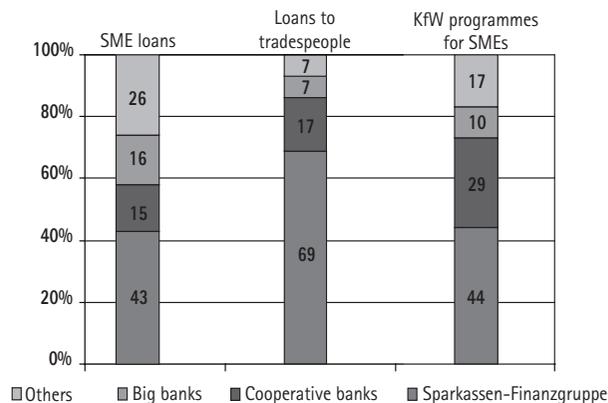
Number of Accounts at Member Banks of the Respective Banking Association	09/1999	09/2003	06/2005	12/2005
Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (cooperative banks)	400,000	500,000	588,000	605,000
Bundesverband deutscher Banken (private banks)	150,000	n.a.	178,000	188,000
Bundesverband Öffentlicher Banken Deutschlands (public banks)	80,000	180,000	239,700	260,600
Deutscher Sparkassen- und Giroverband (savings banks)	486,000	834,700	834,700	839,000
Total	1,116,000	1,514,700	1,840,400	1,892,600

Source: Bundesregierung (2006), p. 8.

Supply of Bank Loans to Small and Medium-Sized Enterprises

In 2004, savings banks and cooperative banks owned a share of 58% of the SME financing market (see Figure 1.6). As for loans to tradespeople – which can be used as an indicator for the small business market – they cover even 86% of the market. The majority (73%) of public SME programmes, which are administered by the stated-owned bank Kreditanstalt für Wiederaufbau but distributed by banks, have been provided by savings and cooperative banks.

Figure 1.6 – SME Financing Involvement in 2004 (Market Share in %)



Source: DSGV (2005a), p. 9.

Conclusions and Future Outlook on the Role of German Community Banking Networks

In a EU-15-comparison, financial exclusion in Germany is relatively low. The branch density is high. More importantly, branches are evenly distributed on the regional level, giving every household and every enterprise the opportunity to access financial services. There are no signs of financial desertification as observed in other countries. Moreover, compared to the EU-15, the access to basic banking accounts and to small and medium-sized enterprise finance is above average, but not without signs of financial exclusion.

Savings banks make a major contribution to the even distribution of the nationwide bank branch network. Because of their close ties to local communities, savings banks exist basically everywhere in Germany. Cooperative banks also establish a dense branch network with some regional focal points. In contrast, private banks concentrate on a few attractive areas. In the remaining areas, about 20 million potential customers have no access to a private bank branch.

Savings and cooperative banks also make a major contribution to the provision of basic bank accounts. In 2006, 78% of all bank account cards are issued by the savings banking and cooperative banking sector. 80% of beneficiaries of social transfers hold their banking account with a savings bank. For the provision of small and medium sized business finance, savings and cooperative bank hold a market share of 58% (2004). Regarding loans to tradespeople, they even have a market share of 86% (2004). In 73% of public SME promotional programmes, savings and cooperative banks acted as an agent (2004).

The analysis leads to the conclusion that the public mandate of savings banks and the member mandate of cooperative banks have a substantial positive influence on the level of financial inclusion in Germany. However, gaps do exist which might call for the regulation of the whole banking industry. For instance, in the case of basic banking services, observed cases of financial exclusion have provoked attempts to introduce a law to make the current voluntary code of conduct obligatory.

Finally it cannot be denied that both savings and cooperative banks work hard to improve their profitability (see Table 1.5). Between 2000 and 2004, both banking groups were more profitable than their private competitors. And the officially announced profitability goal of 15% has not been reached yet. This could have a negative impact on branch density as well as on their willingness to provide financial services to disadvantage customers.

Table 1.5 – Comparison of Return on Capital across "Three Pillars" (after Tax)

Year	All Banks	Commercial Banks	Savings Banks	Credit Cooperatives
2000	9.32 (6.09)	8.19 (7.32)	13.39 (6.05)	8.59 (4.09)
2001	6.19 (4.57)	4.74 (4.24)	9.16 (5.06)	7.46 (4.41)
2002	4.49 (2.91)	0.97 (0.04)	8.15 (4.65)	9.68 (6.60)
2003	0.72 (-1.45)	-6.24 (-6.57)	10.89 (4.00)	10.64 (5.24)
2004	4.19 (1.93)	-0.42 (-1.42)	9.72 (5.03)	10.32 (5.26)
2005	13.00 (9.19)	21.82 (15.52)	10.45 (5.60)	13.79 (9.00)
2006	9.34 (7.51)	11.24 (9.13)	8.95 (4.96)	10.93 (8.47)

The figures for the year 2006 should be regarded as provisional.

Source: Deutsche Bundesbank (2005a), p. 30; Deutsche Bundesbank (2006), p. 29, Deutsche Bundesbank (2007), p. 26.

From a research perspective it would be interesting to analyse whether community banks in other countries have a similar effect on financial exclusion. As Worldbank and IMF research looks closely at access to finance issues at the moment, the distinct structure of the German financial system is definitely a model to look at when thinking about institution building for better access to finance.

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Chapter 2

Commitment to Corporate Social Responsibility through Supportive Actions in the Banking Industry

Jean-Yves Saulquin

The aim of this chapter is to define the concept of social responsibility within the banking world and the managerial stakes it wields, in order to show the depths of its content and the diversity of its functions. We intend to answer, in order, the following questions. What does the CSR concept mean? How has the concept affected banks? What are the implications of the concept on the social aspect of the CSR? More precisely, what is its impact on the community? Examples are provided of initiatives carried out by the Caisse d'Épargne Group, in particular its local and community-based projects (PELS - projets d'économie locale et sociale). The first section outlines the definitions and history of the CSR concept. Its various forms are presented initially from the conceptual point of view then on a practical level. The second section analyzes CSR reports from major French banks. What practices do they tend to favour? An analysis of the contents of these reports enables us to see what actions are prioritised by the banks and, consequently, how they adopt the CSR concept. Finally, to illustrate our argument, we review the supportive actions developed by the Caisse d'Épargne Group, a company deeply committed to the community.

What does Corporate Social Responsibility mean for banking institutions?

In this first section, we define more clearly the notion of social responsibility and examine how it is perceived by companies. The concept cannot be separated from the notion of stakeholders. We establish which are prioritised by banking institutions. In spite of all the academic research carried out, the concept of CSR is still open to broad and variable interpretations. It is well-known for the volume of papers written about it and the vague understanding of it. The research of

Allouche, Huault and Schmidt (2004) highlights this lack of precision, underlining the ambiguities surrounding the definition of the concept which reflect the diverse approaches of its varied players, such as academics, institutions and companies.

From an academic standpoint, Bowen (1953) began the debate on CSR by proposing an open definition of the concept. He presents CSR as a duty for business leaders to implement strategies, take decisions and guarantee practices that are compatible with the objectives and values of the community at large. This initial approach was complemented by the more formal work of Carroll (1979) who suggests a conceptual model based on three defining characteristics of CSR: principles of social responsibility, the way a company implements these principles (social sensitivity) and the community impact of these values. Wartick and Cochran (1985) add to this approach, specifying that CSR is a result of three-way interaction: principles/ process/ politics. Moreover, they stress that CSR is a micro-economic approach to the relationship between the company and its environment.

Adding further to these works, Wood (1991) suggests a model that also integrates three aspects: 1) the principles of responsibility and the incentives underlying actions and choices; 2) organisational processes and practices; 3) the results brought about by the actions and choices taken by the company. The conceptual frameworks proposed by academics remain broad, allowing for numerous interpretations and applications. Some would explain the absence of agreement regarding the meaning of CSR by the conflict between two paradigms: the predominantly liberal paradigm and the paradigm arising from sustainable development (Combes, 2005).

To illustrate the institutional approach, we look back to the definition in the European Community Commission Green Paper (2001). CSR is “the voluntary integration of social and environmental concerns in a company’s commercial operations and its interaction with stakeholders. The main function of a company is to create value by producing the goods and services required, thus releasing profit for its proprietors and shareholders whilst still contributing to the welfare of the company, particularly by a continuous process of job creation”. As far as discussion and interpretation amongst the media and practitioners, research on CSR reports shows that the vocabulary used remains ambiguous. Numerous expressions are to be found that cover many situations: it could be a question of ethics; of social responsibility; of sustainable development; of the behaviour within a community; of public-spiritedness.

In spite of everything, consensus has been reached with regard to the definition of the four areas covered by CSR: the environment, social issues, economics and social or civic duty. Today, major companies appear to have integrated these challenges of CSR. Hence, for B. Collomb, Managing Director of Lafarge: “in these three areas (economic, social and environmental) it is success alone that can ensure the durability of both the company and the world in which it develops” (CSR report, 2001).

This representation of CSR appears to translate the concern of meeting the expectations of the various company stakeholders and implies that company performance should be analysed from several angles (see Table 2.1):

- environmental (what is the impact of the company and its products on its environment?),
- economic (what is the financial performance of the company and, more importantly, what is its ability to contribute to the development of its site and surrounding area and that of its stakeholders?),
- community and civic duty (what are the consequences of the company activity for the internal and external stakeholders?).

Table 2.1 – Corporate Social Responsibility evaluation: dimensions and criteria (Saulquin and Schier, 2005)

<p>Environnemental axis Consumption of natural resources Respect for the environment as demonstrated by the company</p>	<p>Economic axis Corporate strategy and vision Corporate governance and management system Business practices</p>
<p>Social axis Community projects Human Rights</p>	<p>Civic duty axis Ethical products and practices Involvement and dialogue with stakeholders</p>

Because of the conflicting approaches of academics, institutions and practitioners, CSR has a multi-dimensional form. It is seen as a set of complementary parameters that do however impose an element of choice and oblige the manager to define priorities according to policy constraints or decisions. Indeed, adopting behaviour of social responsibility “is a company’s response to the need to maximise objectives through profitability, primarily in the interests of its shareholders, but also of all its other stakeholders” (Allouche et al. 2004). The satisfaction of the stakeholders is therefore one of the essential factors underlying a CSR initiative.

CSR and stakeholders: a framework to discuss governance

Corporate governance involves the processes, rules and regulations and institutions that influence the way an organisation is directed and controlled. The concept of governance incorporates the aim of explaining the distribution of power within an organisation. The organisation is not viewed as a homogenous entity, but as a meeting place for the diverse interests of its managers and investors (Paulet, 2003). Research on governance reveals two main systems. In one system that prioritises value creation for the shareholders, the company’s aim is to maximise its stock market price. Directors’ interests match those of the shareholders and financial investors. The organisation of the Governing Board and the procedures for management transparency and pay are defined in this particular objective.

In the second system, creation of value for stakeholders is prioritised. The company's aim is to create wealth by making the best use of its various human and material resources and by interacting with the different types of stakeholders (clients, suppliers, employees, shareholders, local communities...). Performance is then measured with regard to the expectations of the various stakeholders. This type of governance prioritises the development of two kinds of capital: financial capital and human capital (know-how, skills, innovation).

Governance is thus concerned with the relationships between the organisation and its various partners (stakeholders) that enable it to achieve its objectives. It is precisely these relationships and the awareness of the expectations of the main players involved that we examine in this chapter.

A survey by Price WaterHouse Coopers (2002) studies 140 large international businesses and shows that 70% of their managers were involved in CSR actions, mainly to do with the environment and communities. These actions were in the form of programmes of pollution prevention (91%), environmental management (88%), staff voluntary work (77%), involvement in the local community (74%) and philanthropic or charitable work (74%). Companies deal with various aspects of CSR in different ways and the social aspect appears to be less developed than the others.

These results match those of a similar survey by Maignan and Ralston (2002), whose purpose was to identify the basic elements, the stakeholders and the practices of CSR in the United States, France, the United Kingdom and the Netherlands. The authors show great variation in the kinds of incentives and practices. In France, CSR incentives are based on the notion of performance (contrary to the United States where values form the basis of CSR initiatives) and any actions carried out by French businesses involve the stakeholders to a greater extent and are linked with production processes (product quality or working conditions). In the United States, CSR projects are directed more at the community (quality of life, education,...).

Table 2.2 – Corporate Social Responsibility typology according to Maignan and Ralston (2002)

Three basic or guiding principles	Five areas relating to stakeholders	Seven kinds of CSR processes
values results stakeholders	the community: art and culture, education, quality of life, protection of the environment, security customers: quality of products and services, security employees: fair treatment, health and safety shareholders: corporate governance, transparency suppliers: fair trade, security	philanthropic/charity projects sponsorship voluntary work ethical codes quality-based programmes health and safety programmes management of environmental issues

The idea that the company should take into account the interests of various stakeholders and not just those of shareholders is not a new one. Abrams (1951) defines the management profession as being one in which company business must be

managed so as to maintain equilibrium between the demands of the various directly involved groups. Bowen (1953) depicts the company as a centre whose influence radiates out in ever-increasing circles. The employees are in the first circle; in the second are the shareholders, consumers and suppliers who are directly affected by the actions of the company. The following circle contains the community in which the company is carrying out its activities. The next circle holds the competitors. Finally, the outer circle represents the public at large.

Freeman (1984) defines the *stakeholder* as an “individual or organisation which can influence or be influenced by the achievement of an organisation’s objectives”. Thus the company is the centre of a wheel, linked to its stakeholders by spokes. This conceptual contribution offers us a fresh view of the layout of an organisation and the possibility of reviewing its strategy. Stakeholder theory is concerned both with the nature of the organisation-stakeholders relationship in terms of processes and results and with the managerial decision-making that have shaped the relationship.

Damak Ayadi and Pesqueux (2003), propose a synthesis of three different ways of regarding stakeholder theory. The descriptive angle sees the organisation at the centre of cooperative and competitive actions, each of which has its own inherent value. The instrumental angle is based on the notion that companies that manage their stakeholders are more successful in terms of profitability, stability and growth. Finally, the normative ethical angle emphasizes the ethical responsibilities of the company and the ways of undertaking them without detracting from the company’s objectives of economic performance.

The Value of Corporate Social Responsibility for Business

Stakeholder theory has been analyzed in a variety of studies and many attempts have been made to bring together the various theoretical angles (Gond and Mercier, 2005). Numerous typology models that complement rather than conflict with each other have been suggested to identify the various kinds of stakeholders and their respective influence. These models are based on the nature (internal or external) of the stakeholders, their interests, contributions and their voluntary or involuntary relationship with the firm (Clarkson, 1985).

To answer the question *how do certain groups become stakeholders*, Mitchell, Agle and Wood (1997) suggest a grouping of three characteristics:

- power: for those who are in a position to influence the ongoing decisions of the company,
- legitimacy: when a group is socially recognized and accepted,
- urgency: when the stakeholders require immediate attention to a critical situation.

Different stakeholder categories emerge from these three criteria: First of all, the essential groups are those that combine all three attributes. These are the critical

stakeholders. The company must give priority to this group since it not only has legitimate needs within the company, but its claims are perceived as urgent and may not be put on hold. Having two of the three criteria places a stakeholder in a standby position: dominant, dependent or risky. Such groups are fairly active with regard to the company and require appropriate treatment, since they are only one attribute short of being considered as priority stakeholders.

Finally, showing only one of the attributes identifies the stakeholder as potential, whose attributes may develop over time and that present a risk or an opportunity for the company.

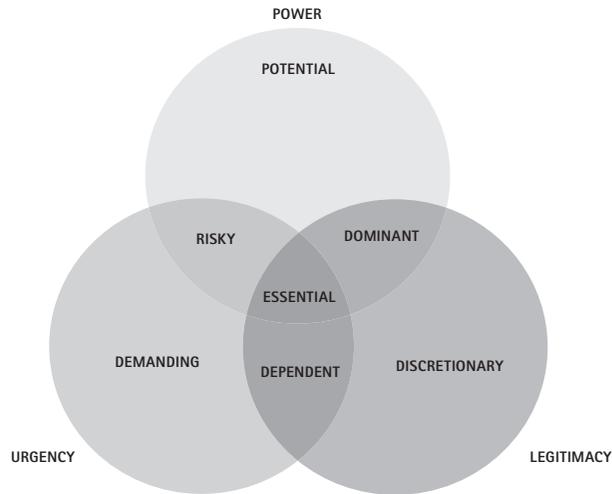
Mitchell, Agle and Wood's typology suggests a hierarchy among stakeholders. In effect, stakeholders are not equal. The notion that no stakeholder should in theory be given priority is, apparently, idealist (Dietrich and Cazal, 2005).

Stakeholder theory presents the company as a zone of competing or divergent interests. It is a management tool that establishes a diagnostic framework for examining the expectations of partners within the context of the firm's objectives and it forms a standard base of recommendations for stakeholder management (Capron and Quairel, 2002).

Banks hold this viewpoint in their relationship with the community. Financial institutions are paying increasing attention to the demands of their numerous partners, including the community. They have understood that it is in their interest to outline programmes and create plans of action with regard to social expectation.

It is the supportive actions which are of greatest interest to us. With regard to the typology described above, the community may be seen as a group of potential players. Often in difficulty sometimes beyond their control, the stakeholders may be demanding or discretionary (see Figure 2.1).

Figure 2.1 – Stakeholder typology according to their attributes (according to Cazal, 2005)



One of the limitations of stakeholder theory is that, within a given category, the expectations and power ratios may not necessarily be identical. Using employees as an example, they do not all have the same weight, as some are indispensable whereas others may not be crucial to the company. A player of one characteristic may not necessarily be grouped in the same category as a player showing similar characteristics. There is therefore a need for individualised management, as is generally observed in practice, and especially where supportive action is required.

French banks and supportive projects – The case of Caisse d'Epargne Group

The second part of this chapter deals with the CSR practices of major French banking institutions with regard to the community. After laying out our perception of supportive action, we describe the ways in which the major French banks have put their plans to action. Supportive action is not restricted to financial assistance, but covers a much larger area. The offer of financial support helps to ensure the joint management of savings products and directs funds towards associated financial institutions (associations, foundations, investment organisations, estate agents,...) with whom the banks work as partners. Supportive projects include:

- inclusion programmes, employment and business creation schemes (40% of funds)
- housing initiatives (40%)
- projects in the developing world (micro-credits) and in Fair Trade regions (5%)
- miscellaneous activities (environment, ecology, organic production, cultural) (15%)

In France, the financial sector has focused particularly on two projects of inclusion, one being by means of employment for the underprivileged; the second by means of housing for families in difficult circumstances. In addition to this type of financial support, banks are investing in many community-based projects such as:

- sponsorship (cultural, humanitarian, ecological) and foundations
- sports sponsorship
- assistance to local authorities.

Their activities may be seen on two levels: actions with a generalised impact (examples include the fight against illiteracy and animal protection), and actions linked to the locality of the financial establishment (such as gifts to sports clubs and local authorities).

The scope of potential action is extremely wide and thus all the more difficult to evaluate.¹ A study was made of the practices of five banking institutions (the Banque Populaire group, the Caisses d'Épargne group, the Crédit Mutuel, BNP Paribas and the Société Générale) by examining their CSR reports² for the year 2005.

1 The financial support operations use traditional financial tools: credit, 0% interest loans, guarantees, venture capital, grants and subsidies, property purchase. Total assisted savings reached 888 million Euros in 2005 and the number of people being assisted passed 200,000 in France. The Banque Populaire leads with funds of 382 million €. Finansol, an association founded in 1995, provides the platform for the development of supported financing, bringing the committed players together and ensuring the promotion of this sector to the public at large and to institutions. Members include: Adie, La Nef, Racines, Caisse d'Épargne, Crédit coopératif, Crédit mutuel, Macif Gestion, Caisse des dépôts, etc (voir www.finansol.org).

2 It should be remembered that the reports are, above all, communication tools and are far from being exhaustive. Details given regarding supportive action differ greatly between the reports studied. They vary from a general report of around fifteen pages long (Banque Populaire) to highly detailed accounts (Crédit Mutuel, for example). There is a further difficulty with banks that have a high number of local branches and consequently run a great many community actions (Crédit Mutuel or Caisses d'Épargne). In this case, the CSR report only relates to examples of activities carried out in specific regions.

Table 2.3 – Supportive actions taken from CSR reports of five French banking institutions

	BANQUE POPULAIRE	CAISSE D'EPARGNE	CRÉDIT MUTUEL	BNP PARIBAS	SOCIÉTÉ GÉNÉRALE
FOUNDATION	Yes	Yes (local economy and supportive funding)	Yes : CèMaVie project management to create 12 retirement homes by 2017	Yes	Yes (professional inclusion and illiteracy)
CULTURAL SPONSORSHIP	Yes (music and exhibitions)	Yes (cartoon strips)	Yes (music, museums, literature, monuments)	Yes (dance, circus, music)	Yes 1.5 million € (music, cinema, art)
INCLUSION AND EMPLOYMENT	Yes (disabled, humanitarian assistance)	Yes, 126 million € (literacy improvement – assistance with professional inclusion)	Yes ("Elan jeunes", youth programme to improve literacy, budget: 325,000 € in 2005)	Yes (suburban project – 3 million € over 3 years: educational support, youth inclusion support)	Yes (disabled sports, supportive action)
ECOLOGICAL SPONSORSHIP	Yes (freshwater and maritime heritage)	Yes (maritime heritage: Belem tallship project)	Yes (protection of birds, Ecocert)		Yes (Nicolas Hulot Foundation)
HUMANITARIAN SPONSORSHIP	Yes (donations to UNICEF, partnership with Médecins sans Frontières)	Yes		Yes (medical research)	Yes (Handicap International)
SPORTS SPONSORSHIP	Yes (sailing and windsurfing)	Yes (cycling, athletics)		Yes (tennis)	Yes (rugby, golf)
Banking schemes (Savings & loans)	CODEVair (ecological savings account) PREVair (loans)	subsidised loans for sustainable development projects)	"energy saving" loans		60 million € credit available for small local businesses

	BANQUE POPULAIRE	CAISSE D'EPARGNE	CRÉDIT MUTUEL	BNP PARIBAS	SOCIÉTÉ GÉNÉRALE
MICRO CREDIT (for individuals and businesses)	Yes (micro credit for individual projects) business enterprise assistance (8.1 million € in 2005)	Yes (business start-up or enterprise assistance)	Yes (consumer credit for 1,600,000 €) business enterprise assistance	business enterprise assistance (credit standby: 2 million €)	Yes (micro credit) 3 million € business enterprise assistance
ECOLOGY	Yes (ecologically innovative small to medium-sized businesses (SME), wind farms 15 million € credit)	Yes (sustainable urban transport: 400 million €)		Yes (wind farms: 931 million € funding)	Yes (wind farms...)
FAIR TRADE		Yes (partnerships)	Yes (partnerships)		Yes (partnership with Alter Eco)
LOCAL AUTHORITY SUPPORT		Yes (Eco Mayors)	Yes (social housing)		

What supportive actions were observed?

Table 2.3 relies on information given by the institutions themselves. Consequently, it is incomplete, naturally biased and falls well short of measuring the extent of commitment of each establishment. It shows whether certain practices take place or not, but the figures that would help to calculate the impact of supportive action are too often missing.

In comparison to examples of supportive action, it was noted that CSR reports are more detailed in other areas. This appears to be due to the influence of essential stakeholders. This is particularly the case in the area of employees (all reports examined contain a very bulky chapter on human resource policies) or other shareholders.

To illustrate the extent of possible actions, a case study was conducted of the supportive actions of the Caisse d'Epargne group in the community. Who initiates the actions of the group? What actual practices are brought into play? How can the effects of the actions be measured? Particular attention has been paid to the effects of the local and community-based projects (PELS) which, since their creation in 1999, have enabled 10,000 projects to be financed (see: www.10000histoires.net).

Local and community-based initiatives of the Caisse d'Epargne Group

The 29 French Caisses d'Epargne are public limited company banks with Executive Boards, a Supervisory Committees, and the status of co-operatives. The capital shares of the Caisses d'Epargne are held by the local savings societies (SLE - Sociétés Locales d'Epargne). The registered members of the SLEs are individuals or corporate bodies. On a national level, the Fédération Nationale des Caisses d'Epargne (FNCE) is the representative body of the Caisses d'Epargne and its members. The Caisses Nationale des Caisses d'Epargne (CNCE) is the central body of the Group and is a public limited company with an Executive Board and Supervisory Committee.

Table 2.4 – Key figures for the Caisse d'Epargne Group, 2005

Euros in billions	2003	2004	2005
Net banking income	9.3	9.7	10.3
Gross operating results	2.6	2.6	2.8
Pre-tax profit	2.5	2.4	2.9
Earning power	1.7	1.8	2.2
Shareholders' equity (of the Group)	16.6	18.0	19.4

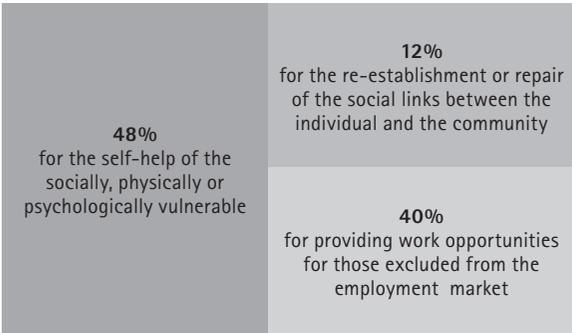
Since its origins in the 19th Century, the Caisses d'Epargne Group has always shown concern for the situation of the poorest and most vulnerable segments of the population, helping them to gain financial inclusion. Over the last six years, the

Caisses d'Epargne Group has developed its activities considerably in the direction of general public interest, particularly through its financial scheme for Local and Community-based Projects (PELS – Projets d'Economie Locale et Sociale), namely the Fondation des Caisses d'Epargne et l'Association Finances et Pédagogie (Caisses d'Epargne Foundation and Financial & Educational Association).

Local and Community-based Projects (PELS), a unique scheme in France

In accordance with the law of 25 June 1999 regarding the co-operative status of the Caisses d'Epargne, every year the company commits itself to funding local and community-based projects, initiated on the whole by non-profit associations and organisations concerned with support and inclusion. PELS are initiatives taken up and supported by the Caisse d'Epargne in the locality. Their ultimate aim, with due respect for a fixed process that is published nationally, is to improve the daily lives of the most vulnerable people. PELS prioritise initiatives relating to employment, self-help and social interaction. Within this framework, each of the 29 Caisses d'Epargne votes, depending on the net accounting result from the previous year, for a budget allocation amounting to a minimum of the equivalent of half the total sum paid out to members. Thus, in 2005, 2,556 projects were agreed on this basis, with a budget amounting to 51.5 million Euros. In 2004, with a budget of 50.6 million Euros, 2,350 projects were financed.

Figure 2.2 – Areas financed by PELS (as a % of the total sum)



PELS assistance with employment

Projects concerning employment are, in the first instance, concerned with helping micro-businesses that do not have access to the traditional bank routes. They are financed by special means through partnerships with support

organisations. In order to succeed, micro-businesses have to be supported on many sides by professional network. Some of the examples of financed projects are the creation of a mobile hairdressing business, the revival of a masonry firm and the establishment of a grounds maintenance service for parks and open spaces. Help for support organisations is offered both directly via means of payments, interest-free loan schemes and guarantee funds, or by supplying expert advice or grants for materials. To encourage integration by means of employment, the Caisse d'Epargne also supports associations or businesses that deal with integration and enable people to undertake professional training, to learn how to lead a working lifestyle and to find a career.

Self-help ventures

To improve the situation of the vulnerable – disabled, sick or disaffected young people – the Caisses d'Epargne promote initiatives aimed at the self-help of such individuals. Emphasis is placed on financing methods of providing basic needs. Initially, it is a case of providing the basic tools that are essential for participating in social life such as courses for learning to read, write and perform basic maths; the publication of customised guides or software; computer workshops; money-management training; driving lessons. Moreover, support for initiatives that help the elderly people, the sick or disabled to maintain their independence, may be offered in a variety of forms. It can be in the form of finance for a variety of special equipment that will enable recipients to improve their mobility in daily life or in leisure activities, to continue to live in their own home, or to avoid being socially isolated. The costs of human intervention (study, training and transport fees) are also taken care of when it contributes directly to a project.

Finally, the aim of supplying these basic needs is to restore a minimal quality of life to those in need: feeding oneself, finding a place to live, being able to dress and move about. The PELS help to support the associations best equipped to deal with the most disadvantaged and finance the investments necessary for this: purchasing vehicles, making home alterations, providing training.

Developing social contacts

This approach concerns project leaders who are committed to social re-integration where alienation has occurred often because of upheavals in a rapidly changing society. Whether from a rural or unstable city environment, whether young or elderly, part of the population is exposed to the risk of exclusion. With their local bank network, the Caisses d'Epargne are able to support initiatives that rekindle social contact: community centres, the organisation of sports activities and purchase of mobile equipment.

Helping culture and the arts

The PELS also foster access to culture, for example by financing theatrical events (artists, equipment, promotion). They also facilitate the conservation of local heritage. Protecting the environment is another way of developing social links. Associations involved in the restoration or protection of nature are eligible for PELS when the project includes elements of social cohesion, such as creating interest in the local environment, creating ecological awareness among schoolchildren, encouraging participation in construction contract initiatives, and offering accessibility to these projects for vulnerable people. In addition to PELS financing by the Caisses d'Epargne, there are a number of parties within the Group that have become involved in projects of general public interest and invest in national long term activities.

For Example, the Val de Loire (Loire Valley) mission group that handles the information on the Val de Loire listed in the UNESCO world heritage, together with the local Val de Loire branch of the Caisses d'Epargne, have launched a scheme of sustainable development to highlight the sites of outstanding natural beauty in the Loire Valley, setting up construction contracts for projects of general interest and generating awareness among local residents for preserving the environment. Ten pilot sites have been identified for river bank maintenance work along the Loire in the departments of Indre et Loire and Loir et Cher. This operation is also supported by the WWF.

Finances Et Pédagogie, Finance Et Education

Founded in 1957 with the support of the Caisses d'Epargne, Finances Et Pédagogie (Finance & Education) is an association that addresses the need for education and training with its theme of money in daily life. It offers collective training for three kinds of groups: young people in education, beneficiaries of association and social schemes, and company employees through professional training. Centering on support for disadvantaged people (long-term unemployed, disaffected young people, families in financial difficulty), this association offers information on budget management, loans and communication with banking institutions. It also offers the means to service providers (social workers, home tutors, home helpers, referees, retirement home personnel) of improving their technical knowledge so that they are better equipped to help their charges to communicate with banks and to participate in social life. These are full training programmes in which the learners rely heavily on Caisses d'Epargne Group dynamics. In 2005 more than 3,400 training or educational sessions were held in conjunction with 700 partners, benefiting 70,000 people.

Foundation Caisses d'Epargne pour la solidarité

Recognized as a public utility in 2001, the Caisse d'Epargne Foundation for supportive action promotes actions to fight against dependency and isolation linked to old age, sickness, disability or illiteracy. As a non-profit operator it runs a network of 69 establishments, employing more than 4,500 people in France. Through its programme "Savoirs pour réussir" (Knowledge for success), the Foundation makes it possible for young people to become involved in a process of acquisition of basic knowledge, thanks to the support of voluntary tutors, some of whom are Caisses d'Epargne employees.

Having identified people with problems of illiteracy through special literacy promotion days and local incentives to improve literacy rates, the Foundation organises a programme of education for these young people. This programme follows the national format agreed with the government authorities. In 2005, the Foundation pursued its support of actions of public interest by promoting programmes that were capable of revealing innovative solutions both on a technical and a social level. In order to do this, it has been able to make use of contributions from the Caisses d'Epargne and subsidiaries of the Group.

The Caisse d'Epargne example shows that, for banks, having a co-operative or mutual status is another way of creating sustainable social economy. Its ties to traditional values prompts it to exercise greater support than its capitalist counterparts who are only interested in the creation of share value. Furthermore, mutual and co-operative establishments are in a healthy financial position and do not appear to feel the necessity to become a giant institution in view of competition between banks. The future of co-operative establishments is not under threat, even if pressures for profitability have forced a number of closures and mergers, and even if the members have less control over operating procedures and management. According to Roux (2002), "there are probably no grounds for contradiction but rather room for elaboration in stating the existence of a link between the values of a mutual company (supportive action, responsibility and community support) and the values of a private company (service, expansion and profitability)".

Why not then combine the strengths of the co-operative status with those of the financial market? If the co-operative establishments understand how to maintain their qualities linking them to the community, placing human beings above economic considerations, we feel that they will be able to play a major role in the future with a guarantee for their sustainability. This issue depends on the way in which the managers of such establishments understand their social responsibility and carry out appropriate actions for their stakeholders.

Management of performance, stakeholders, and investment within Corporate Social Responsibility

In order to understand the involvement of companies as far as CSR is concerned, Saulquin and Schier (2005) have put forward an idea proposing that the companies should define their CSR actions in different ways according to how committed they are (closed or receptive management vision of the company) and to the managerial approach to performance (static or dynamic approach). The authors suggest a typology of managerial perceptions of CSR (figure 2.3). CSR may thus be perceived by managers in four different ways.

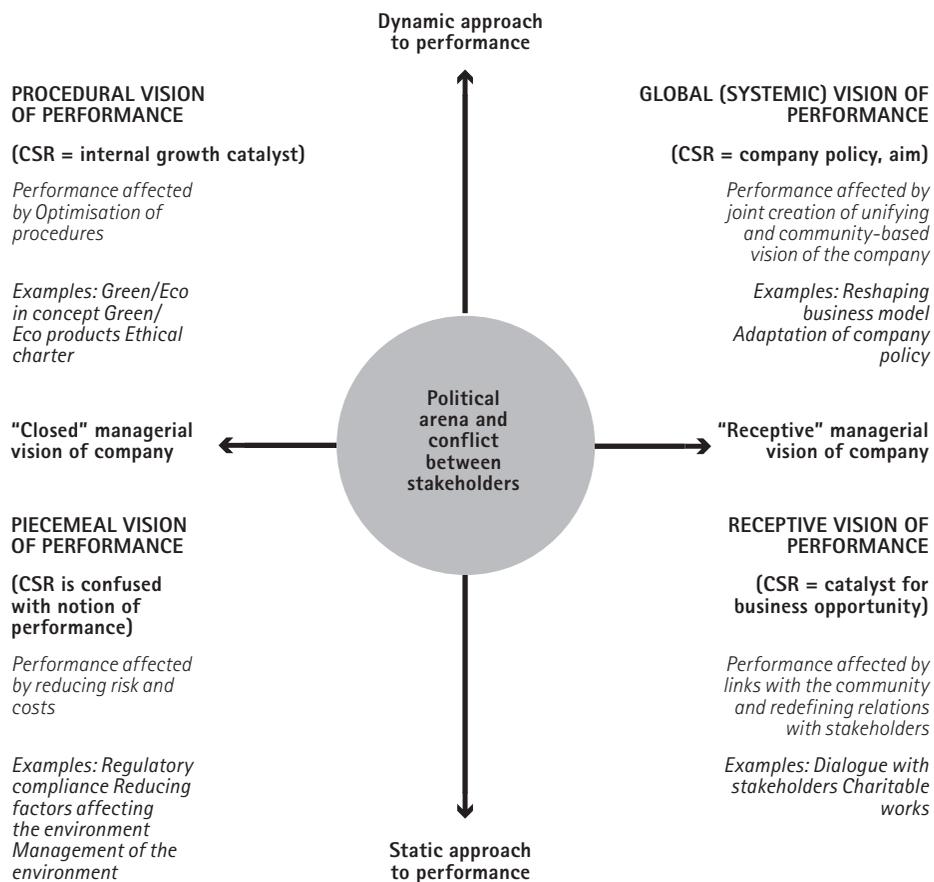
- An regulatory constraint. CSR actions are initiated as and when the need arises. Each “CSR case” will be dealt with to ensure compliance. In this case, CSR actions reflect little managerial influence.
- A catalyst for business opportunity. In this case, CSR is managed as a receptive tool. CSR is viewed as a means of improving the management of business relations with other stakeholders, especially with the community. Here, CSR appears as vehicle for opportunist communication. Where the approach may create value by altering the company relations with its environment, it does not call into question the fundamental operating methods of the company. These actions are often likened to a “cosmetic” CSR approach.
- A catalyst for internal growth. By legitimising certain aspects of the company’s operations and by making various stakeholders aware of the need to change certain practices, CSR can become a real catalyst for change. In this scenario, the accent is placed on the procedures and the anticipated medium-term performance. The company tries to develop its practices in depth with regard to certain key aspects of CSR. Such action increases internal movement: for example, it enables employees to become involved with the CSR strategy and it helps to launch initiatives (certification, sponsorship,...).
- A strategic catalyst or an opportunity to review the company’s policy. This involves a wider acceptance of CSR in that it makes the company redefine its policy on the environment and critically analyse its global operations.

From a theoretic point of view, CSR, if taken in its strict sense, should only apply to this last scenario. It should no longer be a question of meeting the “demands” of CSR in a piecemeal fashion, but of offering a unifying and community-based company vision which will help to bring together a number of apparently contradictory requirements.

From a practical point of view, CSR becomes a management objective, a legitimate response to stakeholders’ expectations. By following the global approach, it is possible to establish methods of improvement, to identify opportunities and to foresee financial and, above all, publicity difficulties.

We know that the game played out by the stakeholders on the political chessboard has a great influence on the company's attitude to CSR and on the choice of actions it develops. Moreover, we believe that the company may vary its management of some aspects of CSR according to the nature of the partner it is dealing with. Consequently, it is entirely possible that a company may hold a "piecemeal" or "procedural" approach to some issues (the environment for example) and a more "receptive" approach to others (humanitarian for example). Company boundaries are certainly less clear and more permeable than theories would have us believe, and business directors understand and handle relations with the environment in a variety of different ways. "One sometimes finds that the company within its environment is dissolved into a collection of stakeholders whose relationships all vary in strength" (Dietrich and Cazal, 2005).

Figure 2.3 – Managerial perceptions of CSR and CSR practices



Conclusion: Corporate Social Responsibility as an illustration of how to reconcile economics and social aims for firms

We can conclude from this chapter that banking institutions do have a presence on the CSR stage. Following the example set by major industrial and commercial companies, banks do now publish reports that enable us to understand their incentives and positive initiatives relating to CSR. The study of CSR reports shows huge variety in the nature of supportive actions initiated by banks. There are many projects falling within the category of financial support but, equally, many of them are directed towards patronage, sponsorship and assistance for local authorities. Whether the banks act through expediency or policy, the fact remains that CSR actions are increasing annually in number and improving in quality because of pressure from a number of factors, particularly from the influence of stakeholders.

For financial establishments, the community represents potential, even expectant partners, who are managed in varying order of priority. Where CSR is managed within a procedural or opportunist framework, it becomes the object of a specific management operation directed at perceived risks. Where CSR is used as a management objective, it leads to a process of redefining relations with stakeholders and inviting strategy review by bringing in community-based objectives. The Caisses d'Épargne Group appears to hold this unifying vision whose ultimate goal is a commitment to Local- and Community-based Projects.

From reading CSR reports, it is still difficult to ascertain what position is held by executives. Managers from banking institutions are unanimous in their statements of commitment to the human factor and to values of supportive action. In this case, they should prove it in their CSR reports. Publication of CSR reports forces decision-makers to examine and question their practices, the true objectives of the company and conflicts between making profit and helping society. Social responsibility should be a commitment that endeavours to put the company's economic performance to the service of the community and to create a more supportive society.

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Chapter 3

European savings banks and the future of public banking in advanced economies.

The cases of France, Germany, Italy and Spain

Olivier Butzbach

Public banking has played a key role in the development of continental European economies over the past two centuries. Government-owned banks offered access to banking deposits to categories of customers not served by private or commercial banks; they channeled funds to sectors selected or identified by public authorities; they often financed government deficits, especially in time of war; they stood on the forefront of monetary policy; they served as stabilizers of the banking system. However, in most countries, over the past twenty-five years an unprecedented wave of privatization has dramatically shrunk the role played by public banks. Nowhere is this so apparent as in countries such as France or Italy, where the State used to play the dominant role in allocating credit. In the early 1980s, the French state owned the majority of shares in all large or medium-sized banks; the Italian state owned, through its giant public holding IRI, majority shares in three of the largest national banks, and directly owned and controlled a series of specific medium-term credit institutions. By the mid-1990s, in both countries, state shareholdings in banking were radically scaled down. All major banks are now private in both countries, as they are in most other European countries.

The European case, therefore, is of limited interest in a broader comparative survey on the future of public banking *stricto sensu* (that is, defined as central government-owned banks).¹ However, Europe has produced another kind of non commercial (i.e. non strictly for profit) bank, besides government-owned banks: savings banks, whose role and functioning in contemporary European capitalism might be of interest for

¹ Of course, this is not to deny the role played by Europe's remaining government-owned banks, which still thrive in specific sub-segments of the banking market: the French *Caisses des Dépôts et Consignations*, the German KfW, the Italian *Cassa dei depositi e prestiti*.

analysts of public banking elsewhere. Savings banks are not, strictly speaking, government-owned banks. There is, it is true, a great variety in European savings banks' legal status and ownership patterns: from joint-stock companies in Italy to cooperative banks in France to mostly public banks in Germany.² A common feature that characterizes these very different entities, however, is their bottom-up nature (created by local governments or organizations) – their not being, that is, *central* government-owned, by contrast with what is usually meant by public banking.³

Savings banks do belong, however, to a broader category which one could call the “public banking sector” for two reasons, independent of their legal status (again, only in Germany are most savings banks public). First, European savings banks have historically flourished under the protective (and sometimes oppressive) umbrella of the State (more on this in the following sections). Secondly, savings banks' business identity was built, over the years, on two premises that relate to a broad definition of the public interest. Those two characteristics are: (i) savings banks' historical rooting in local territories and inclusion of local stakeholders in their corporate governance; (ii) savings banks' institutionalized provision of public goods – a peculiar mix of profit & non-profit objectives.

European savings banks benefited, for most of the second half of the XXth century, from a favorable legal, political, social and economic environment. That environment was characterized by: (i) credit market segmentation; (ii) banking market fragmentation; (iii) specific legal & regulatory protections; and (iv) a relatively “passive” customer base. Of course, that environment differed from one country to the other. Spain, until the mid-1970s, was a dictatorship with direct control of the State on the credit system (Perez, 1997). The French post-war financial system was defined as a “state-administered credit system” (Zysman, 1983), a definition that fits post-war Italy as well (see Barca, 1997). In the latter two, the state was the key player (against banks and capital markets) in allocating credit, both through public banks and specific credit institutions. Those systems culminated in quantitative credit control in the 1970s (see Loriaux, 1989, for the analysis of the French system and its demise). The German credit system was altogether different on this account, as the central state played a much less important role in the allocation of funds. However, beyond those differences, the four countries mentioned above exhibited strong similarities on the four criteria mentioned above.

2 As will be emphasized in the next sections, the 463 member-strong German savings banks sector included, as of August 2006, 7 private savings banks (among which the largest single German savings bank, the Hamburgsparkasse), whose equity does not belong to local government, by contrast with the public ones.

3 One further premise must be made here: savings banks in this paper refer to autonomous, local savings banks, and not to the peculiar central state-owned institutions created in several European countries at the turn of the last century, invariably called “national savings banks” and often linked to the Postal offices, most notably in Belgium and France, Italy, the United Kingdom. See section 2 for further details.

This favorable or loose “selection environment”⁴ gradually but steadily changed in the 1980s and 1990s in all four countries. Changes have led to much more market-oriented financial systems, apparently giving private, for-profit banks an advantage when compared to non-profit credit institutions such as savings banks.

Therefore, the first issue tackled by this research is the following: how have European savings banks adjusted to exogenous changes that led to a tightening of their selection environment? In other words, as the Institute of European Finance put it in a 1999 report: “how might those savings banks survive?” (IEF, 1999) Secondly, how have savings banks managed to be (become) successful business while still fulfilling public service functions? “Successful adjustment” here is defined as survival in an adverse environment (tight selection) - survival meaning, for any business organization, its profitability, together with the conservation of the organization’s business identity (core activities, structure, objectives).⁵ Survival, therefore, does not preclude transformation; but to “successfully adjust” a firm should maintain, in a changed environment, the core elements that characterized its business model in the previous environment. In our cases, legal and corporate statuses could change, therefore; as long as savings banks remain distinguishable from other types of banks, they will have adjusted in a successful way.

The paper is organized in two sections. Section 1 presents evidence showing savings banks’ successful adjustment to this new environment. Section 2 analyzes the transformations that have taken place in savings banks’ structure, organization, governance and strategies in the four countries over the past twenty years, with particular attention paid to the “general interest mission” fulfilled by savings banks in the four countries.

Table 3.1 – Savings banks in France, Germany, Italy, Spain (January 2005)

Country	Banks	Branches	ATMs	Staff	Total assets in million euro (% of total)	Total non-bank deposits (% of total)	Total non-bank loans (% of total)
France	31*	4,700	6,000	52,900	543,911	214,103	188,501
Germany	463**	17,001	24,636	303,966	2,284,567 (-35.30%)	970,934 (39.7%)	1,031,841 (37.9%)
Italy	46***	3,715	n.a.	34,136	137,973	104,843	94,796
Spain	49*	21,528	30,856	113,408	636,668 (42.1%)	447,669 (52.1%)	444,592 (47.9%)

Source: European Savings Banks Group website. * Plus one clearing institution; ** plus 11 Landesbanken, 13 Landesbaubanken, 1 clearing institution; *** of which 2 are still independent (others are part of larger banking groups)

- 4 This concept is borrowed from evolutionary economists, and refers to a bundle of institutional and non-institutional characteristics: “the definition of ‘worth’ or profit that is operative for the firms in the sector, the manner in which consumer and regulatory preferences and rules influence what is profitable, and the investment and imitation processes that are involved” (Nelson and Winter, 1982: 266). Evolutionary economists argue that there exists a plurality of selection environments, loose or tight being the two opposites kinds, depending on the particular features taken by one of the elements just mentioned (e.g. oligopolistic versus competitive product market...).
- 5 Savings banks’ “core business identity”, which may appear as an elusive concept, will be elucidated in the following sections.

How do savings banks fare in today's European banking markets?

Over the past fifteen years, overall, European savings banks have fared remarkably well in the face of the adverse developments mentioned above. Savings banks are generally sound and profitable businesses, and they are important players in the banking markets in the four countries surveyed. Size alone gives European savings banks a key position in domestic (and international) banking markets, despite differences across countries. In Spain and Germany, individual savings banks do not belong to a financial group with consolidated accounts, as all French and many Italian savings banks do. Yet in the former, savings banks sector's overall size supplants all other banking categories. Considering total assets on a consolidated basis, the German savings banks sector is certainly the largest banking group in the world.⁶ Individually, the largest Landesbanken (WestLB, Balaba, LBBW, NordLB) are among Germany's biggest banks after the so-called "Big Four".⁷ With the announced merger (by 2008) between LLBW and WestLB, the new banking group will rank second in Germany in terms of the size of its balance sheet (behind Deutsche Bank and ahead of Commerzbank). In Spain, savings banks had in 2003 a total balance sheet representing 35% of banking sector total. In 2005, the leading Spanish savings banks, the Caixa di Barcelona and the Caja di Madrid, stood respectively at the 3rd and 4th rank in terms of total deposits collected (after Santander Credito Hispanico and BBVA). The French savings banks group ranks third in France for overall assets (behind Crédit Agricole and BNP-Paribas), and 39th in Europe (*The Banker*). Italy is a tricky case since, as mentioned above, the banking sector restructuring process led to the quasi-complete disappearance of the savings banks sector as such. It is important to note, however, that the four leading banking groups in terms of size and market shares have been built around the mergers of former government-owned banks with large and medium-sized savings banks.

Savings banks exhibit overall high market shares in most segments of the banking market. In 2002 European savings banks represented, on average, 25% of overall housing loans extended by the banking system in their home country, 23% of lending to firms and households, and held 19.6% of total assets in the banking market; on the liability side, they held around one third of total deposits⁸.

6 With a total balance sheet of around 3.000 billion euro in 2004, divided as follows: 1.000 billion euro for Sparkassen, 1,282 for Landesbanken, 105 billion euro for Dekabank, 49 billion euro for Landesbausparkassen, the rest coming from the group's many subsidiaries (7 leasing companies, 6 leasing companies of the Landesbanken, 2 factoring companies, 80 venture capital companies, 13 public insurance companies). Source: DGSV, 2005 Annual Report.

7 Deutsche Bank, Dresdner Bank, Commerzbank and HypoVereinsbank, which merged with Italy's Unicredito in 2005 to form the first pan-European banking group.

8 Data from the European Savings Banks Group's 2003 *Annual Report*, except when noted. The data refer to the eight countries mentioned above plus 15 other European countries – all members of the ESBG.

In Spain, the 46 *Cajas* held, as of December 2002, 46% of banking loans and 47% of deposits. And these market shares have been growing over the past ten years. In Germany, the non-profit sector is even more dominant; in 2002 75% of deposits were held at *Sparkassen*, *Landesbanken* or at *Deutsche Genossenschaftsbank*, the lead institution of the co-operative banking sector. And its hegemony does not seem to be questioned by the failed mergers between Deutsche Bank and Dresdner Bank, and then between Dresdner and Commerzbank. In Italy, savings banks⁹ held in 2003 a 27% market share for deposits, and a 17% market share for lending. In 2004, French savings banks “weighed” 12.4% of total household deposits (with 33.1% for commercial banks and 46.6% for cooperatives); and 8.8% of total credit (with 40% for commercial banks and 35.3% for cooperatives).¹⁰

Current market shares reflect a historically strong position of European savings banks in deposits and lending to SMEs. Table 3.2 shows savings banks’ market shares of banking system deposits from 1984 to 2004 for our four countries.

Table 3.2 – Savings banks’ market shares of banking system deposits

Country	1984	1989	1992	1994	1996	1999	2004
France	n.a.	20.3	18.7	19.8	27.3	17	12.4
Germany – Sparkassen	41.7	37.2	32.9	34.8	34.5	39.8*	39.7*
Germany – Landesbanken	8.0	9.7	11.1	12.2	9.8	-	-
Italy	26.6	25.4	24.2	27.1	27.3	27	-
Spain	35.4	44.1	46.2	48.8	46.4	49.3	52.1

Sources: IEF, 1999, p.51; for 1999, Mentré (2002); for 2004, ESBG (2006). *includes Landesbanken
 **2003 data

The more recent numbers cited above, therefore, are no outliers and show but a steady trend in European banking systems. Including other countries in our analysis, such as Austria, Belgium, Norway, Portugal and Sweden, would reinforce our observation that savings banks constitute a key part of European banking systems.¹¹

9 As will be precised later on, all of Italy’s savings banks have lost their specific legal status during the 1990s. Many of them have merged or been acquired by commercial banking groups.

10 Source: Banque de France, 2004.

11 In those countries, market shares of banking system deposits during the eighties – mid-nineties averaged 35% (Source: IEF, 1999, p.51).

Table 3.3 – Savings banks' market shares of banking system lending

Country	1984	1989	1992	1994	1996	2004
France	-	4.0	4.3	5.2	5.3	8.8
Germany – Sparkassen	31.1	29.2	26.4	27.2	22.4	37.9*
Germany – Landesbanken	22.4	18.4	20.2	21.0	15.2	-
Italy	20.7	21.2	20.5	21.1	18.1	-
Spain	25.4	33.8	35.5	36.4	39.2	47.9

Sources: IEF, 1999, p.52; for 2004, ESBG (2006). * includes Landesbanken's market shares **for 2003 (Source: OECD, Banque de France)

In terms of profitability and efficiency, savings banks fare well in comparison with other banking categories. In France, the *Groupe Caisse d'Epargne* showed a 11.9% return on equity in 2005 (10.0% in 2004) and a 10 billion euro operating income, close to levels showed by the leading French banking groups. Net banking income has constantly increased over the past three years, despite cuts in the interest rate paid to regulated savings accounts.¹² Interestingly, the increased in net banking income from 2004 is due to commissions and other income, while interest income has stabilized. In Germany, savings banks displayed a 2004 net operating profit representing 0.45% of total balance sheet, against 0.29% for commercial banks – only cooperative banks displayed a slightly better performance, with a ratio of 0.5%.¹³ The numbers were in 2003, respectively, 0.46% for savings banks, the same ratio for credit cooperatives and 0.21% for commercial banks.¹⁴ Perhaps more strikingly, over two years (2003 and 2004¹⁵) German savings banks produced a profit which almost made up half of total profits from the country's banking system. This buoyant situation is not without uncertainties. In the context of a long-term trend towards the reduction of the interest margin¹⁶ (from 2% on average to 1% on average in the banking sector over the past ten years), German savings banks in 2004 displayed an interest margin above the average, at 2,35%. This last number indicates the heavier reliance of savings banks on balance-sheet revenue, which might constitute a liability in a macroeconomic context characterized by low interest rates.

As for efficiency, German savings banks again showed their strength as compared to commercial banks, in the context of a five-year decline in productivity

12 The government recently decided on a rise in the rate.

13 Source: Deutsche Bundesbank (2005), *Monthly Report* (September), p.3.

14 Source: *Ibid*. To be noted, however, is the significantly distinct performance registered by the “Big four” commercial banks (Deutsche Bank, Dresdner Bank, Commerzbank, Hypovereinsbank) and the smaller regional commercial banks. The weight of the Big four (three quarters of the total assets held by commercial banks) explains why their negative performance over the past years drives down the average performance of the commercial banking sector, captured by the figure mentioned in the text. However, this difference vanishes when focusing on pre-tax profits, more of which below.

15 The last years for which data is publicly available as of July 2006.

16 The ratio of net interest on balance sheet total.

(1998–2002) in the banking sector, followed by a slow recovery.¹⁷ In particular, the savings banks' *Finanzgruppe* showed better cost-income ratios than other banking categories: in 2004, primary savings banks and *Landesbanken* displayed, respectively, a 65.7% and a 57.4% cost-income ratio, against 77.8% for commercial banks (driven up by the poor performance of the Big Four).¹⁸ French savings banks are less efficient than their commercial competitors and their German counterparts, with a 73.2% cost-income ratio, while Spanish savings banks exhibit a low cost-income ratio (60% in 2003), remarkably stable over the past 12 years, slightly above that of commercial banks (around 55%).¹⁹

Savings banks' positive returns in most European countries have earned them very good ratings. In Germany, despite the prospect of a (gradual) abandon of state guarantees in 2005, that same year Moody's attributed to the savings banks group a floor rating of A1 – meaning that most single savings banks would receive a rating at least equal to A1. Moody's positive assessment was mainly based on three elements: (i) the sector banks' intrinsic credit strength (their market position); (ii) the high degree of cooperation and cohesion within the group (which significantly decreased default risk²⁰); (iii) “the ability and willingness of a bank's owner to provide financial assistance if need be, regardless of its legal obligation to do so”.²¹

There is, as showed above, ample evidence supporting the assertion that savings banks have “successfully” adjusted to the new environment they now face. As discussed in the introduction, however, a second condition for survival is that surviving firms remain faithful to their core identity. In the case of savings banks, therefore, the question we must now address is that of their “public” nature, and whether the successful strategies which led to high market shares and profitability levels built on that characteristics or removed it at the margins. As will be clear from the following sections, the striking observation is that savings banks have dealt with this issue in very different ways.

Different paths to survival... Or disappearance

a. Corporate restructuring in the savings banks sector

In all European countries, the savings bank sector has undergone, in the past twenty years, a profound restructuring, together with other categories of banks. First, the total number of savings banks has shrunk over the years. From 1980 to 2005, the number of savings banks fell: from 451 to 31 in France; from more than 1,000 to 463

17 Source: Deutsche Bundesbank (2005), *Ibidem*.

18 Source: Deutsche Bundesbank (2005), *op.cit*.

19 Source: Deutsche Bank research (2004), “EU Monitor” on Spanish savings banks.

20 Through a system of sector guarantees available at the Lander or the national level.

21 Source: Moody's Investors Services, Bank Credit Strength Assessment, March 2006.

in Germany;²² from 90 to 46 in Italy;²³ from 81²⁴ to 46 in Spain. Moreover, such a drop in numbers (the IEF 1999 report calls it “natural attrition”) occurred in other European countries as well: in Austria, the number decreased from 131 to 74 over the same period; and in Norway, there were 133 savings banks in 1996 against 227 in 1984.²⁵

Although they show different scales, which we will analyze later on, changes do follow the same decreasing trend, which is continuous over the years. This trend, moreover, and perhaps more importantly, concerns all categories of banks. The total number of French credit institutions fell from 1975 in 1980 to 879 in 2003; the total number of banks *stricto sensu*²⁶ from 1025 to 479. Similarly, the total number of Italian banks fell from 1250 in 1980 to 841 in 2000. In Germany, the total number of banks fell from more than 5,000 in 1980 to less than 2,000 in 2005. All sectors have been affected: commercial banks, cooperatives and savings banks. This is a strong indication that same dynamics are at play in all segments of banking. Interestingly, the Spanish case is an outlier here, since the number of commercial banks actually increased from 1981 until today (from 10 to 138), a trend that did not, however, put into question the high concentration level in the banking sector.

The drop in the number of savings banks reveals a wide restructuring process within the banking sector in all countries, through mergers and acquisitions (M&A) and corporate re-organization. As many observers have noted, these M&As have been chiefly domestic (vs. cross-border) and defensive, in the prospect of increased competition at the European level. As far as savings banks are concerned, however, it is interesting to note that the paths undertaken and the outcome of this restructuring process vary widely from one country to another.

In France, all savings banks are now part of a single banking group (*Groupe Caisse d'Épargne*). This group is the outcome of a double aggregation process consisting of, on the one hand, mergers between and among local savings banks – resulting in the existence of 31 regional savings banks, legally autonomous entities; and, on the other hand, the tightening of operational and organizational bonds among these 31 regional savings banks. The group includes, besides regional savings banks themselves, several subsidiaries and partly owned specialized financial firms. The restructuring process, which lasted 16 years, was gradual and negotiated with the State. In July 1991, French law-makers passed a reform institutionalizing the re-organization of the network (through a rapid movement of mergers and acquisitions), based on a discussion that took place within the

22 To which we have to add 11 Landesbanken and 11 Landesbausparkassen.

23 Those are the numbers of *legal* entities, and do not reflect the fact that a) many Italian savings banks belong to banking groups and b) all French savings banks are parts of a single group. Those aspects will be addressed below.

24 In 1981.

25 Numbers cited in that paragraph come from: central bank annual reports, IEF 1999 report.

26 Credit institutions include banks and other types of financial intermediaries: investment firms, specialized credit institutions (leasing or factoring firms), and so on.

savings banks sector in the previous two years. This “piloted” process led to the constitution of a universal banking group, composed of cooperative regional banks (the cooperative status was given to savings banks by the government in a 1999 law) and a central holding structure which includes an investment bank branch (IXIS), taken over from state-owned CDC.

In Germany, the restructuring process among savings banks bears three notable characteristics: (i) despite dozens of mergers and acquisitions in the past fifteen years, savings banks are still numerous (463 in 2006); (ii) The sector cohesion of German savings banks has been maintained, if not reinforced, throughout the years; (iii) within the savings banks group, public regional banks are the most changing segment.

The drop in number of savings banks is due exclusively to mergers and acquisitions within the sector (the Sparkassen cannot be taken over from private, commercial banks), despite talks of alliances across sectors, which surfaced in the years of the legal dispute with the European Commission on the public guarantees given to German savings banks. In 2002-2003, there were talks of status change for German savings banks, in order to facilitate mergers across sectors. This discussion²⁷ arose when, with the perspective of the removal of state guarantees, one expected a spur in M&As. At the end, however, restructuring processes have been limited to a few cases which do not put into question the fragmented and federal nature of the savings banks sector.

A second characteristic of the restructuring process within the German savings banks sector is the maintained coherence of the sector. Originally, the savings banks sector has a three-level, dual structure, illustrated in Table 3.4.

Table 3.4 – Territorial organization of the German savings banks group

Territorial levels	Banks	Associations
Local	Sparkassen (savings banks)	Sparkassen verband (local savings banks association)
Regional	Landesbanken (public regional banks)	Sparkassen und Giro verband (regional savings banks associations)
National	DK Bank	Deutsche Sparkassen und Giroverband (DGSV)

The emergence of the Dekabank Deutsche Girozentrale (following a merger between Dekabank and the Deutsche Girozentrale) as a provider of financial services (mainly mutual funds) to savings banks has not led to the constitution of an integrated group, as is the case in France. Both in terms of total assets and status, the savings banks’ sector “central bank” does not constitute the heart of the *Sparkassen Finanzgruppe*.²⁸

27 Which often referred to the French and Italian cases. See “Status critical for Sparkassen” in *The Banker*, August 2002, pp.27-29.

28 This name should not confuse readers into considering the savings banks as a group similar to commercial banking groups.

Despite this overall pattern, however, Landesbanks have shown particular dynamism in recent years. As is well known, those banks have a triple identity: they (i) are banks active on the credit markets; (ii) operate as central banks of the savings banks system at the regional level;²⁹ and (iii) provide public banking services for their Land (region). Those banks have been exposed to increased pressures for changes recently, for various reasons: (a) a perceived (by public officials and analysts) lack of dynamism in the market for corporate control in German banking; (b) corporate governance obstacles to their participation in the restructuring process; (c) specific problems that have arisen in recent years, and reveal the contradictions within Landesbank's business and status. One can cite, in particular, the cases of Westphalia-based WestLB, which experienced problems linked to proprietary trading in stocks, while Saxony-based SachsenLB almost went bankrupt due to its exposure to the sub-prime mortgage credit market in the US, which underwent a major breakdown last summer. These difficulties prompted public efforts at organizing a rescue, and re-ignited public discussions about the future of public regional banks. Interestingly, however, the first (and preferred by regional public officials) candidate to rescue the two Landesbanks was another Landesbank, Landesbank Baden-Württemberg (henceforth LBBW), which is also the largest Landesbank.

LBBW already owns 100% of shares of LRP, the Landesbank from Rhineland-Palatinate. With the further acquisition of controlling positions in WestLB and SachsenLB, LBBW will become one of the top banks in Germany. Cross-holdings are not limited to LBBW, however: Bayerische Landesbank owns 75.1% of SaarLB and NordLB holds a 92.5% stake in Bremer Landesbank. Finally, in June 2007 the Savings Banks Association (Deutsche Sparkassen und Giroverband, henceforth DSGV) acquired a 82% stake into Landesbank Berlin Holding,³⁰ after an intense battle against commercial banks. The more dynamic restructuring process at the Landesbank level thus follows a well-known pattern geared towards the reproduction of the coherence of the savings bank system, through two channels: cross-ownership and outright mergers between Landesbanks.

Italy is the other country, besides France, where changes have been far-reaching. In comparison, corporate restructuring in Italy has been a rapid process: in ten years, the country has seen the creation of the four leading banking groups. Within the savings bank sector itself, one can distinguish three different aggregation patterns, which ended up producing three different kinds of banking

29 In particular, Landesbanks establish a link between savings banks and national and international banking systems by providing know-how in more complex products, joint ventures, efficient payment systems and liquidity management. They also handle operations for savings banks at a regional level, such as securities business and foreign payment transactions.

30 One of the most important segments of the German savings banks financial group, which comprises all Berlin savings banks and stood at the top of the most profitable European banks in 2006, according to FitchRatings, with a ROE of more than 30%.

groups. The first pattern characterizes the constitution of national banking groups, building on the alliance between a large savings bank and one of Italy's former large public banks. This pattern corresponds with the emergence of Italy's four most important banking groups: *IntesaBCI*, *San Paolo IMI*, *Unicredito* and *Capitalia*. To these four one might add two large banks: *Monte Paschi di Siena* (the oldest Italian bank, which has been legally associated with the savings banks category since the late 19th century) and *Banca Nazionale del Lavoro* (a former public bank, where the Treasury has kept a small stake). All of these groups were created through a strikingly similar aggregation process, in which we can identify four distinct phases: a first phase in which a leading savings bank absorbs a smaller one; a second phase in which the resulting groups create specialized subsidiaries; a third phase in which the whole group associates itself with another major former public bank; and a fourth phase in which this alliance transforms itself into a new integrated banking group.

A second aggregation pattern characterizes the formation of regional banking groups with a strong territorial basis and often alliances with the *Banche popolari*, a form of cooperative bank – which one could call, therefore, the “regional group” pattern. The territorial element is fundamental within this pattern: the aim of such aggregation is to strengthen savings banks' retail market positions through specialized joint-ventures – while keeping the local clientele networks and organizational flexibility. This pattern is common to several groupings among cooperative banks – mainly, small *Banche popolari* and the *Banche di credito cooperativo*. A good example of such a pattern is the Carige Group, which formed around the *Banca Cassa di Risparmio di Genova SpA (Carige)*.

A third pattern characterizes those (small) savings banks that have remained independent, or formed a group on their own. These banks, or mono-banking groups are characterized by circumscribed territorial rooting and almost exclusive reliance on the retail market. Out of 76 remaining savings banks³¹ in 2002, 16 followed the independent or small group pattern; 30 were owned, controlled by or headed a regional group; and 30 belonged to or were controlled by national universal banking groups.

In terms of the depth of the restructuring process, Spain might be ranked in-between France and Italy on the one hand and Germany on the other. As mentioned above, the number of savings banks has been cut in half. Mergers took place within the sector (savings banks acquiring other savings banks), but Spanish savings banks ventured into other sectors as well: acquisitions of several cooperative banks in the early 1990s and of commercial banks in the late 1990s. The abolition of the regional principle in 1988 led to the emergence of truly national banking groups: in 2002 6 savings banks had national branch networks (against none in 1985)

31 That is, remaining legal entities.

and only 5 banks restricted their business to their region (*comunidad autónoma*) of origin (against 17 in 1985).³² Branch strategies and aggregation patterns differ according to the respective size of savings banks: in 2004, La Caixa and Caja Madrid made up one third of savings banks' total balance sheet, another third being constituted by nine medium-sized, and the last third made up of combined balance sheet totals of the 36 smaller savings banks.³³

This short overview of the restructuring process undergone by savings banks over the past fifteen years raises two observations. There is, first of all, a variety of aggregation patterns within countries. This is clearer in Italy and Spain less so in France and Germany. In Italy, as shown above, there have been various aggregation patterns and savings banks have not behaved in a similar way. In Spain, savings banks of various sizes are pursuing different aggregation strategies (national and regional). In France, savings banks have restructured along the lines of other federal cooperative banking groups (Crédit Agricole, Groupe Banques Populaires, Crédit Mutuel), which are clearly trying to move towards forming universal banks in order to compete with national commercial banks.³⁴ In the case of the *Caisses d'Epargne*, the growing centralization of the group and the acquisition of CDC Ixis certainly points towards that direction.³⁵ In Germany, most mergers and acquisitions took place within the sector, keeping in line with the regional principle.

A second interesting aspect of change – and a second element of differentiation – is the sector dynamics of banking aggregation patterns. In other words, shifts in firm boundaries have occurred mostly *within* bank categories: commercial banks with commercial banks, savings banks with other savings banks... Such intra-sector dynamics were stronger in France and Germany than in Spain and, above all, in Italy where, as we just saw, the biggest savings banks choose to form groups by forging alliances with non-savings banks.³⁶ Overall, therefore, corporate restructuring in the savings banks sector has assumed varying extent in shapes across European countries. What interests us, however, is the impact such restructuring has had on the “public sector” characteristics of savings banks, especially with regard to two aspects: (i) savings banks' local rooting (through corporate governance) and (ii) savings banks' non-profit objectives. These two aspects will be analyzed in the next two sections.

32 Source: DeutscheBank research (2004), EU Monitor on Spanish savings banks.

33 *Ibid.*

34 A move that is evidenced by the recent acquisition of merchant and investment banking branches by the Crédit Agricole (Crédit Lyonnais in 2003) and the *Groupe Banques Populaires* (Natexis).

35 The Groupe Caisses d'Epargne has recently announced its intent on creating an alliance with the Groupe Banques Populaires.

36 Of course, it can be argued that the partners chosen by savings banks for these large deals were former public banks – and since savings banks were considered as quasi-public banks, there is a 'sectoral' flavour to the aggregation patterns that brought these banks together.

Organization, corporate governance & the role of stakeholders

Local rooting is a core part of savings banks' identity, ever since their creation in the 19th century. Savings banks are mostly local produces. Their local rooting expresses itself at three levels: the capillarity of their networks, relationship banking (on the asset side, with SMEs and local governments; and on the liability side, with customers and savings accounts holders); and their corporate governance. The present section will mainly focus on the latter, for two reasons: (i) it is the aspect most immediately linked to the individual and sector boundaries of savings banks, and therefore more susceptible to change with corporate restructuring; and (ii) corporate governance contributes to determining savings banks' strategies with respect to branch policy and relationships with customers.

Again, the brief comparison undertaken here brings up two observations. First, in two countries, namely France and Italy, savings banks' corporate governance has been fundamentally altered in the 1990s, while in the other two, Germany and Spain, it remained roughly the same over the period. Secondly, local rooting seems to have survived changes in corporate governance although, again, the latter have taken very different patterns in the four countries surveyed.

France & Italy

Until the 1980s, neither French or Italian savings banks had clear owners. In both cases, savings banks were *sui generis* entities, whose location with respect to private or public law was ambiguous, whose managers were co-opted within a pool of local power holders (*notables*). Savings banks' equity, whether it had foundational or associational origins (in the Italian case), did not give rise to property rights over the bank or the bank's revenues, and their benefits were redistributed through grants to local associations, or to finance social or artistic endeavours.³⁷ As a French interviewee (top official at the national federation of savings banks, or FNCE) said:

[In 1981] Savings banks' ownership was confused: did they belong to the State? To the nation? That's what Beregovoy [the Socialist Minister of Finance] said then. But what does that mean? Who is "the nation"?³⁸

This ambiguity did not, however, place savings banks in equidistance from private and public sectors. Savings banks were strongly associated with public intermediation circuits, where public entities – especially the Minister of the Treasury, in both cases – played a key role in the banks' corporate governance. In France, savings banks were not really autonomous entities but part of the so-called 'Treasury circuit' (Zerah, 1993) in financial intermediation: decisions about

³⁷ Such funds were tellingly called in France the "*Fortune personnelle*" (personal wealth) of savings banks.

³⁸ Interview, 24.04.02.

lending and collection were made by the *Caisse des Dépôts et Consignations*, itself organically linked to the Treasury department at the Ministry of the Economy. In Italy, the two key members (Director and vice-Director) of the savings banks' executive board were appointed by the *Comitato Interministeriale per il Credito e il Risparmio* (intergovernmental committee for credit and savings, or CICR), which was dominated by the Treasury as well.

Such unclear ownership lines were problematic, or more precisely became problematic for several reasons. First, they became problematic for savings banks themselves, faced with recurrent needs to increase equity (or recapitalize), under the pressure from prudential regulation and increased competition. Who should contribute, and under what form? Since there were no equity owners, there was nobody to turn to when the issue of recapitalization arose. The need for recapitalization (a precondition for systematic banking restructuring) was among the driving forces in savings banks reform process during the 1980s.³⁹

A second problem associated with blurred ownership was the 'undue advantage' arguably enjoyed by savings banks over other banks – by exonerating them from remunerating owners. This undue advantage became even more problematic after 1985 in Italy, and the introduction of prudential regulation. Unclear ownership meant, for savings banks, having more resources at disposal for complying with prudential regulation (equity-related ratios, reserves).⁴⁰

A third problem was the issue of power. In the context of a gradual loosening of the state's grip on the banking system, and on savings banks in particular, who would take a hold of savings banks, and therein control savings banks' economic resources and political assets? In Italy, the power of the Ministry of the Treasury over executive directors' appointments had a great political significance. The *Casse di Risparmio* were, indeed, a pillar of the Christian-Democrats' Northern and Southern power base, and of the Communists in Toscana and Emilia-Romagna, which points to a complex game of political alliance and support between central and local authorities. There is no study on the relationships between the *Casse di Risparmio* and political power – just brief mentions in monographs or broader essays.⁴¹ However, anecdotic evidence seems to show that Italian savings banks were much more of a national and regional political stake than their French counterparts – the French *Caisses* did represent a political power place, but at the very local level. In addition, until the 1980s French savings banks did not pursue an active strategy on the asset side, which made savings banks in France

39 In Italy, several ways to recapitalize short of bringing in new owners were tried in the 1980s, without much success.

40 The undue advantage given to savings banks by their public status also concerns the favourable ratings given to them by rating agencies (since they are backed by public entities, which cannot go bankrupt). Such was the argument recently used against the system of public guarantees to the savings banks sector in Germany (see below).

41 See, in particular, De Rosa (2003) for a historical perspective.

much less of an economic power holder than in Italy, where the *Casse di Risparmio* could effectively allocate resources to “friendly” firms or clients.⁴² This is a key difference that explains much of the subsequent variations in ownership changes.

In the Italian case, the transformation of savings banks’ corporate governance had ambivalent effects on the representation of stakeholders, which resulted being a by-product of the power struggle that took place between central state authorities and the savings banks and their new owners, the Foundations (more on this below). The watershed moment in the history of Italian savings banks occurred in 1990, with a reform called the “Amato-Carli law”, from the name of the two ministers at its origin. The 1990 law succeeded a decade of attempts at internal change, that is, change within the sector itself. In the 1980s, several savings banks implemented statutory changes that were however quickly rebutted by the courts for encroaching upon constitutional matters (See Cassese, 1983 and Merusi, 1984). Those statutory changes were primarily aimed at allowing savings banks to raise new equity and change their governance mechanisms. Given the limits posed to such changes by the courts and the existing regulatory regime, savings banks started pleading in favour of changes in the legislation. This was clearly expressed at several official meetings. At their 13th annual congress in April 1982 in Sicily, for instance, the *Casse di Risparmio* asked for a legal reform to change the rules governing the access to capital markets, then restricted, and the possibility to change their governance structures – introducing the separation between management, control and direction, on the model of the joint-stock company (*Società per Azioni*) (ACRI, 1995). This view was shared within the central bank, which made it explicit first in a 1981 White Book; and in a second White Book published in 1988, where it proposed that public banks be transformed into joint-stock companies, a status more appropriate for getting access to capital markets.

The failure of internal change, and the widespread awareness of the necessity to spearhead the restructuring of the entire banking sector, led to with the Amato-Carli reform in 1990. The Amato-Carli law opened the possibility for savings banks and public law banks which belonged to the same broad legal category⁴³ to transform themselves into joint-stock companies. Savings banks’ equity would then be entirely transferred to new entities created by the law, the *Fondazioni di origine bancaria* (banking Foundations). New owners were thus created *ex nihilo*. The Amato-Carli law can be read as an attempt to solve the three issues that surfaced in the 1980s. More precisely, the 1990 reform constituted an attempt to: i) allow savings banks to access new shareholders for recapitalization, and ultimately corporate restructuring; ii) level the playing field and iii) make sure that

42 Of course, this is not to suggest that savings banks’ lending policies were guided by political or clientelistic motives.

43 Monte Paschi di Siena, Banco di Napoli, Istituto San Paolo di Torino, Banco di Sicilia, Banco di Sardegna.

the transition from the public sphere to the private one would occur smoothly, and would lead to the gradual constitution of new owners and stable power groups.

Within this new framework, Foundations would then be owned and controlled by the founding entities of the original savings banks: mostly, local governments. In addition, the revenues earned from savings banks' business would finance the non-profit activities the Foundations were supposed to engage in. In that way, savings banks' traditional local rooting was preserved. However, Foundations' relationships with savings banks and their autonomy from the State were at the heart of a hotly debated controversy during the 1990s, which has not been concluded yet. This controversy originated in the ambiguity created by the 1990 reform. In fact, the latter disposed that the Foundations should keep controlling shares in the savings banks from which they had been created. In addition, the 1990 law disposed that the management of shareholdings in *Casse di Risparmio* would constitute the *raison d'être* of the newly created Foundations.

The application decree published that same year blurred the picture by disposing, in contrast to the law it was supposed to transcribe, that managing shares held in savings banks were merely instrumental in producing revenues; and that the mission of Foundations was to pursue public interest and "social utility" goals, through actions in the field of welfare, scientific research, education, health and art. Foundations, therefore, would not (should not) become holding firms.

These contradictions were at the center of the subsequent discussions, which lasted until 2003, and mainly revolved around three issues. The first one was: what should Foundations do with the shares they owned in savings banks? The second and the third issues were, respectively, what was the legal nature of Foundations and who should control them? These three issues were closely linked to each other, and represented a crucial stake for the Italian political economy as a whole. If Foundations were to retain controlling shares in savings banks, and were to be simultaneously recognized as public entities, controlled by other public entities, then a sizeable share of the Italian financial system would still belong to a broadly defined public sector. If instead, Foundations were to be recognized as private entities with private owners, but kept holding majority shares in savings banks, this would imply a shift from public sector to a *sui generis* political economy, in which non-firms and non-governmental entities governed part of the financial system; if, thirdly, Foundations were to lose their control in savings banks, privatization would become complete.

Policy-makers first moved to solve the first issue - that of Foundations' control of savings banks. The objectives of successive governments in the 1990s were remarkably similar: Foundations should (gradually) give away control of savings banks, so as to (i) allow the restructuring of the banking system through mergers and acquisitions and to (ii) avoid having powerful politically-influenced actors determining the strategies of an important part of the credit system. To that effect, law-makers used a series of instruments, more and more constraining over the

years. They first introduced fiscal incentives for share dismissals. A 1993 law exempted the sale of shares by Foundations from tax on plus-values.⁴⁴ Then, a law passed in July of 1994⁴⁵ eliminated the obligation for Foundations to keep control of *Casse di Risparmio* (CR henceforth) in which they held shares;⁴⁶ on the contrary, it obliged Foundations to relinquish control of the banks. Building on that law, a November 1994 directive (known as the “Dini directive”, from the name of the then Minister of the Treasury)⁴⁷ specified the criteria and modalities of share dismissals from Foundations.

What is interesting is that the Dini directive did not address the issue of control upfront. Rather, its official aim was to encourage the Foundations to gradually diversify their risks. In fact, the two ‘parameters’ set up by the directive were: (a) that at least 50% of the resources (assets) used by the Foundations for the pursuit of their ‘institutional goals’ (*finalità istituzionale*) come from other sources than their shareholdings into the CR; and (b) that no more than 50% of Foundations’ capital be invested into shares of the CR. In a sense, then, the directive echoed, on the regulatory side, the prevalent portfolio management character of the management of CR shares by Foundations, which was continuously claimed by the latter in subsequent years. In addition, the Directive set a deadline (1999) for such control dismissal to take place.

Did the Dini directive impose an unwanted constraint on reluctant actors? This is what emerges out of several actors’ accounts and perceptions of the period. Many CRs resorted to the courts to object to the directive’s dispositions. But, according to a central bank official, this was just foot-dragging on the part of the *Casse di Risparmio*; what they wanted was to earn more time. This interpretation seems quite sensible, in light of the lame performances of the stock-market in those years, which prevented from foreseeing the maximization of gains on the sale of CR controlling stakes. By contrast, the ACRI, in its first report on Foundations, claims that a trend towards control dismissal could be observed before the Dini directive (ACRI, 1995). Subsequent years, however, proved it wrong. The 1990s were characterized by a constant struggle between policy-makers and Foundations around the issue of the control of savings banks. A law was passed in 1998 (“Ciampi” law), which tried to put an end to this deadlock. The law was greeted with positive reaction from the world of savings banks. According to savings banks officials⁴⁸, the law “finally recognized (Foundations’) private nature”. Such recognition was reinforced by the fact that the law, in the Foundations’ view, set up incentives, not obligations, for the sale of shares

44 Art.4, Law 489 November 26th, 1993.

45 Law n.474 of July 30th, 1994.

46 More precisely, article 7 bis of the cited law abrogated articles 13, 14, 15, 19, 20 and 21 of the Legislative decree n.356/1990 that contained references to the public control obligation.

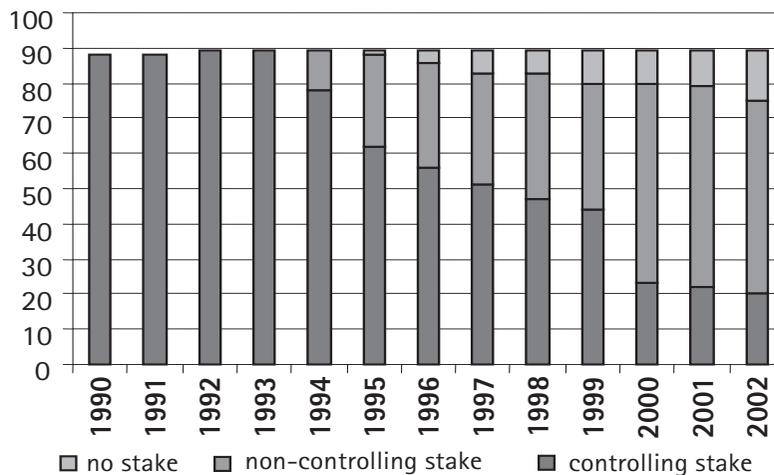
47 Directive of the Minister of the Treasury of November 18, 1994.

48 See the conclusion of their 1997 annual congress, in ACRI (1997b).

on the part of the Foundations. Foundations were right to see a shift in attitude from policy-makers – but the Ciampi law was passed in a context much more favorable to the sales of shares on the market.

Data gathered from savings banks individual documents and from ACRI annual reports on *Fondazioni* show a clear decline of ownership shares of *Fondazioni* in savings banks, as shown in figure 3.1. The median share started diminishing in 1994, and has diminished every single year since then. The trend towards share dismissal accelerated in the late 1990s, and slowed down in 2001, due to the European Commission’s decision to suspend the concession of fiscal incentives set in the Ciampi law, arguing that these amounted to State aid, allowed under EU law under very strict conditions. Those *Fondazioni* that were intent on selling further shares thus suspended their dismissals, the time for the EC to close its inquiry. The median stake is now (2006) around 14%. Of course, this general trend reflects different individual strategies. In fact, one could classify *Fondazioni* in several groups, according to the importance of their ownership share and, more importantly, to the rhythm of dismissal. As of end 2005, out of 88 Foundations, 16 held shares representing more than 50% of the savings bank’s total equity;⁴⁹ 57 held shares representing less than 50% of the savings bank’s total equity; and 15 did not hold shares in savings banks.⁵⁰

Figure 3.1 – Foundation’s Stakes in Italian Savings Banks (n foundations)



Why did share dismissal seem such a painful process? Again, this issue raises conflicting interpretations. Government officials and policy-makers claimed that

⁴⁹ According to the law, holding majority stakes is permitted only to the smallest Foundations (with assets of less than 200 million euro), or those located in “special status regions” (Sardegna, Val d’Aosta, Sicilia).

⁵⁰ Source: ACRI (2006)

the Foundations were just reluctant to cede control over savings banks. Savings banks and Foundations officials disagreed. The 1997 ACRI annual report went on to say that “The action of Foundations in [the field of share dismissals] will be determined above all by market assessment and economic considerations.” (ACRI, 1997). All savings banks interviewees confirmed this view. As one of them, a former savings banks official, said:

It's not that Foundations do not want to get out [of banks'equity]. It's just a matter of selling [their shares] at a good price. Sometimes it's difficult to sell well the shareholding portfolio, it's not easy.⁵¹

In fact, that interviewee added, Foundations' shareholdings within savings banks are “more a problem for the Foundations than for the banks”.⁵² Another interviewee, president of a major Foundation, shared this view:

Regarding shareholdings in the bank, they are just financial shareholdings; I have always thought this way. I have never defended shareholdings. In fact, had I been able to get rid of them, I would have invested in real estate.⁵³

Another President said

About [the obligation to sell shares imposed by the government in 1998], I have nothing against it, if we can sell the shares for profit, and find alternative investment opportunities.⁵⁴

However, the decrease in Foundations' ownership did not solve the issue of effective control of savings banks. In other words, have *Fondazioni* seen their control decline along with ownership shares? This question is difficult to answer, for at least two reasons: first, the dataset used above focused on *Fondazioni*'s stakes in their own banks – and not in other savings banks, excluding cross-shareholdings from the picture; second, control does not diametrically correspond to ownership. One has to look, therefore, at other measures of *Fondazioni*'s control, besides majority ownership. Indeed, indirect ownership, cross-shareholdings, and low ownership concentration (meaning that however little their shareholdings are, Foundations still count among ex-savings banks' largest owners) all point to a persistent power of Foundations, both at the large banking groups and in medium-sized savings banks groups.

The control of savings banks by the Foundations was as hotly debated as the control *of* the Foundations. The latter was intensely discussed during the 1990s (and early 2000s), in relation to the legal nature of Foundations. Were they public or private entities? That debate had obvious practical implications: were Foundations to be recognized as public entities, control by local government would have been justified – and savings banks would fall again in the public realm. The private nature of Foundations was pleaded forcefully by the ACRI, a staunch

51 Interview, 30.05.03.

52 Interview, 30.05.03.

53 Interview, 06.05.03.

54 Interview, 14.02.03.

defender of autonomy, and backed by several scholars such as Merusi (1993) and Galgano.⁵⁵ As the ACRI argued, the very concept of “Foundation” indicates the “civil society provenance of their patrimony” (ACRI, 1997). As mentioned above, the 1998 Ciampi law recognized the private nature of Foundations. Both, therefore, the issue of savings banks’ ownership and of Foundations’ control were resolved by the early 2000s.

However, Foundations’ operational autonomy (the use of their resources) was still an open issue, and led to another power struggle in the past five years. Foundations’ bank shareholdings, especially in the upswings of the stock-market in the late 1990s, represented, overall, an important pool of resources – Foundations total assets amounted to 41 billion euro in 2004⁵⁶ – which aroused cash-strained governments’ interest. Under the last center-right government, there were several attempts to tap into Foundations’ large resources to finance various government programs, from public infrastructures to the newly national civil service (see ACRI, 2006) – and this despite a 2004 Ministerial decree which reaffirmed Foundations’ private nature. These attempts were only half-successful, as Foundations accepted to participate into EXPAND.

A final issue lay with the extent of Foundations’ control over savings banks’ strategy and management. In fact, the transformation of Italian savings banks into joint-stock companies with the Amato-Carli law transformed the ownership issue into a control issue – that is, what degree of control could and should the Foundations exercise upon savings banks’ management and strategies. Since the governance mechanisms put in place by the successive reforms were, in contrast to the French case, in line with “normal” governance practices in joint-stock companies, the attention should shift to the control of senior management by Foundations.

Before the Amato-Carli law, top officials at savings banks were political appointees. The appointment system was called ‘*terne*’ (threes): at the moment of the renewal of the mandate of savings banks’ chief executive, the central bank proposed three names to the Treasury. The appointment was then decided at CICR meetings, in which the central bank governor had no say. It is notorious that once in the 1980s the Governor of the central bank was expelled from the meeting room for having expressed his views about the appointees. Of course, this system became obsolete with the transformation of savings banks into joint-stock companies, and with the institution of formal governance mechanisms. A 1993 referendum abrogated the dispositions of a 1938 law that gave the Minister of the Treasury the power to appoint the President and

55 As noted in ACRI first annual report on Foundations, if the legislator gave Foundations a public nominal recognition, the latter authors claim that given the private origin of their equity, the mostly private *locus* of their creation, and the end of mandatory control disposed by the 1994 law, Foundations are private entities. (ACRI, 1995, p.17.)

56 Source: ACRI (2006). It is noteworthy to observe that by 2005, bank shareholdings represented only 29% of Foundations’ total assets (which included other financial instruments), a proportion that was, of course, wholly different from Foundations’ balance sheet composition in the mid-1990s.

Vice-President of those *Casse di Risparmio* with institutional origins. In addition, a 1993 banking law, the so-called *Testo Unico*, put an end to the Ministerial appointment of the President and Vice-President of the Banche del Monte, a category assimilated to that of savings banks. Therefore, while before the renewal of the boards in 1994-95, almost 19% of board members had been appointed by the Minister of the Treasury, by 1995 they were only 0.4%.⁵⁷ This shift benefited ACRI, which almost doubled its appointees within the boards (from 8.4% to 15.5%), and cooptation by the board, which reached 9% of total members by late 1995. Meanwhile, members of the board appointed by local governments (cities, provinces and regions) still constituted in the late 1990s a sizeable part of the board: 43%; and Chambers of commerce appointed 19% of members. As for *Casse di Risparmio* with associational origins, more than two thirds of their board members were co-opted by the Assembly of stakeholders.

The appointment power then passed to savings banks' legitimate owners, the Foundations. In addition to being able to appoint their men to savings board's top management, Foundations were for a while able to have their own board members serve on banks' boards. This was a logical continuation of the previous regime: in the immediate aftermath of the 1990 reform, it was conceivably difficult for Foundations to renew all executive positions either on their board or on savings banks' board.

A 1993 ministerial decree⁵⁸ further severed the links between Foundations and *Casse di Risparmio* by disposing the incompatibility between mandates at Foundations and savings banks. In other words, top officials and directors of Foundations who were also top officials at the controlled savings bank were forced to choose between one of their mandates.⁵⁹ This was a widespread practice in "institutional" Foundations: in November 1995, more than 11% of members of the Foundations' administrative boards were also board members at the controlled savings bank – half of which were either the President or Vice-President of the *Cassa di Risparmio*.⁶⁰ Statutory changes were completed in 1997; and in the 1995-97 period, 54% of board members were renewed.

However, here again, the process of change was slow. In 1998, 24 Foundation board members (out of a total of 880) still held mandates within the controlled savings bank.⁶¹ They had to choose. As a top official at one of the savings banks said:

In all the *Casse di risparmio*, there was a powerful man. When they had to choose between the bank and the Foundation, after the spin-off, almost all of them chose the bank, because banks, more than Foundations, were seen as a power center.⁶²

57 According to data provided by ACRI (1995).

58 Decree of the Minister of the Treasury of November 26th, 1993, transposing a decision taken by the governmental committee on credit and savings (CICR) of August 1993.

59 Originally, in the 1990 reform, as the ACRI reports, compatibility between the two mandates was considered useful to facilitate transition from the old to the new regime (ACRI, 1995).

60 Data from ACRI, 1995.

61 According to ACRI, 1999.

62 Interview, 30.05.03.

Did this mean, however, control of the bank by its owner? It is not very clear. As one of the interviewees said,

We cannot generalize. Where there was a strong character, and that character chose the bank, then it was the manager who controlled the shareholder. Where the opposite was true, it was the shareholder who controlled the manager.⁶³

Overall, one could sum up the Italian case in the following terms: successive reforms severed the direct links between savings banks and their territory, at least at the level of corporate governance: however, the Foundations, controlled at the local (regional) level, still belong to the core shareholders of savings banks and of the major banking groups created from mergers between savings banks.

The same issues of ownership and control were also at the heart of the transformation of French savings banks. A first reform took place in 1983, and allowed savings banks to become banks in all effects (enabling them to offer all kind of banking services, notably lending until then restricted). Although bringing up key changes in the business definition of savings banks, the law did not address the issue of ownership upfront. Representation of stakeholders was ensured through the establishment of “*Conseils consultatifs*” (advisory bodies). But those vague entities, with no clear juridical basis and corporate legitimacy, did not really function, as a top official admitted in 1991.⁶⁴ The ambiguous status (neither clearly private nor public, with no owner) of the *Caisses* lasted until the successive reform, in 1999, which completed the far-reaching transformation that had taken place in the previous two decades by giving savings banks a cooperative status – and thereby creating new owners under the form of cooperative membership (*sociétariat*). It seems that the time lapse was justified by the savings banks’ need to form their own equity before being able to distribute it to the new owners. That is why the 1980s and 1990s were used by gradually constituting equity or own funds, through the accumulation of revenues and common funds at the network level (“*fonds de solidarité et de modernisation*”, “*fonds commun de réserve et de garantie*”), which represented 49 billion francs in December 1990.

Under the 1999 cooperative status, each client of the *Caisses d’Épargne* can acquire up to 1,000 euros in shares. Whatever the amount paid and the number of shares held, all subscribers are entrusted with an equal degree of ownership. Each owner exerts his/her ownership rights through two levels of governance: a first level, within a *Société Locale d’épargne* (SLE), which is a cooperative institution. There are several SLEs for each *Caisse d’Épargne*: each SLE covers a chunk of the territory on which the savings bank operates. Clients-owners belong to the SLE of their residency. Their shares entitle them to voting rights, on the (cooperative) basis of “one person, one vote.” SLE members meet at least once a

63 Interview, 30.05.03.

64 Lucien Peretti in *La Revue des Caisses d’épargne*, February 1991, p.17.

year, at a general assembly where they elect the board. The board, in turn, is entrusted with representing SLE members' will through the *Comité d'Orientation et de Surveillance* (COS), whose members are elected by the SLE boards. The COS works like a monitoring board, since it appoints the three to five members of savings banks' *Directoire*, which is the body that effectively runs the bank.

As of 2006, 80% of stakes (*parts sociales*) in each savings bank were held collectively by SLEs, while the remaining 20% were held by the group's central institution, the *Caisse nationale des Caisses d'épargne* (savings banks' national cashier, henceforth CNCE), which is a joint-stock company entirely own by savings banks themselves.⁶⁵ The stakes held by the CNCE take the form of *certificats coopératifs d'investissement* (investment cooperative certificates, or CCI), with an entitlement to dividends but no voting rights.

Apparently, therefore, the ownership problem in French savings banks was definitely solved with the 1999 law. In practice, however, the issue of effective control remains open. French savings banks' owners did not seem, in the years following the reform, to be very eager to exert their controlling rights. Internal documents, as well as interviews, showed that savings bank senior staff (both at the national and the local level) show little interest in giving the *sociétaires* real control; and until recently staff at the *Fondation nationale* despaired at finding owners interested in exerting their rights.

The effective exercise of their ownership rights by *sociétaires* met with serious difficulties early on. These difficulties were of two types. First, both the CNCE and the FNCE do not seem to have been wholehearted in their efforts first to "recruit" *sociétaires* and then to consider them as the real owners of savings banks. As mentioned above, the *Fédération* was entrusted with the mission to coordinate relations between savings banks and their owners. Its first task was to *create* the new owners, by selling equity to the public, and setting up, in parallel, the governance mechanisms through which owners would exert rights. The acquisition of shares started on January 1st 2000 and ended on December 31st 2003. In practice, this means that savings banks employees ("agents") started to propose to their clients the acquisition of shares in SLE. After a year and a half, the number of clients-owners reached two million. As of March 2003, there were 2.7 million clients-owners. The original objective was to reach 4 million shareholders by the end of 2003.

But that objective was brought down to 3 million in 2003, one million less than initially planned. Indeed, each *sociétaire* has subscribed more than expected: on average, from 600 to 750 euros of shares. And, in 1999, the State was set for the *Caisses d'Épargne* objective of selling 2.42 to 2.87 billion euros in shares by

65 In January 2007 savings banks acquired the 35% stake in the CNCE held by the state-owned *Caisse des dépôts*.

2003, the amount raised being affected to the *Fonds de réserve des retraites* (the State's emergency pension fund). This was, in a sense, the “price of freedom”⁶⁶ – the “transfer of ownership” authorized by the State.

As a consequence, the drive to attract new *sociétaires* responded first and foremost to a financial necessity: that of not “over-paying” the State in the operation.⁶⁷ Had the Group maintained the initial target of 4 million stakeholders, it could have ended up raising much more than the 3 billion euros originally targeted, and thus lost further money to the State. This operation, in sum, bears testimony to the low importance given by the Group to the effective number of their owners.

Besides, it does not seem that either the CNCE or the FNCE expected to generate new owners through access to the *sociétariat*. A document disseminated by the FNCE in December 2001 is very revealing for that matter: it shows the potential returns that the Group could get from promoting *sociétariat*:

- a better *fidélisation* of a growing group of *sociétaires*, who will become more prone to acquire new products and services from their *Caisse*;
- the emergence of a new “communication force”, since satisfied *sociétaires* will “sell” the *Caisse d'Épargne* in their familial and social environment;
- the availability of a strong potential to be mobilized when needed;
- the availability of a reserve of subscription to draw from [in the case of future capital needs].⁶⁸

As one can see, the drive to attract, “recruit” and satisfy *sociétaires* is not just a matter of finding owners. It is also (above all?) aimed at keeping and multiplying faithful customers. This objective is, of course, only half-heartily acknowledged at the FNCE –it is much more explicit at the CNCE. But this is one side of the coin. The other is that *sociétaires* themselves do not seem eager to exert ownership rights, as successive surveys conducted by the FNCE have shown. Of course, there is no certainty that those surveys are not biased : the *Fédération* might well see what it wants to see. However, one could oppose a counter-factual to this potential bias: in its power conflict with the CNCE, the *Fédération* has a vested interest in developing its power basis within savings banks – namely, the *sociétaires* themselves, whose interests it is supposed to represent.

In 1999, 2000, 2001, 2002, a series of quantitative surveys were thus conducted by the *Fédération* in order better discern the *sociétaires* profiles, their expectations and the degree of their desired involvement in the life of *Caisses*. The quantitative surveys were completed with qualitative studies of samples of *sociétaires*. This

66 See “La Fédération des Caisses d'Épargne veut peser sur le projet stratégique pour 2004-2007”, in *Les Échos*, February 27, 2003

67 From interviews with savings banks managers and regulators.

68 Fédération Nationale des Caisses d'Épargne, *Un projet coopératif pour enrichir le projet stratégique des Caisses d'épargne – Promouvoir l'identité remarquable du Groupe Caisse d'Épargne*, November 2001.

effort was systematized with the creation of an “*Observatoire du sociétariat*” within the FNCE. One of the consistent findings of such studies is that the most important motivations behind becoming a shareholder are (1) to earn dividends and (2) to benefit from special offers and banking services. In a recent study, the FNCE found that only 19% of respondents identified the participation in the bank’s life as a reason behind acquiring shares.⁶⁹ Of course, it might be too early to judge whether this situation will stabilize in time. Nevertheless, the FNCE is now focusing its efforts on that small part of “motivated owners”. But the current situation does not favor the exercise of strong monitoring and control on the part of clients-owners.

A final, and critical obstacle to the effective exercise of ownership rights by the new owners is the role played the CNCE in the corporate governance of savings banks. As mentioned above, the CNCE intervenes at a key moment of the governance chain: it gives its “agreement” on the *Directoire* (executive board) members appointed by the COS. The law is ambiguous as to what “agreement” means, and what is the precise extent of CNCE’s power over COSs’ nominees. In practice, however, all interviewees (be they at the CNCE, at the FNCE, or at the local savings banks) recognized the predominance of the CNCE in the choice of *Directoire* members.

In addition, the segmentation of SLE (there are 448 SLE for 34 CE) leads to a greater diffusion of ownership, which, in the legal-economic literature on corporate governance, is seen as the breeding ground for managerial control. As a local savings bank staff member candidly said:

The creation of 48 SLE in Picardie (a national record) enables us to be closer to our clients; but it also gives less weight to SLE ...⁷⁰

In sum, both the FNCE or the CNCE are ambiguous as to what they expect from sociétaires; in addition, key veto points are retained by CNCE in the governance process; and the FNCE – that is, the organ supposed to represent owners – has much less power than CNCE. A first element that indicates the real balance of power is the sheer size of the two institutions, in terms of staff: the FNCE includes around 30 people, while the CNCE is staffed with more than 500 employees. A second element is the fact that the FNCE participation into the definition of Group’s “strategic orientations”, set by the law, is marginal, and does not encroach upon the business goals that stand at the core of savings banks’ strategy (see next chapter). These are clear obstacles to any kind of substantial monitoring and control from owners.

There is a ‘cultural’ path dependent explanation to such a situation, which is given at the FNCE : the CE have no “culture” of cooperation (by contrast, for

69 FNCE (2002), “*Enquête quantitative auprès des sociétaires*”, internal document, (done through 1224 phone interviews with sociétaires in December 2001 – January 2002). One should not rely on those numbers, since different numbers have been given by interviews or in the newspapers. What remains constant is the *trend* and the relatively low proportion of owners willing to engage actively in the savings bank’s life.

70 Interview, 22.07.02.

instance, with the *Crédit Agricole*). So the current outcome could reflect path-dependence, and the difficulty to change paths. But that does not explain change in paths, neither does it account for the fact that there is an internal conflict and the effective exercise of ownership is not doomed in advance.

In sum, in the French case the relationship with local stakeholders was reinvented by successive reforms: from institutions controlled by the State and the local bourgeoisie, French savings banks became cooperative firms with a very large pool of shareholders disseminated on the territory. In the past few years, it seems that those local owners have become more eager to play a direct role in the savings banks' strategies.

Spain

With respect to corporate governance (as well as other aspects of reform), Spain stands between the French and Italian case on the one hand (radical change) and Germany on the other (relative persistence). In Spain, too, like in France and Italy, savings banks used to have blurred ownership and *sui generis* statuses. In addition, corporate governance was dominated by central and local governments, which had the final say in appointing the president and vice-president of the banks. In the 1970s, furthermore, Spanish savings banks were part of a state-centred credit allocation system, which was rapidly dismantled after the death of Franco in 1975.

Successive reforms did not really clarify savings banks' status. The *Cajas* are "non-profit private foundations" listed on a specific registry at the central bank. They do not have to pay dividends to shareholders: at least half of their after-tax profits should go to build their equity, while the rest should fund projects fulfilling savings banks' social mandate. Their non-profit objectives are, therefore, recognized by law.⁷¹ Without legally identified owner, savings banks are immune from takeover – while they can, themselves, acquire banks and cooperative credit institutions and engage in mergers with other savings banks. Interestingly, savings banks' persisting *sui generis* status lends itself to the similar legal disputes and scholarly debates that took place in Italy in the 1980s.⁷²

As for corporate governance, instead, several important reforms have taken place since the late 1970s. A 1977 law standardized savings banks' corporate governance (by instituting two governing bodies, the general assembly and the board of directors) and opened share ownership to the public and to depositors,

71 The 1985 legal reform, called LORCA (*Ley de Órganos Rectores de las Cajas de Ahorro*), disposed that members of governing bodies (the General Assembly and the Board of Administration) should "fulfill their functions to the exclusive benefit of the savings banks' interests so that they could carry on their social role".

72 Witness, for instance, the discussion that took place about the Constitutional court's 1988 ruling on the *Cajas'* legal nature.

foundations, cultural and charitable organizations. Public authorities often controlled savings banks in their quality of founding institutions, or representatives of the founders, and the 1977 law aimed at circumscribing their influence. A 1985 law,⁷³ however, together with regional laws, reversed the trend and allowed public authorities to gain substantial power over the direction of the *Cajas*. In the following years, the combined shares of local and regional authorities increased and, in some cases, reached 70% of voting rights within the savings banks' governing bodies.

A subsequent reform of the financial sector passed in 2002 (the *Ley Financiera*) limited the number of representatives of public authorities in savings banks to 50% of their governing bodies.⁷⁴ In 2005, on average, Spanish savings banks' stakeholders' representation broke down in the following manner: (i) customers (36% of voting rights); (ii) municipalities and local administrations (25%); (iii) founders (12%); (iv) employees (10%); (v) general interest organizations (8%); (vi) regional governments (9%).

Those stakeholders appoint their representatives at the general assembly (*asamblea general*), who elect a board of directors (*consejo de administración*) whose voting power distribution must reflect that of the assembly. The board is responsible both for the management of the bank (for which the board can delegate its prerogatives to an executive committee and/or to an executive director) and for the management of the savings bank's social activities (*Obra social*). The general assembly also elects a supervisory body (*comisión de control*), whose mission is to oversee the board of directors' work – and whose composition must, again, reflect the general assembly voting rights distribution.

Overall, public authorities' control over savings bank corporate governance is extensive. First, provincial governments (*comunidades autónomas*) hold considerable regulatory power over savings bank governing bodies: they can set the absolute numbers of representatives on those bodies; they can set the exact proportional representation of each group of stakeholders, within the range set by law; they can shape the process of selection of representatives to the general assembly. In practice, political parties play a central role in the governance of the *Cajas*, given the latter's political relevance at the regional level. Secondly, the *comunidades autónomas* have a say over many matters pertaining to: profit distribution, large grants (which have to be previously approved by the *comunidades* in several regions), investment in corporate holdings and, perhaps more importantly, mergers.

Germany

As mentioned, German savings banks belong to a multi-level financial group, organized in different categories (at the territorial level), with different corporate

73 Law 31/1985 (LORCA law) of August, 2, 1985.

74 That reform was passed in part to avoid state aid procedures at the EU level.

governance arrangements. Savings banks themselves (Sparkassen) are mostly public entities, owned by municipal or district Gewährträger (holders) – or both.⁷⁵ There are only few privately-owned savings banks, notably the largest one, Hamburger Sparkasse AG (with a balance sheet total of €31.8 billion in 2005); and those private savings banks are owned by private Foundations rooted in a territory.

By contrast with the other European cases cited above, the public nature (in statutory terms) of German savings banks has never really been questioned – since most of them were founded and remain controlled by local governments. In fact, during their 2004 congress in Frankfurt members of the DGSV executive board adopted a declaration confirming their commitment to three core principles of savings banks organization: municipal ownership, public legal status, and the regional principle (*Regionalprinzip*). Their corporate governance perfectly reflects this commitment: at the savings banks level, management is controlled by a board of directors (the *Verwaltungsrat*) composed, usually for two-thirds, of representatives of the local government, and for one third of representatives of employees. The *Verwaltungsrat* chairman is usually the head of the local government body. Local authorities are therefore in position to control the conformity of the bank's strategy with local interests. Moreover, several chairmen of regional savings bank associations are also members of the respective regional Parliament, thus reinforcing this close relationship between savings banks and local and regional politics.

The *Landesbank* situation is a bit more complex, and has been changing fast over the past few years, contrasting with a long period of continuity. Most of the 11 *Landesbanks* are jointly owned by regional savings banks associations and the regional government (the Land). On average, ownership is equally divided by the *Länder* and the regional savings bank associations. There are only a few exceptions: LBB Holding AG, which, as has been mentioned earlier, has been taken over by the Savings Bank Group through an ad hoc subsidiary, which owns 81% of the Berlinese Landesbank, but with a participation of the local government; and Bremer Landesbank, SaarLB, Landesbank Rhineland-Palatinate, all three controlled by other *Landesbanks* (respectively NordLB, BayernLB and LBBW) – which means that those three banks are indirectly controlled, or linked to local governments. Furthermore, as mentioned above, there is cross-ownership between several *Landesbanks*.

In fact, the composition of the Aufsichrat (supervisory board)⁷⁶ of *Landesbanks* confirms the importance of local authorities, beyond the equity stakes they might directly control. For instance, out of 18 members the Aufsichrat of Bremen LB (which

75 Municipal, district and municipal & district-level savings banks are nominally distinguished (respectively, *Stadtsparkasse*, *Kreissparkassen*, *Zweckverbandssparkassen*).

76 As is well known, the German system of corporate governance traditionally relies on a dual board pattern: the board of managing directors (the Vorstand), which guides the firm's strategy; and a "supervision board" (Aufsichrat), which controls the activities of the former, and usually includes representatives from staff and other stakeholders (beyond the shareholders), such as banks in the case of non-financial companies.

is controlled by NordLB), was composed of (as of October 2007): 6 representatives of various local governments (the city of Bremen, the local district, the neighboring *Lander*), 4 representatives of the *Landesbank* staff, 3 representatives of the savings banks associations, two private entrepreneur, one University Professor and only one representative of the main shareholder, NordLB. On average, representatives of public authorities, savings banks and employees express, respectively, 33%, 25% and 28% of members of the supervisory board. Through such representation, local authorities can exert a significant influence over *Landesbank* management. Under the Codetermination Act, indeed, the supervisory board: appoints or dismisses management board members, provides supervision and guidance to the management board, approves financial statements and important business decisions (such as decisions to merge, for instance).

At the national level, as mentioned before, the Savings Banks Group is headed by the DSGV – the central office of all regional savings banks associations, funded both by the regional savings banks associations and *Landesbanks*. It is governed by the *Mitgliederversammlung* (members congress) and the DSGV Board, composed of representatives of regional savings banks associations, *Landesbanks*, savings banks management and local authorities. Again, therefore, public local authorities play an important role within the corporate governance of the top level of the savings banks financial group.

Table 3.5 – Local stakeholders and savings banks' corporate governance

	France	Germany	Italy	Spain
Representation of stakeholders in savings banks' governing bodies				
Local governments	No	Yes	Yes	Yes
Customers	Yes	No	No	Yes
Degree of control exerted by main stakeholders				
Indirect or direct control	Direct	Direct	Indirect	Direct
Degree of control	Low	High	Low	High

c. Savings bank business strategy & the provision of public goods

As mentioned above, savings banks offer a variety of public goods, among which we can single out: (i) the historical inclusion into the banking sector of otherwise bankless people (poorer households); (ii) the collect of savings through

special savings accounts; (iii) the availability of long-term finance for small and medium-sized enterprises; (iv) the participation into local development (through, in particular, financing local businesses, local governments and local associations); (v) the education of savers; (vi) the redistribution of their earnings through grants and donations in favor of the arts, culture, social inclusion, and other non-profit activities. One could sum up this list by distinguishing between *explicit* and *implicit* public goods (respectively including, on the one hand, (v) and (vi) and, on the other, (i) to (iv)): explicit public goods could be defined as those public goods savings banks have to provide to abide to particular statutory, legal and regulatory provisions (namely, non-profit activities); implicit public goods, by contrast, could include the public goods related to traditional banking activities (collect, lending) provided by savings banks on the basis of their specific market positioning (often mistaken for a function of “banker of the poor”, which savings banks are not).

Non profit activities

Overall, European savings banks remain, as of the early 2000s, committed to explicit non-profit activities. Such commitment bears three characteristics: It stems from a 200-year old history; it is often embedded into legal or statutory obligations; and it is common to all savings banks across Europe.

Savings bank’s commitment to the “public good” is the product of their 200-year history. At the root of the savings bank concept were the ideas of self-help promotion on the one hand (the idea that individuals should be educated to manage their funds in a sustainable manner) and access to lending on the other (the idea that poorer borrowers should be freed from usury). The latter had already led to the establishment of pawnbrokers in XVIth century Spain and Italy (the “*Montes Pietatis*” and “*Monti di pieta*”, respectively). But savings banks differed from pawnbrokers on many accounts, among which lie the freedom to save whatever amount of money, the payment of interest and the liquidity of deposits. Moreover, and more importantly, pawnbrokers did not emphasize self-help and individual emancipation: these were teachings from the Enlightenment, and they impregnated the origins of savings banks.

These ideas were carried by powerful new actors, coming from philanthropy, banking, the Church, universities, and business. These new actors were the “engine and elite of the new liberal society” (Duet, 1999). Most of them were inspired by the philanthropic movement, of which some were prominent figures - such as Reverend Henry Duncan and Priscilla Wakefield in Great Britain, the Duke of Holstein in Denmark, Benjamin Delessert and the Duke of La Rochefoucauld-Liancourt in France (the latter two being at the origins of the Paris savings bank), or by philanthropic groups, such as the “patriotic society” in Hamburg or “Het Nut” in the Netherlands. Where savings ideals first spread throughout less aristocratic “friendly societies”,

such as in Great Britain,⁷⁷ the management of the first savings banks was entirely in the hands of wealthy individuals, philanthropists or social conservatives.⁷⁸

These new elites witnessed the unraveling of old society, brought about by the industrial revolution. “What savings banks’ founders [had] before them [was] the assertion of the market economy and the monetary economy, and the risks they [bore] in terms of social uprooting, economic disadjustment and pauperism”. (Duet, 1999: p.15) Philanthropists were concerned about these new developments and their consequences on the lives of lower classes. Savings was conceived as a form of social (individual) protection against those risks. Furthermore, it soon became evident, indeed, that beyond liberal ideas of self-help and individual emancipation, savings banks could promote social order, by giving the poor classes access to credit – and thus integrating them into the capital accumulation process at the root of the nascent capitalist economy. The savings banks provided, according to the Duke of La Rochefoucauld-Liancourt, both “individual happiness and public order” (cited in Duet, 1999: 19).

Social responsibility was a natural continuation of savings bank philosophy. Social responsibility consisted in (a) the promotion of savings as an instrument for self-emancipation and (b) extending access to credit to individuals or groups who were excluded from it by commercial banks. Social responsibility was associated with the public mandate often formally granted to savings banks by governmental authorities, although not systematically. Furthermore, social responsibility often translated into non-profit corporate objectives.

Non-profit missions have, over time, become legal or statutory obligations. In France, the *Caisses d'Épargne* are, since 1999, cooperative banks; in Germany, they are public banks. In Spain, the *Cajas de ahorro* have a sui generis status, halfway between private firms and foundations. In fact, the constitutional court ruled in 1988 that, while Spanish savings banks were undoubtedly credit institutions, they could not be considered as companies because of their non-profit activities.⁷⁹ An apparently widespread legal interpretation built on this ruling to establish that savings banks constituted “foundation-companies” (*fundación-empresa*) – i.e. legal persons behaving in an entrepreneurial way and being organized so as to fulfill a social mandate.⁸⁰

Italy is a peculiar case: as mentioned above, the non-profit and for-profit functions were separated in 1990, with the creation of the Foundations. The role of non-profit objectives in savings bank business strategy is marginal since the

77 According to Gosden (1996), in Great Britain friendly societies represented the first sizeable attempt at providing mutual insurance against sickness and death. Those societies counted on 700 000 members in 1800 and 5,500,00 one century later.

78 Such as the members of the “Society for Bettering the Condition of the Poor”, which, according to Gosden, played a central role in the foundation of the early savings banks.

79 Tribunal Constitucional, ruling 49/1988, March 1988.

80 Casares Marcos, Anabélen (2003), *Cajas de Ahorro: Naturaleza jurídica e intervención pública*, Valencia.

unambiguous divorce between banking business and general interest activities that took place in the early 1990s. The Legislative Decree 356/1990 specified the sectors of intervention. A 1991 law⁸¹ made mandatory for the Foundations to dedicate part of their annual revenues⁸² to constitute special funds at the regional level and at the disposal of voluntary associations. Non-profit objectives, therefore, were entirely transferred to the newly born Foundations.

The non-profit status of French, German and Spanish savings banks has a direct bearing on their capacity to finance public utility projects or entities. Spanish savings banks are required by law to channel all after-tax profits not used to build reserves to activities fulfilling their social mandate, or *Obra Social*. French savings banks are also legally required to contribute to general interest activities,⁸³ to which they dedicate part of their revenue. Finally, German savings banks direct part of their revenues to Foundations active in the fields of culture, social assistance and philanthropy.

If non-profit activities are common to all the countries surveyed here, their organization changes from one country to another. One may identify two alternative models: what one may call an “external” model, represented by Germany, Italy, Spain; and an “internal” one in France.

In the “external” model, non-profit activities are outsourced by savings banks to *ad hoc* entities. In Germany, the savings banks group includes 616 Foundations, created by local savings banks, *Ländesbanken*, regional savings banks associations, with a total capital endowment of 1.2 billion euros. Those organizations gave out, in 2006, 418 million euros for “public welfare” (as they call it). Main areas concerned were culture (€150 million, or 34% of total funds), social assistance projects (€99.8 million euro, or 25% of total) and sports (€70 million, or 17% of total)⁸⁴. Thanks to these contributions, according to the DGSV report, the savings banks group is the largest non-government sponsor of sport and culture in Germany. In Spain, each savings bank finances its *Obra Social* (philanthropy) through *ad hoc* Foundations, mostly involved in social assistance projects, culture and patrimony. Interestingly, Spanish savings banks’ commitment to local development is not circumscribed to savings banks’ outward financial flows; it concerns inputs as well, since Spanish banks acquire 49% of their non-labor inputs locally.⁸⁵

In the French case, non-profit activities are managed under an “internal” model that is both new and innovative, with respect to European savings bank

81 Law n.266, August 11th, 1991, article 15.

82 Specifically, one fifteenth of their revenues, net.

83 The law of 1999 states that savings banks “contribute to the protection of people’s savings, to collecting funds directed to social housing, to the improvement of local economic development, in particular in the fields of training and occupation, and to the fight against banking and financial exclusion of all actors of economic, social and environmental life”.

84 Source: DGSV, 2007 Annual Report. Other areas include scientific research and environment protection.

85 According to Quintas Seoane (2006).

history. Until 1994 there had never been any successful attempt to centralize, or at least coordinate such activities. In 1994 a Foundation was created: called “*Fondation Caisses d’Épargne: Agir Contre l’Exclusion*” (Savings banks foundation against social exclusion), it was set up to rationalize the uses of the *fortune personnelle* of the single Caisses. It defined three axes for intervention: fight against illiteracy, fight against the exclusion of the elderly, and fight against the exclusion of the unemployed.

The 1999 reform represented a major turning point for French savings bank non-profit activities. The law, indeed, instituted mandatory general interest initiatives (*missions d’intérêt general*, or MIG), financed each year by individual savings banks, which must direct part of their revenue to these non-profit activities. By contrast with the Italian case, non-profit missions and activities have therefore been reinforced by the law, rather than weakened or dissociated from profit objectives. Concretely, these general interest activities take the form of project funding - the so-called “*projets d’économie locale et sociale*” (social and local economy projects, or PELS) discussed in chapter two above. The FNCE, whose mission was to coordinate non-profit activities at the national level, defined in 1999 three main axes for intervention, drawing on savings banks’ variable past experience: “local development” (including loans and subsidies for firm creation), “social cohesion” (subsidies to associations fighting illiteracy, for instance), and “quality of life” (housing, environment...). In their 2005 Annual Report, the CNCE identified three key areas: employment (preferential loans available to micro-entrepreneurs), social cohesion (social integration promoted through sport, culture and environment protection) and self-reliance (services to vulnerable citizens, sick or disabled). In 2005, 2.556 projects were funded, totaling 51,5 million euro. Another interesting aspect of PELS has to do with their bottom-up conception and implementation. Projects are submitted to the COS by SLE directors, and their implementation is a cooperative venture between the banks and the beneficiaries, which are not the individuals themselves, but a whole range of non-profit organizations.

Besides the PELS (at the savings banks level), the savings bank group operate several Foundations which fulfill specific non-profit missions. In particular, the Foundation for social solidarity, created in 2001, is involved in social welfare activities and the fight against illiteracy. In particular, the Foundation directly and indirectly manages 76 social care centers for the elderly, with a capacity of 4,500 beds (which makes it the country’s leader in care for the elderly).

What makes French savings banks original, especially compared to their German, Italian and Spanish counterparts, is that most of their non-profit activities are pursued alongside for-profit ones. The linkage is even stronger since, as a top FNCE official said,

In Italy, Fondations get their revenue from their assets, whereas in France, if the CE does not make profits, there won’t be any MIG (Mandatory Generalinterest Activities).⁸⁶

86 Interview, 24/04/02.

And according to another respondent,

The French situation is very peculiar: it's the law that gives MIG to the CE (*Caisse d'Épargne*). We are not sad about that. This situation is linked to history and to the culture of CE. It's an incentive to make profits.⁸⁷

This second quote, however, underlines the ambiguity of PELS. Yes, there is an incentive to pursue non-profit activities that is nestled within the very core mechanism of profit-making. But doesn't it mean that, reciprocally, PELS could be conceived as a somewhat other form of profit making?

In fact, looking at the substance of some PELS themselves, for instance those within the "local development" axis, one quickly notices that they look more like venture capital. This is duly acknowledged (within the Group) by the *Fédération*.⁸⁸ Asked about the linkages between redistributive goals and corporate interest, one interviewee responded:

We try not to link the two: it is not because we support an association that we will force it to open an account with us. We are very careful not to mix the two: first because we would compete with ourselves, secondly because it's very complex.⁸⁹

Added to the ambiguity regarding the nature of PELS, and the expectations nourished by the *Caisses* about them, is the ambiguity about the status of PELS within the day-to-day business activities of savings banks. There is no coherent practice across *Caisses d'Épargne*: MIG are sometimes the direct responsibility of a *Directoire* member; sometimes they are managed by junior staff. In Picardie, for instance, responsibility for the PELS belongs to the Direction for Communication (headed by a junior manager). Besides the issue of location of MIG within the organization, there is the issue of the means attributed to their management. At the *Fédération*, all respondents acknowledged this was an issue. In Paris, for instance, only five agencies have someone specialized in MIG. As a respondent belonging to a regulatory authority said in an euphemistic way,

One can question oneself about the means savings banks give themselves to manage those PELS.⁹⁰

Overall, therefore, the precise meaning of PELS within the new Group is a moving target. An interesting recent development occurred in 2005, with the Group's decision to launch projects aimed at helping households with financial difficulties (*accompagnement bancaire*). Such projects, carried on in 2006, point towards a full fledged "reconciliation" between savings banks' non-profit activities and their for-profit banking business.

87 Interview, 24/04/02.

88 For instance in the appendix to the internal document *Orientations des projets d'économie locale et sociale des Caisses d'Épargne*

89 Interview, 27.06.02.

90 Interview, 06.03.03.

Implicit public goods

As mentioned above, besides non-profit activities, savings banks also provide implicit public goods, related to their specific market positioning – a focus on individual customers and small and medium-sized businesses, which is a constitutive part of savings banks' historical identity. The major innovation brought about by savings banks in the 19th century concerned the new clientele whose banks professed to familiarize them with credit and banking: namely, workers, employees, lower-income individuals and households. As the status of the first savings bank, Hamburg's Ersparungskasse, disposed, "This savings bank has been created for the utility of industrious people from the lowest extraction, namely house employees, daily workers, factory workers, fishermen and so on, so as to give them the opportunity to put aside and safely deposit savings earned with difficulty with some interest; one hopes, moreover, that such benefits be soothing and become useful and important for the State" (cited in Clarich, 1984: p.13).

Savings banks' particular mission, analyzed above, led to, or was tied to a peculiar way of doing business, on both sides of the balance sheet. On the liability side, savings banks differed from existing commercial banks (up to the middle of the 19th century) in that the funds they managed did not come from their own funds or from the deposits given by a small group of wealthy individuals: they mainly came from small savings. In that regard, the initial funds provided by savings banks' often wealthy founders did not intend to be invested, but were an investment in themselves, geared towards allowing the nascent institutions to start collecting savings from modest clients. Indeed, savings bank corporate identity built first and foremost on savings deposits, which constituted in many cases and for a long time their core liability (they remain so for the French savings banks). As Wysocki points out, when they were first introduced, savings deposits represented a true product innovation, since they were not offered then by other financial intermediaries (Wysocki, 1996).

Savings deposits were conceived for small amounts of money – the kind of savings commercial banks were uninterested in, since they implied diseconomies of scale and did not allow for a flexible policy on the asset side. In other words, lending money on the basis of small deposits was not an attractive business for 19th century bankers. From the depositors' point of view, savings deposits represented the first medium tailored to their needs – the first entry into the world of credit. In addition, savings deposits presented three characteristics that made them attractive when compared to the alternative (that is, keeping the money at home): (a) they were interest-bearing deposits (although the interest rates paid on savings deposits were, and have been since, small in comparison to other types of banking products; they were still better than no interest at all); (b) they were secure (both because lending was at first either forbidden or strictly regulated, and because

many savings banks benefited from public or State guarantee); (c) they were liquid (upon a short period of notice).

Beyond savings deposits, savings banks faced at the outset limitations on their liabilities, especially ceilings on deposits (in Great-Britain, under the 1817 Trustee Savings Bank Act; and in France and Italy in successive regulations). However, over the years (but at different points in time in different countries), savings banks opened themselves to other forms of liabilities – such as sight deposits, generally along with the development of payment procedures, and in particular cashless payment procedures (checks and money transfers). Germany was an early starter, with a 1908 law that allowed savings banks to issue checks, and with the 1909 creation of the first giro association in Saxony. By 1924, savings banks covered the entire territory through their giro network. Denmark quickly followed suit, introducing savings banks' checks in 1914. In all remaining European countries, however, this diversification of business on the liability side took place much later: Greece in 1953, UK and Ireland in 1965. France stands among the late comers with the authorization to draw checks dating to 1978.

On the asset front, savings banks differ from one period to the next and from one country to another. Most savings banks faced early limits on lending – mostly set in savings bank statutes, before being included in state regulations. Danish savings banks did not engage in lending until the 1840s. Nor did the French savings banks; the latter were allowed by an 1829 Decree to invest part of deposited funds into savings accounts held at the Treasury. The Act of March 1837 entrusted the administration of such funds to the “*Caisse des dépôts et consignations*” (CDC) – the French Treasury's financial arm, which invested most of its assets in long-term government securities. The transfer of funds was nothing but an option, left to the choice of local savings banks – but they all chose that option at the exclusion of others (such as investments in industry). Therefore the Decree of April 15, 1852, which made it mandatory for all funds collected by savings banks to be transferred to the CDC merely sanctioned a *de facto* restriction.

The preferred asset, for most European savings banks during the 19th and early XXth century, was government securities. According to a 1817 act, British savings bank trustees were required to invest their funds in a special account with the British Commissioners for the National Debt, who paid a guaranteed fixed annual interest. Investment in government stock and other public debt securities (such as local government loans) was not limited to British savings banks – it was a widespread practice in France, Denmark and Italy. Such reliance on public bonds was often associated with legal or regulatory provisions in savings bank statutes. They could also be interpreted, as Wysocki contends, “as a measure for the precautionary securing of liquid resources where the possibility existed for such instruments to be used as collateral for advances at times of sudden increased demands for payment.” (Wysocki 1996:18).

When savings banks were allowed to engage in lending activities, they usually turned to mortgage loans, which to this day represent a typical lending activity. As Wysocki argues, mortgage loans combine the high security requirement for the use of savings deposits and relatively simple administration. In many cases, mortgage lending offered a secure alternative for government securities, or vice versa. In Italy, for instance, mortgage loans did not take off until the late 1870s (when government securities reached a low point), and represented up to 56% of savings bank assets in 1960, then declining in favour of government securities; in Germany, government securities were slowly dethroned by mortgage loans as the main asset at the turn of the century.

Finally, one important activity on the asset side undertaken by savings banks in the 19th century was pawnbroking. This was the case in Germany in the early XVIIIth century, where “savings bank deposits served only as an endowment for a pawnshop which was independent in law and in practice” (Wysocki 1996: 18). In Spain and Portugal, savings banks were associated with pawnshops, too, but the latter had been established previously.

Beyond government securities and mortgage lending, savings banks did not, at first, engage in other forms of lending, with the exception of German and Danish savings banks (which, in the early 19th century, offered personal loans, bill businesses (Germany) and loans, guarantees and bills (Denmark)). In the 1830s and 1840s, ministerial decrees in Prussia promoted the establishment of district savings banks to provide personal loans and to meet the need for credit of industry and agriculture. However, an 1838 bill restricted lending to mortgages and the acquisition of public sector securities, and put ceilings on small loans.

Such was the context in the 19th century. What is the situation now? First, it is clear that savings banks in the four countries surveyed are still biased, on the liability side, towards savings or current account deposits, with a “preference” for small deposits. On the asset side, on the other hand, savings banks still work, in Spain, Germany and France, as bankers of more modest households and small and medium sized enterprises (SMEs). Lending to SMEs (the *Mittelstand*) is a traditional strength for German savings banks, who held 44% of the market in 2006, with loans totaling 490,160 million euro – largely ahead of Big Four⁹¹ (15.5%), cooperative banks (14.6%) and other private, commercial banks (25.8%).⁹² As for *Ländesbanken*, in 2004 they had a loan portfolio to SMEs of 182,647 million euro and to public administrations of 99,426 million euro. Furthermore, both *Sparkassen* and *Ländesbanken* play an important role in funding business start-ups as well. In 2004, the group held a 56% market share in KfW-promoted funding programs StartGeld and MicroLoans. Funding comes with advice and knowledge

91 Deutsche Bank, Commerzbank, Dresdner Bank, Hypovereinsbank.

92 Source: DGSV, 2007.

transfer programs. The savings banks group held in 2004 a 69% market share in lending to “tradespeople”, i.e. micro-entrepreneurs.

German savings banks are active on the mortgage lending market as well. In 2004 Sparkassen extended new mortgage loans totaling 8,121 million euros – with a portfolio amounting to 194,950 euros. Overall, 76% of personal loans granted by savings banks (on a stock basis) were related to housing, the remaining 24% being consumer credit. More importantly, the Savings banks group includes specialized regional vehicles for mortgage lending: the *Landesbausparkassen* (savings and loans associations), which provide savings banks from their region with specialized products for home loans with favorable interest rates. Those vehicles provided 1,445,560 new building loan agreements in 2006, with a 35.7% market share.⁹³

French savings banks are still heavily specialized in lending to households (for housing) and local governments (for equipment), two items which represented in 2004, respectively, 45% and 21% of total lending.⁹⁴ The very nature of this lending tends to give savings banks a longer-term profile in their assets: in 2004, 93.3% of its loans were medium and long-term (against 74% on average for the whole banking system, and 78% for the cooperative banking sector).⁹⁵

The Groupe Caisses d'Épargne has remained, besides, the historical partner of the social housing movement (HLM). According to the Group's 2006 annual report, “the Caisses d'Épargne manage more than one third of the private debt of social housing companies and HLM agencies, whose construction programs are financed by the collection and distribution of funds on Livret A savings accounts.” In addition, savings banks own shares in 100 of 300 social housing companies. With the Crédit Foncier, the Group is also the largest distributor of state-sponsored rental accommodation and construction loans (*prêts locatifs sociaux* – PLS, and *prêts locatifs intermédiaires* – PLI). In addition, the Caisses d'Épargne are the largest private shareholder in semi-private real estate companies, whose majority shareholders are local authorities.

By contrast with either German or Italian counterparts, French savings banks are new to the SME lending business. But their strategy over the past seven years seems to identify in that market a priority for the Group. Since 2003, the CNCE holds 60% of shares in Banque Palatine, formerly Banque SanPaolo SA, with its former majority owner, SanPaolo IMI,⁹⁶ holding the remaining 40% of equity. Banque Palatine is specialized in lending to medium-sized firms (between 15 and 150 million euro annual sales), helped by a leasing and a factoring subsidiary, respectively CGE Bail and CGE Affacturage.

93 Source: *Ibid.*

94 Source: Banque de France, 2005.

95 *Ibid.*

96 Interestingly, SanPaolo IMI, the third Italian banking group, was built on the merger between formerly public and savings banks.

To assess savings banks' public nature, or their actual conformity with a "public bank" model, it is more relevant, perhaps, to focus on the way they conduct business rather than the markets or market segments they specialize in. Such an evaluation is complex. On the one hand, indeed, French, German and Spanish savings banks remain committed to non-profit missions and objectives, mentioned earlier, which their cooperative or public corporate governance should maintain over time. Official documents (annual reports in particular) are full of references to that peculiar public mission.⁹⁷ On the other hand, savings banks' good performance (compared to commercial banks), illustrated in the first part of this paper, cannot be attributed solely to their market positioning. In fact, savings banks are, or have become, modern banks whose *modus operandi* is quite similar, in many areas, to the one followed by other (namely, commercial) banks.

Since the early 1990s, indeed, savings banks have actively taken part in the "universalization" of banking.⁹⁸ Savings banks now look more like commercial banks, with their presence in most markets, their ability to offer any service to any kind of client; their statutory homologation with commercial banks in some countries (Italy). Quesada (1994) found that Spanish banks in general and savings banks in particular have integrated the financial innovations rather well. And according to Gardener, the growing role of the marketing function in savings banks indicates the growing "demand-determination" of bank strategy (Gardener 1994).

Conclusions

European savings banks are still powerful actors in the banking industry in France, Germany and Spain, more than one century (two centuries in some cases) after their creation. As shown above, their business and economic performance is surprisingly good, in comparison with commercial banks, using mainstream indicators (market share, cost-income ratios, return-on-equity...). During the 1990s in particular, European savings banks have proved to be a very competitive force in the banking industry – against the backdrop of an a-priori less favourable regulatory and business environment – less public protection, more competition. The main challenge faced by savings banks is, indeed, to interpret their historical legacy and their public mission in the current context, characterized by a greater "commodification" (the extension of market values and *modus operandi* throughout the economy and society) and profound change in the banking industry.

97 For instance, as a 2004 report from the German DSGV puts it, "a key feature of a business strategy is to improve net assets and not to pursue short-term return targets" (DSGV 2004, p.8).

98 As Revell (1994b) notes, the term "universal banking" has come to mean many things different to many people. The two defining criteria, according to him, are that the universal bank (i) undertakes both retail and wholesale business and (ii) operates in other countries than its home country.

Two conclusions can be made here. First, while having undergone profound transformations themselves, European savings banks have not lost their soul. In other words, they still address the needs of low-income households and small and medium sized companies; they still support local economic development; and they still fulfill public interest missions. Secondly, interestingly, and perhaps not surprisingly, the answers found by savings banks themselves (with the help of law-makers, given savings banks' embeddedness into local and national political networks) differ from one country to another – in terms of corporate organization, corporate governance and the organization of non-profit activities. But these conclusions are temporary, given the on-going changes in banking. What remains is European savings bank capacity to produce a multifaceted “public bank” model capable of competing in a globalized economy.

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PART II

Government Banking in Latin America

Chapter 4

*From Development Banking to Microfinance: Reflections on the Recent History of Banking and International Cooperation Policies in Latin America*¹

Manfred Nitsch

This chapter provides insights into the scientific and development policy debates about development finance over the last 30 years, with Latin America providing the empirical background. Development theory and policy, including financing for development, are discussed by comparing theories over time rather than on a regional basis, so that the *general* questions on the development of financial systems and microfinance in the development process and the role of international cooperation stay in the foreground. A second volume with selected articles on rather macro economical subjects with the title: “Dependencia, money economics and global responsibility” is to appear to complement the present one. Since these observations are based on a variety of contexts, they may appeal not only to graduate students, but also those involved with the management of banks and microfinance institutions, development cooperation practitioners, and the general public. This chapter thus follows neither strict systematic lines nor a unified style. Instead, it attempts to reflect the different paradigms and suppositions of periods, the different interests of readers, and, evidently, my personal interaction with the corresponding spirit of the times and contemporaries.

In the attempt to isolate something like a central theme or key notes for the knowledge interest and the analytical view of things in the chronological sequence, I come across, above all, the subject “Development of Underdevelopment” – something not unexpected in 1968 as the year of my first countrywide empirical survey of Colombia (cf. 1970). In contrast to the theoretical mainstream of modernization

1 Translation of: *Glaspaläste und Mikrofinanz. Beiträge zur Entwicklungsfinanzierung* (Glass Palaces and Microfinance. Contributions to Development Finance), Frankfurt/M.: Peter Lang, 2002 (Entwicklung und Finanzierung Bd. 12), pp. 1-6; slightly changed by the author for this volume.

and growth of the guild, critical economists at that time and up to now have not perceived underdevelopment as a backlog that should and could be resolved with capital and technology transfers so that, eventually, even the poorest countries would gradually pass the finishing line to Rostow's mass consumption society. Instead, research has studied the social mechanisms that repeatedly reproduced poverty and authoritarian structures. The fact that capitalism at the periphery of the US as the leading economy can lead both to Western European welfare and to Latin American misery has always challenged and inspired theoretical imagination and empirical investigation. After the fall of the Berlin wall, this question has also gained cardinal meaning for Eastern Europe. It was and is expected that international development cooperation can learn from recent experiences as receivers and as donors when dealing with underdevelopment on the periphery.

From this perspective, an issue which has been especially at stake over all these years is the question whether a fundamentally different economic system is necessary in order to overcome underdevelopment; whether change need come about through evolution within the dominant social order or through revolutionary, alternative forms of economy. Therefore, the economic and social developments in Cuba after 1959, in Peru after 1968, in Chile with Frei and Allende until 1973, in Portugal after 1974, in Nicaragua after the *triunfo* of the Sandinistas in 1979, as well as all the utopias and alternative designs of Latin American intellectuals and representatives of popular movements which I have met since my first stay in Colombia as a student in 1963, have provided important inputs for my theoretical as well as my practical work as consultant and co-player in cooperation projects and programs.

The economic results of alternative and revolutionary regimes have proved highly problematic, if not catastrophic, just as their human rights performance, so that – especially after the fall of the wall – even very convinced Latin American leftists like Herbert de Souza in Brazil (cf. 2000) and a revolutionary during the 1990s like Comandante Marcos in Chiapas began to emphasize civil society in their egalitarian discourses and pathos at their word pursuing *ciudadania* or *ciudadanía*; that means civil rights as citizens of state and the economy, in the existing capitalist economic order and a firmly democratic political order, instead of markedly non-capitalist goals. Only very recently has the banner of socialism been raised again in the 21st century, with results still to be seen in the future. Beyond the confines of this new *bolivarianismo*, the way was and is clear for money, financing, banking and credit policies that do not try to fundamentally place politics *against* the market and *against* the laws of capitalism, but rather takes over the concept of a *social* market economy which can offer the improvement of living conditions of the broad population strata without threatening with fundamental interventions into the order of private property. This volume explores recent experiences from Europe and Latin America in this tradition of social market economy.

As an established academic since October 1967 in the public service, first as

an assistant lecturer for Business Administration at the Economics and Business Administration Department of the Ludwig-Maximilian University of Munich, then as an assistant at the Max Planck Institute for Foreign and International Patent, Competition and Copyright Law, later at the Institute of International Relations SWP in combination with a lectureship for Development Economics at the University of Munich, and finally, since December 1977, as a Professor of Economics and Political Economy of Latin America at the Latin American Institute and at the Department of Economic Sciences of the Freie Universitaet Berlin, I have followed both these alternative models and mainstream discussions. In the latter, the core idea is that, not capitalism, but rather the repression of market forces, namely financial repression, is responsible for the backwardness of Latin American economies. Mainstream research has provided good reasons and empirical research to support these views. A certain convergence of discussion strands was also just a matter of time. Like Betinho in Brazil, many critics of the mainstream orthodoxy in Germany and other donor countries have turned away from socialism, in its anti-capitalistic varieties, and also from emphatic alternative economics to make peace with social market economics as a normative model. Debate has also turned to ecological matters.

The apologetic orthodoxy, as well as variants of socialism and alternative economics, which I mostly sense as utopian, have always dissatisfied me as a child of re-education in post-war Western Germany belonging to the skeptical generation (Helmut Schelsky) of the 1950s. It was thus a happy providence to finally find, during the last 15 years, the Monetary Keynesianism of the Berlin School, lead by my colleague Hajo Riese at the Department of Economic Sciences, as a convincing solution for at least some of the puzzles encountered in all the previous years regarding monetary theory, banking, macroeconomics, and the political economy of development.² After all, according to the rules of economic theorizing, underdevelopment can be seen as nothing else but long-term equilibrium, similar to underemployment according to Keynes.

My own learning process regarding support for the financing of the poor is portrayed, above all, by what currently circulates under the keyword microfinance. In 1970 I published a case study of Colombia with ideas that soon thereafter became flagellated by scholars of finance theory in general as financial repression. Two official, non-published reports (not quoted here) from 1972 and 1981/82 about German development assistance for development banks in Colombia and other Latin American countries confirm this diagnosis. They also provide an explanation for why donor institutions face strong incentives to play the game of

2 Manfred Nitsch: "Vom Nutzen des monetär-keynesianischen Ansatzes für Entwicklungstheorie und -politik" (On the use of monetary Keynesianism as a base for development theory and policy), in: Schubert, Renate (Hrsg.): *Neue Wachstums- und Aussenhandelstheorie. Implikationen für die Entwicklungstheorie und -politik* (New Growth and Foreign Trade Theory. Implications for Development Theory and Policy), Berlin: Duncker und Humblot, 1999, pp. 183-214.

the other (i.e. local underdevelopment players) so willingly, even when successful development policies fail to appear. A subsequent investigation in Colombia about rural finance in Boyacá (1982) demonstrated the deficits of state-run development banks within the framework of one of those integrated rural development programs which were so much *en vogue* at the time. When a later project of the German Society for Technical Cooperation (GTZ) was established in one of the then still positively appearing credit cooperatives, it proves, unfortunately, to be equally vulnerable to underdevelopment practices. Since, in cooperatives, every member, regardless of the value of his or her share, has only one vote, there is typically a lack of ownership incentives, so that management is not sufficiently controlled. A summary of these experiences appears in the publications from 1987 about “Glass palaces and Underdevelopment” and in 1989.

In those times, a rather conflict-laden debate took place in the Ministry, other development organizations in the Federal Republic of Germany, the World Bank, and in many other countries, about alternatives to foreign support for traditional development banks. Since 1982, I had already taken part in conceiving and structuring municipal savings banks in Peru with support from the BMZ (the German Federal Ministry for Economic Development Cooperation), the GTZ, the National Association of Municipal Savings Banks in Germany, and the Internationale Projekt Consult GmbH in Frankfurt (IPC, formerly “Interdisciplinary” Project Consult) (1987 with Jan Krahn and 1997). I also followed other reform movements in different parts of the world.

During the 1980s, support strengthened for rotating funds from non-governmental organizations (NGOs) until people realized that, even with a lot of endeavor and commitment on the part of their members, there nonetheless remained a lack of outreach in these fights against poverty. Directed credit with subsidized interest rates and compulsory training (organized by NGOs) turned out to be a wrong alternative to traditional development banking. A policy alternative that covered costs and reached out to the masses mired in poverty still failed to exist. However, some endeavors were emerging that viewed rotating funds as the embryo of a bank, which requires utterly different management principles from the parent NGO, but opens the option of deposit-taking thus contributing to long-term stability and growth. A little later, small farmers from Uraim in the Brazilian Amazon region demonstrated, from the other side, how clever it can be, under inflationary conditions, to found a declaredly financial institution, namely an agrarian *savings bank* (Caixa Agrícola), and then *not* really run it as a bank, but rather as a multi-purpose self-help organization (1992).

In an article on rotating funds (1991) I used for the first time the image of duck feeding, which has become a type of trademark of mine. The background was a walk on Wannsee lake, where I observed children in the act of feeding ducks and other fowl which reminded me of development cooperation projects: no outflow

problem for mother's stale bread pipeline; management as easy and pleasant as child play; high acceptance on the receivers' side; every crumb size is possible; and you can change your target group haphazardly. Unfortunately, however, the net energy balance is likely to be negative because the additional wing flap, struggle, and time lost in the search for other fodder has created high opportunity costs for all the birds. Meanwhile, a few get a chance to be beneficiaries, based on arbitrariness, coincidence, recklessness, or power, enjoying the breadcrumbs that have fallen from the sky. Underdevelopment is thereby reproduced through development assistance – also and precisely with small projects. The alternative explored is – if the reader permits further metaphors – the salt-lick; meaning a provision of resources comparable to salt stones, more able to match demand from those in pasture or forest that cannot otherwise be met, and the use and application of which is not sugar coated.

A type of credit which is in line with market requirements, that is neither loan-shark-like or monopolistic, nor (half-)received as a gift by a beneficiary, as well as other financial services for the target groups in question, can be described as such salt stones. In the 1990s, it was finally shown that new development finance in the sense of a commercial approach with full cost coverage is possible. Not only in Latin America, but also in Eastern Europe, Africa, and Asia, microcredit institutions began to develop on a broad front. Professor Yunus' Grameen Bank in Bangladesh followed similar lines in that they insist on proper repayment and a customer-bank type of relationship instead of beneficiary-donor relationships; avoiding gifts and leniency in repayments.

Some NGOs were ready and able to transform their rotating credit funds into proper banks or other formal finance institutions (upgrading). At the same time, commercial banks started to shift downmarket, sometimes with the assistance of international development projects, establishing special services for small business clients (downscaling). For some state-run development banks the efforts towards reform and downscaling were successful. Finally, some development agencies, support institutions, and consulting firms like the IPC and other technical services providers opened their own micro business banks by starting from scratch. Together with the BMZ-owned German Investment and Development Society (Deutsche Investitions- und Entwicklungsgesellschaft – DEG, recently merged with the Kreditanstalt für Wiederaufbau – KfW), the Dutch DOEN-Foundation, which runs a lottery in favor of development and ecological projects, the Bolivian NGO ProCrédito, and IPC employees and managers founding of the Internationale Micro Invest AG (IMI) in Frankfurt (1998) should be mentioned. The IMI was later renamed ProCredit and has since developed into one of the leading frontrunners in international microfinance.

Starting from scratch will certainly not remain the last word, because many questions regarding development finance and micro finance, in the sense of a comprehensive provision of financial services for lower population strata, are

still open. Both analytically and normatively, important questions arise about the delimitation between different actors, namely the state on its various levels, employers and employees, non-governmental organizations, self-help groups, public-private partnerships, private business with socially-oriented investors, and profit-oriented businesses. Concerning types of activities, concerns for institutionalizing pension plans, health insurance, and other fields of insurance for the target group of poor population strata also provide new challenges and opportunities. Likewise, discussions about approaches from the side of development policy decision-makers towards consumption financing are not yet concluded, and what the call for empowerment and participation, for globalization from below and international networking all concretely mean or should mean also remains open for further discussion. The United Nation Microcredit Summit initiative from 1997 set the goal to provide 100 million families with small credits by 2005. The Monterrey-Consensus emerging from the March 2002 UN conference on Finance for Development, and the Nobel Prize for Yunus and the Grameen Bank in 2007 have given additional boosts. Not only for scientists and academics, but also for politicians, managers, practical economists, NGO's and all the staff working in microfinance institutions: There is still a lot to be done!

Chapter 5

The Chilean BancoEstado; Inclusive Finance; Expanding Borders

José Manuel Mena V. & Enrique Errázuriz L.

Financial inclusion, that is offering banking services to low-income or isolated populations, is an essential part of BancoEstado's mission and its daily management, a history that began in 1855. In terms of financial inclusion, BancoEstado's philosophy and strategy to date seek to create and provide market solutions to social and economic challenges facing families and micro/small businesses, to contribute to their progress and national development. Aside from the ongoing challenge of expanding and deepening financial inclusion, in the past decade BancoEstado has faced an enormous challenge of its own: overcoming the steady drop in financial revenues resulting from the decline in inflation and government account balances that it manages, while still remaining a bank both true to its mission and profitable, a requirement *sine qua non* of the Chilean authorities.

This chapter illustrates how BancoEstado has successfully dealt with both challenges, financial inclusion and becoming a fully competitive bank, sustained by its customers, offering suitable profitability to the public resources invested, all of which has required an integrated modernization process throughout the company. The chapter is divided into four sections. The first describes BancoEstado in terms of its mission and objectives, financial and commercial indicators, and its most recent achievements. The second section examines trends, progress and challenges to financial inclusion, particularly in Chile. The third section focuses on the strategy for financial inclusion followed by BancoEstado and how it has changed over time. Finally, two cases of financial inclusion are discussed in terms of the challenges they posed and their results. One involves the bank's experience with the microbusiness sector and the other the development of a new electronic and massive distribution channel, the *Caja Vecina* (neighborhood teller).

Background and Mission

A bank with a long history, BancoEstado's story goes back to 1855, with the creation of the *Caja de Crédito Hipotecario* (a mortgage institution), just a few decades after Chile's declaration of independence. The merger of the *Caja de Crédito Hipotecario* with the *Caja Nacional de Ahorros* (a savings bank, 1910), the *Caja de Crédito Agrario* (a farm-oriented bank, 1925) and the *Instituto de Crédito Industrial* (a manufacturing-oriented bank, 1928) gave rise to the *Banco del Estado de Chile* (Chile's state bank) on 12 June 1953. The bank's mission is to make Chileans feel proud for the quality and coverage of its services; the warmth of its attention; and its contribution to the country's growth, financial system modernization, and social integration, by giving priority to ensuring broad access to banking services. As a public bank, the mission of the Chilean BancoEstado involves meeting three main objectives:

Bringing Formerly Excluded Sectors into Banking

Access to financial services for individuals and micro- and small businesses helps to improve their quality of life, social integration and their access to modernity. To do so, the bank works to bring new sectors into banking, particularly those who, due to poverty or isolation, face more barriers to access to basic financial services and products, reaching them through friendly, massive and low-cost services.

Contributing to Chile's Development: Competitiveness, Growth and Modernization

Contribute to competitiveness, transparency and financial system development, by completing markets, is another priority for the bank. Similarly, to support state modernization (public bodies) and contribute resources to finance social projects, through tax and profit transfers.

Excellence in banking and public company management: to be a competitive, profitable bank, making a large contribution to its customers and stakeholders.

A third central objective consists of satisfying its customers with excellence and, in broader terms, its stakeholders. This involves performing well commercially and financially, as reflected in solid indices for competitiveness, risk, solvency, profitability and efficiency. At the same time, internally, sharing a vision of the firm with employees, through a management style based on shared values and objectives.

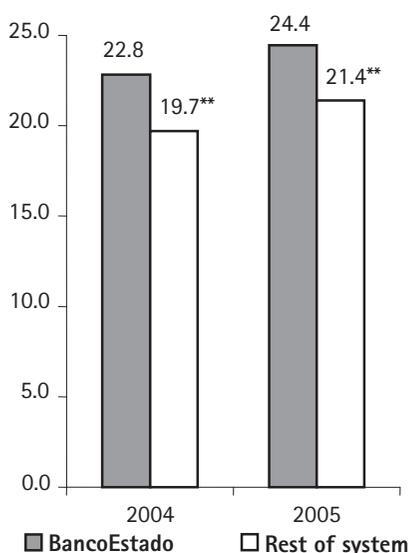
Financial – Commercial Summary

The modernization process developed by BancoEstado management from the 1990s onward, after the recovery of democracy, combined with a suitable growth strategy, have enabled it to achieve a high competitiveness in the banking market, with different financial and commercial indicators revealing that it is performing better than the system overall and its competition. At the same time, as sector leader in terms of bringing new people into banking, including lower income sectors, it is also contributing to social integration.

Performance 2000-2005

During this period, BancoEstado saw its business and results post solid growth, with loans growing on average 9.1% annually, while before-tax earnings rose 4.6% annually on average. In 2005, solid management brought consolidation, thanks to further expansion of its customer-centered strategy, successful compliance with goals and prevailing sound economic conditions. Thus, BancoEstado and its subsidiaries obtained before-tax earnings of US\$ 192.7 million, generating before-tax return on equity (ROE) of 24.4%, more than the average for the rest of the system (see figure 5.1).

Figure 5.1 – Return on Equity (ROE), 2004-2005 Before-tax income*/ capital and reserves, %



* The bank is subject to a 40% surtax, so for comparison's sake before-tax income is used.

** Non-consolidated figures.

Source: SBIF; BancoEstado

Table 5.1 – BancoEstado and Subsidiaries* Consolidated Data

(Figures in US\$ million**)			
Indicators	2000	2003	2005
Before-tax net earnings	144	139	193
Core capital	670	721	788
Total loans	7,479	9,204	11,416
Total assets	11,774	15,432	20,558
Before-tax Return on Equity (ROE, %)	21.44	19.28	24.45
Cost-income Ratio (a)	74.3	68.11	62.69
Credit risk (%)	1.52	1.55	1.41
Basel index (%) (b)	12.7	11.34	10.66
Number of branches	294	310	312
Number of automated services	1,555	1,894	2,131
Total monthly transactions (December, millions).	12.9	20.5	23.5

* Some figures may differ slightly from those for BancoEstado

** Exchange rate: ChP 514.21 per US\$

(a) Administrative expenditures over gross margin plus monetary correction.

(b) Legal minimum 8%.

Source: BancoEstado

BancoEstado's risk indicators are lower than the system average, while its international credit risk rating ranks it on par with the top financial institutions in Chile and Latin America.

Table 5.2 – BancoEstado's International Credit Risk Rating 2005

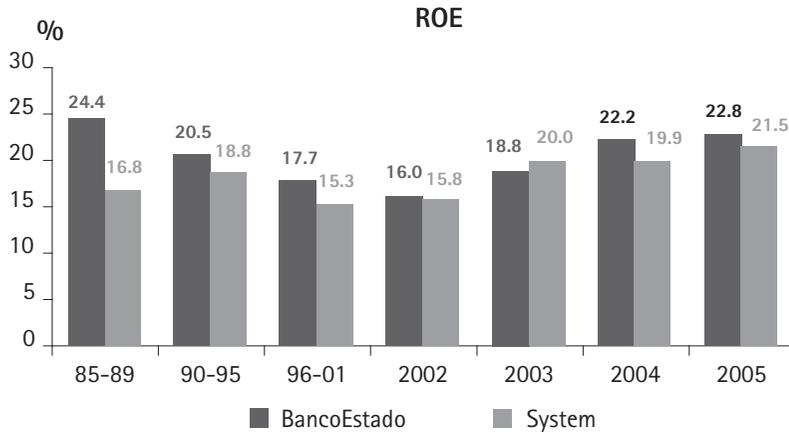
Agency	Long-term*	Short-term**
Moody's	Baa1	P2
Standard & Poor's	A	A1

* Debt in foreign currency, maturing in over one year.

** Debt in foreign currency, maturing in one year or less.

The bank's main achievements can be seen in three areas: solvency, customer confidence, and progress in modernization. The bank's traditional solvency throughout its history has improved further in recent years, as profitability and risk indicators, among others, reveal. Throughout its history, the bank has always posted a profit, something which is unusual among public banks in emerging countries. Moreover, it has performed well in absolute and relative terms. In absolute terms, it has overcome the profitability required by the government for social projects; and in relative terms, it has outperformed the rest of the financial system.

Figure 5.2 – BancoEstado Return on Equity, 1985–2005

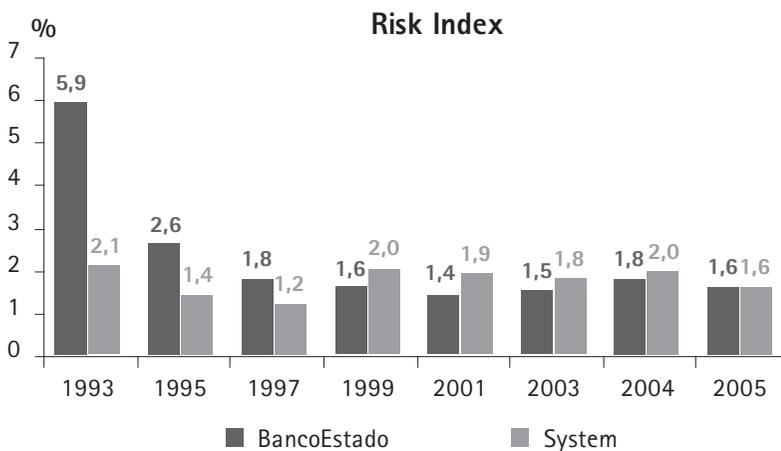


Source: SBIF, BancoEstado

Risk Management

A pillar of healthy growth in bank business has been the suitable management of risk; in fact, thanks to a strategy focusing on optimizing the risk/return on assets ratio, the bank has met its commercial goals. Since the early 1990s, BancoEstado's risk index has fallen steadily, and has been lower than the system average since the Asian crisis.

Figure 5.3 – BancoEstado and Sistemic Risk Index, 1993–2005



Source: SBIF, BancoEstado

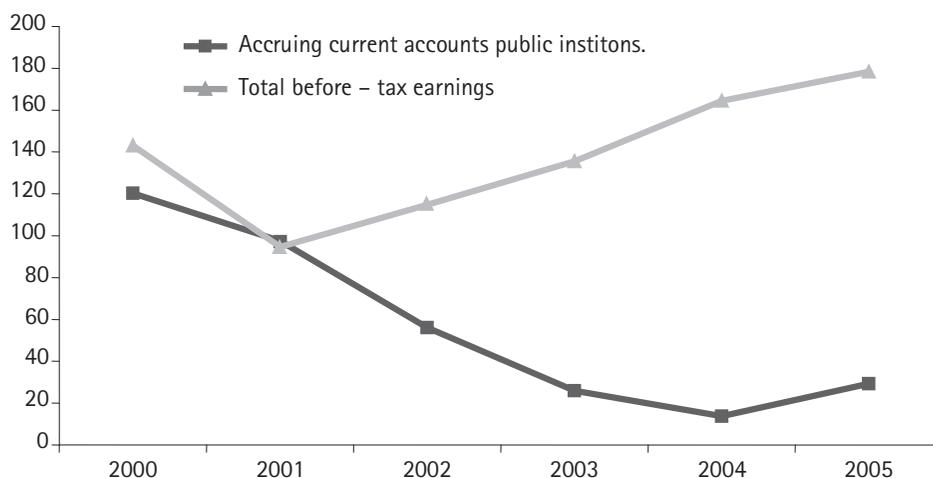
The main risk rating agencies, among them Moody's and Standard & Poor's, have maintained their positive ranking of BancoEstado at levels similar to those of banks in developed countries. Moreover, according to these agencies, as in 2004, BancoEstado continues to enjoy the best risk rating for debt in foreign currency among Chilean and Latin American banks, thanks to its solvency.

Customer-Supported Bank

As a sort of compensation for the significant costs incurred by its social function, BancoEstado has traditionally managed the national government's *Cuenta Unica Fiscal* (single fiscal account, CUF), essentially the Treasury serving central government institutions. At times when inflation was high, reaching as much as 30%, as occurred in Chile until the late 1980s, this ensured financial spreads were enough to generate a significant proportion of bank profits.

When inflation plunged and the State modernized in recent years, income from public institutions' demand deposits plunged dramatically. This required an enormous effort to obtain new income, reflected in the rise in before-tax revenues for this period (Figure 5.4).

Figure 5.4 – BancoEstado, Public Institutional Accounts, and Surpluses and Revenues, 2000–2005, US\$million*



* Excluding costs associated with these accounts.

Source: BancoEstado

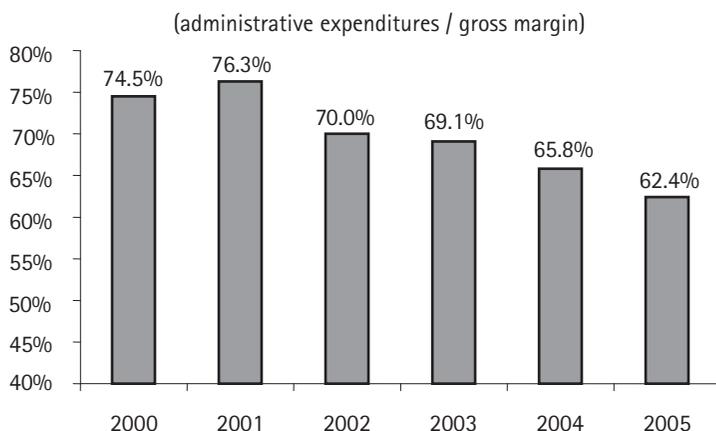
One key factor to the success of this process has been a new customer-centered commercial strategy, which boosted their number as part of bringing new people, from low and middle-income sectors, into banking and deepening ties

with existing customers. As a result, today the bank's results depend primarily on its competitiveness and the quality of its customer relationships, rather than exogenous factors.

Modernization

The BancoEstado has also improved its efficiency and increased its competitiveness, which expanded customer access to financial services. The efficiency index, measured using the industry standard, operational and administrative expenses over the gross margin, improved by 3.4 percentage points, dropping from 65.8% in 2004 to 62.4% in 2005. This completed a 12.1 percentage point improvement for the six years between 2000-2005, reducing the gap with other institutions in this sector.

Figure 5.5 – BancoEstado Cost-Income Ratio, 2000-2005*



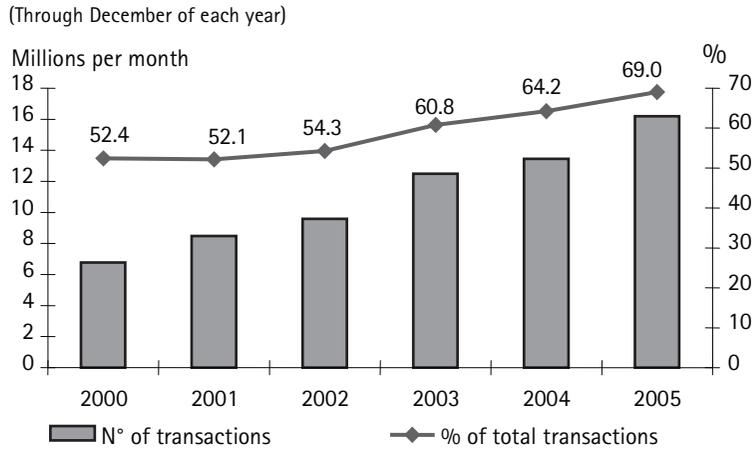
* Not consolidated.

Source: SBIF

Automation

BancoEstado has also continued to update its technologies and processes, improving service quality and reducing response times through innovation in these spheres. In December 2005, Bank customers carried out 23.5 million transactions. Of these, 16.2 million (69%) were through automatic channels, up 16.6% since December 2000.

Figure 5.6 – Automated Transactions, 2000–2005, million per month



Source: BancoEstado

The Bank’s own ATMs rose from 826 to 1,050. Thus, through its own ATMs and those of the networks it belongs to (Globalnet, Redbanc and Presto), BancoEstado has become one of the financial institutions with the largest network of ATMs. Of the electronic channels currently available, Internet experienced the highest growth in 2005, with the monthly average number of transactions rising 75%, totalling 23.7 million operations in the year.

Repositioning and Changing Image

The progress summarized here has allowed the bank to consolidate a new market position, which was reinforced by the change in its corporate image in 2001, to reflect modernization. Altogether these efforts boosted its market share to 13.2%, reinforcing its standing as the country’s third largest bank. This progress is based on its constant search for excellence in customer service, which has cut costs and response times, along with improving standards, achievements that have been widely recognized by different indicators revealing positive customer attitudes and public opinion in front of BancoEstado. All this has increased customer satisfaction, bringing with it awards and recognition from independent bodies:

Certification of Labor Competencies.

Fundación Chile (the Chile Foundation) distinguished BancoEstado as a pioneer in certifying labor skills using international methods in its Lota Contact Center.

Corporate Reputation

The Bank won a Gold medal and was ranked 18 among 25 of the most prestigious Chilean firms, according to the ranking of company reputations prepared by Hill & Knowlton Captiva and La Tercera, a daily newspaper.

Procalidad 2005 Award

Granted by Capital magazine, Adolfo Ibáñez University, Adimark and Chile Capital, to BancoEstado as the company with the second highest approval rating among its customers.

Best Organization to Work For

The Great Place to Work Institute awarded *BancoEstado Microempresas* this prize for being one of the 35 best places to work in Chile.

Best Image and Publicity

Diario Financiero, a financial newspaper, gave BancoEstado first prize for Best Image and Publicity.

National Quality Prize 2005

A public distinction granted by the national center for productivity and quality (*Centro Nacional de Productividad y Calidad, ChileCalidad*) to *BancoEstado Microempresas*, in the Large Company category. This reward goes to companies demonstrating management excellence at the international level.

Inclusive finance

In recent years, both in Chile and abroad, there has been a trend toward financial inclusion in terms of individuals and companies, driven by factors such as economic growth, urbanization and the rapid adoption of information technology by the financial industry. In fact, technological development has been a key factor in new trends in financial service and product provision, both in terms of the growing supply and the commoditization of the more massive ones, as well as in terms of simplifying and facilitating access to the financial system (the payment of wages, accounts, withdrawals, transfers) as new channels and means of payment have emerged. One expression of the latter has been the explosion of electronic means of payment, such as credit and debit cards, which have increasingly replaced traditional methods and increased client coverage. Likewise, automated distribution channels and others not requiring a physical presence have reduced costs, favoring improved access. For example, if the cost of a human teller is about 1 per transaction, it could be a half via an ATM and a quarter through e-banking.

There is also growing interest both privately and publicly in developing microfinancing. Governments are increasingly aware of the enormous social impact of micro- and small businesses, especially in terms of employment and poverty reduction. For example, in Chile, of formally constituted firms, 97% are micro- and small businesses (81% micro and 16% small), which altogether contribute about 63% of employment (46% micro and 17% small businesses). For private banks this segment has also grown more attractive. The trend toward financial disintermediation among large firms, as they increasingly issue their own financing instruments, has driven banks to seek new customers among

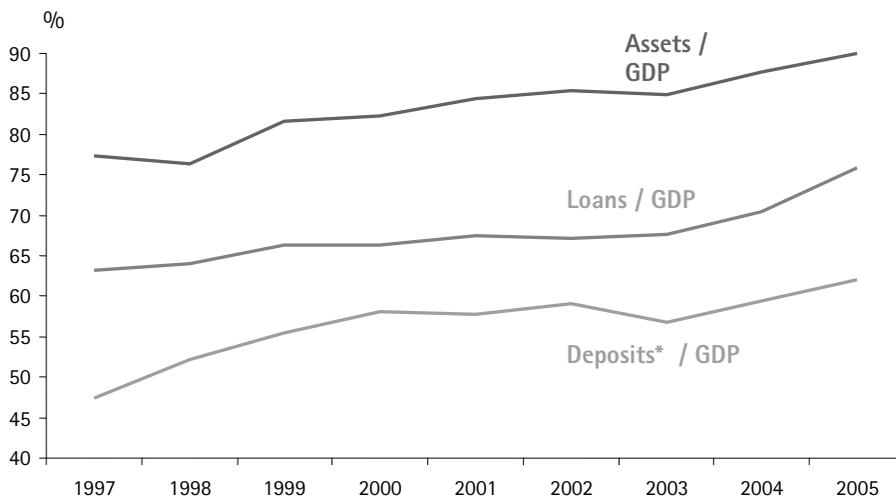
microbusinesses and in retail. Similarly, empirical evidence has revealed that contrary to common expectations, microcredits can be managed both efficiently and profitably. Thus, financial institutions such as *Triodos Bank* (Netherland), Citibank and the *Deutsche Bank* have shown a growing interest in supporting microfinancing, to obtain earnings and contribute to reducing world poverty.

In short, the trend toward introducing new sectors to banking seems to be consolidating. A simple but telling fact that reveals the public and private importance of this segment is, in Muhammad Yunus' words, the fact that "Microbusiness gives poor people the chance to generate resources; they have talent, skill and entrepreneurship, and can return the loan." Proof of the relevance of this idea worldwide is that the United Nations declared 2005 the "International Year of Microcredit."

Progress in Bank Development and Inclusion

In the past decade, Chile has experienced rapid progress in financial development, encouraged by favorable economic conditions and ongoing modernization of its own industry, influenced by strong competition in this sector and new information technologies. Many indicators for banking depth reveal the growing importance of banking to the domestic economy in recent years, as reflected in its growth compared to out put (GDP).

Figure 5.7 – Chile, Banking Depth Indicators, 1997–2005



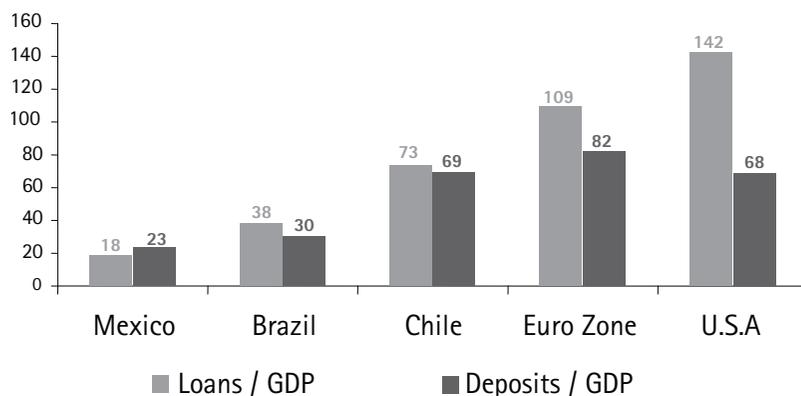
* Includes demand and time deposits, and other liabilities.

Source: SBIF

At the same time, Chile has the most developed banking system at the regional level, according to comparative studies by international agencies. However,

compared to developed countries, notwithstanding the important differences in income levels and distribution, a significant gap remains, revealing the magnitude of the challenge to be met today and in coming years.

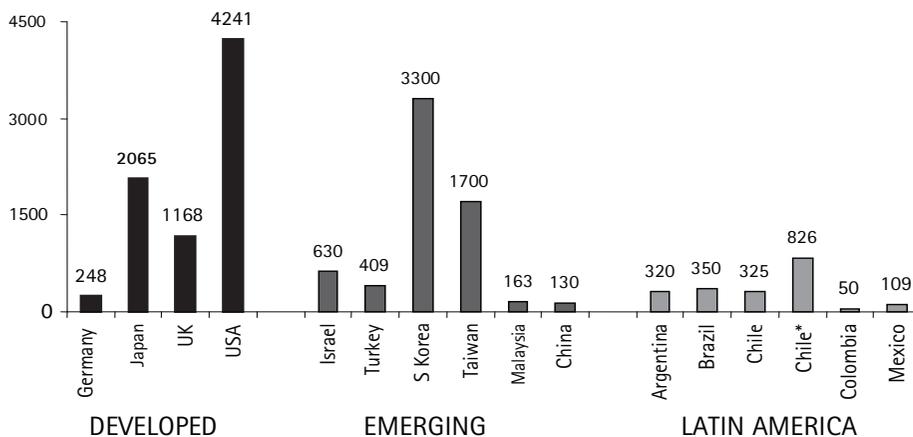
Figure 5.8 – Loans and Deposits as percent GDP in Comparative Perspective



Source: Bear Sterns, 2003

This gap is also apparent in other indicators, such as electronic means of payment, which today are an effective instrument allowing lower income sectors access to the banking system. In fact, although debit and credit cards have enjoyed explosive growth in Chile since 2000, the country still lags well behind more advanced economies.

Figure 5.9 – Credit Card Penetration in Select Developed, Emerging, and Latin American Countries, n cards per 1000 population



Source: Central Banks, Euromonitor, Press releases, Merrill Lynch estimates

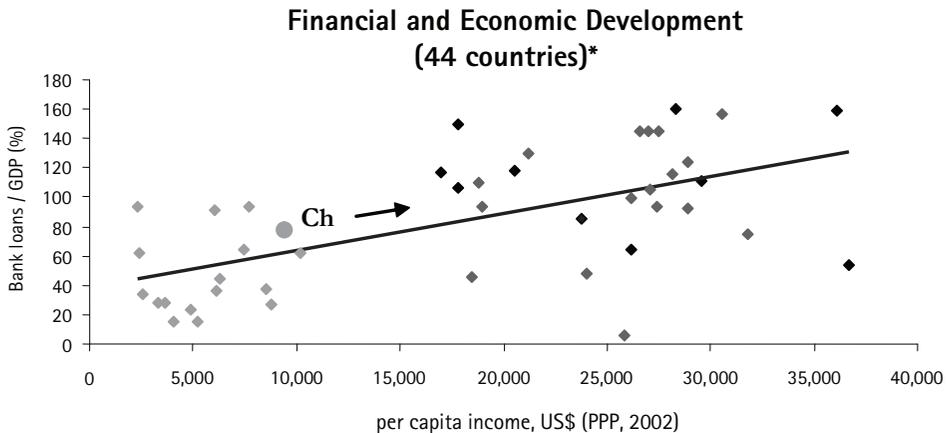
Note: Most data end-2005, some end 2003 & 2004, some ML estimates

*Total credit cards, including department stores

Challenges

Financial reforms, new technologies and growing interest in microfinance offer a solid base for bringing new people into banking at a massive level. As well as helping to reduce poverty and inequality, international evidence indicates that access to financing is crucial to economic growth (Figure 5.10).

Figure 5.10 – Financial and Economic Development in 44 Countries



* Includes 17 countries of Latin America and the Caribbean, plus 27 countries with per capita national income (INB pc) of over US\$ 15,000

Source: World Bank

As a result, the challenge remains of how to promote and ensure inclusion, a responsibility that falls on the shoulders of public authorities and private agents. In Chile, public authorities have encouraged new segments to join the banking system by creating a friendlier environment, amidst stable pro-growth policies and regulations favoring market competition and transparency, which have boosted wealth and financial services to lower income sectors. Aside from the favorable economic environment, some measures contributing to further inclusion have included: more stringent requirements for transparency and information about the price of credits to individuals and standardization of financial information that banks require of small and medium-sized companies to evaluate credit and reduce risk (e.g., FECU PyME); measures to encourage legalization of productive and commercial activities and different instruments, including direct subsidies, which are more focused and efficient, to both supply and demand.

Examples of subsidies applied in Chile include those to promote mortgages and microbusinesses, and some so-called 'smart subsidies' among them, on the supply side, those going to microbusinesses (US\$ 85 per operation, first three credits) and low-income housing, worth up to US\$ 17,000, to offset fixed costs (averaging US\$

175 per operation). On the credit demand side, low- and middle-income housing worth from US\$ 13,000 to US\$ 30,000 can get a redistributive subsidy, higher for lower price houses (US\$ 4,500 and US\$ 1,000, respectively per operation/family).

Other instruments that have proven useful to encourage financial access have included Deposit Insurance, covering up to US\$ 3,100 and guarantees for credits to small and microbusinesses. In this sense, the government has successfully implemented a fund for this purpose, the *Fondo de Garantía para el Pequeño Empresario* (FOGAPE), which guarantees a percentage of the capital involved in credits provided by public and private financial institutions to eligible small businesses, without guarantees, or insufficient ones. Fund management was assigned to BancoEstado, and is supervised by the Superintendency of Banks and Financial Institutions (*Superintendencia de Bancos e Instituciones Financieras*, SBIF).

Fund users have posted strong growth, from 13,000 clients in 2000 to 44,400 in 2005. Annually, more than 30,000 guaranteed credits are processed. From 2000 to 2005, 88,000 customers with over 156,000 guaranteed credits were served. A study of FOGAPE's impacts on small business revealed further credits to users of around 40%, which brought higher sales and annual profits. The social benefit of this instrument is estimated at around 700%.

Finally, it should be noted that financial institutions such as BancoEstado must adjust their management to meet the challenges implicit in inclusion. The use of new technologies reduces operating costs and product/service prices, making it vital to simplify access and expand the banking network into rural areas, using units involving low operating costs. Other requirements include: massifying payment means and designing low-cost products for low-income sectors, thereby commoditizing products; and encouraging financial literacy, by developing education campaigns aiming mainly at younger generations.

BancoEstado Business Strategy

Traditionally, efforts to improve financial inclusion as part of BancoEstado's mandate, involved primarily expanding the geographic and social coverage of its products and services to those living in isolated areas or with low incomes. This effort toward financial inclusion / bringing new sectors into banking took the form of two main products: savings accounts and mortgages. Their placement in the market was through a constantly expanding distribution network. By the late 1980s, BancoEstado had a huge savings client base of from six to seven million people, virtually all of whom used only this product, while many maintained a distant relationship with the bank, as passive customers. Although this was a problem, it also offered an enormous opportunity to take advantage of this customer base with a suitable commercial strategy. Since the 1990s, BancoEstado continued to bring new people into banking, particularly through the significant expansion of its branches

from 181 to almost 300. It also started to develop a more intensive form of banking, based on a new commercial strategy that sought to deepen ties with customers, by offering them a range of financial products and services to cover their needs (including savings, credit, means of payment, insurance).

This commercial strategy involved diversifying and segmenting the supply of products and services and their massification and commoditization, to expand the borders of inclusion and capture new customers, particularly from the low-income segment. At the same time, the strategy sought to strengthen ties with old customers, retain them and increase their loyalty by offering a broader range of new products and services, or combinations with existing ones (product crossing). At the same time, this strategy formed part of the bank's overall modernization, through several initiatives and projects applied in the past decade, including the creation of subsidiaries, such as microbusiness and insurance, and the development of distance banking by Internet and telephone. In 2005, the bank implemented its new service and sales model (*Modelo de Atención y Ventas*, MAV, Service and Sales Model).

The New Service and Sales Model (MAV)

In its 2006-2010 Strategic Plan, BancoEstado set itself the goal of becoming one of the best banks in the world in terms of efficiency, service excellence and employee quality of life. To do so, the new sales and service model (*Modelo de Atención y Ventas*, MAV) was fundamental. MAV was designed to bring a qualitative leap in service to individual customers. It required more knowledge about them, combined with profound and simultaneous change in many areas. It also made it essential to offer new value-added products to customers, with the commercial area providing branch management with support. Strengthening branches as sales centers, by increasing time invested in generating new business and transferring operating tasks, also became essential. The third pillar of MAV was creating or strengthening central areas to absorb operating tasks, achieving benefits through centralization and specialization.

In 2005, the MAV was implemented in 86 branches in Metropolitan Santiago and through three pilot programs in regions, generating higher sales and better results on the transference of transactions. Credit to individuals rose 29% (in offices without this model, 7%), the number of checking accounts 57% (without the model, 15%), lines of credit 89% (without the model, 50%) and credit cards 167% (without the model, 25%). Similarly, the migration of deposits from traditional tellers to self-service rose 230%. In 2006, the challenge came applying MAV in a further 213 branches around Chile.

This modernization process, which aims to improve efficiency and service quality to expand and deepen financial inclusion, has required an enormous effort

to massify products and automate channels, transactions and means of payment. Several examples of this process conducted by BancoEstado in recent years to bring banking to new sectors are described below, including the steps followed, its evolution and main traits.

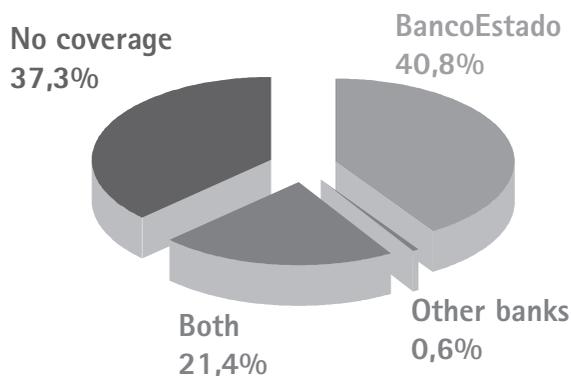
Traditional Banking and Outreach

Traditionally, BancoEstado has been a popular bank, a leader in family savings and mortgage financing, with many customers using the country's most extensive banking network. Data on BancoEstado customers suggest its predominant market position:

- 8 million with savings accounts.
- 191,000 with checking accounts.
- 580,000 with electronic checkbooks or credit cards.
- 500,000 with mortgages.
- 1.3 million insured.
- 450,000 with consumer and university credits.
- 190,000 in small and micro businesses.
- 1.2 million receiving monthly wages, pensions and grants.

BancoEstado is the financial institution serving the most Chileans, with more locations countrywide, a network composed of 312 branches, 42 special access points (*Puntos de Atención de Cercanía*, PAC), and 1,050 automated teller machines, complemented by another 3,700 private ATMs (Redbanc) and 1,081 delivery boxes and providers of balances. For 41% (141) of the country's municipalities (*comunas*), BancoEstado is the only banking institution present, with 106 branches, 34 PAC and 1 auxiliary service. These are some of Chile's poorest and most isolated locations.

Figure 5.11 – Bank Coverage of Chilean *comunas* (municipalities)

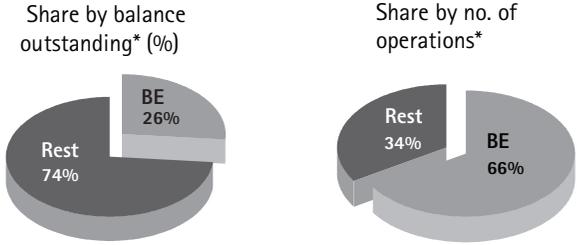


Source: BancoEstado

In terms of family savings, one of every two Chileans has a savings account in the BancoEstado. The Bank holds an 88% market share by number of saving accounts. Most have balances under US\$ 100.

In terms of mortgages, two of every three Chileans (66%) with a bank mortgage are BancoEstado customers. In 2005, the value of these loans rose 15.4% and its market share reached 26.3%, similar to 2004.

Figure 5.12 – BancoEstado Market Share of Mortgages, 2005



*Both types of mortgages (letras de crédito, mutuos).

Source: SBIF

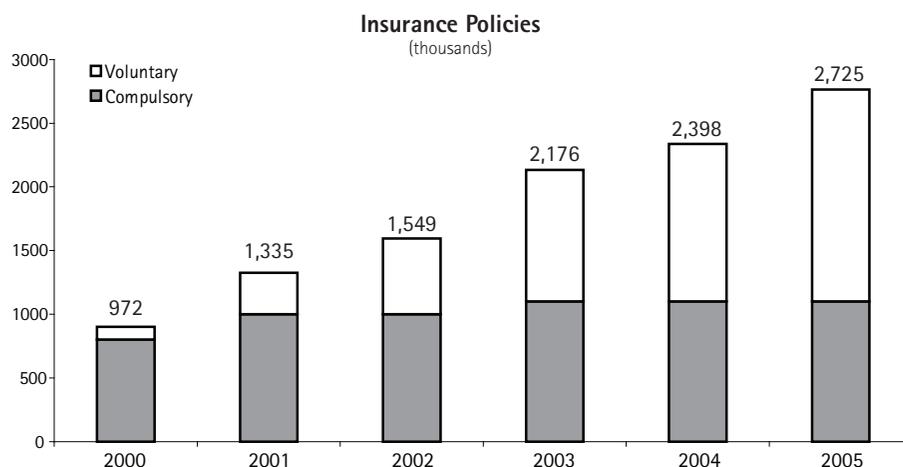
Both the large number of operations and the average value of BancoEstado mortgages account for one-fifth of those in the system (US\$ 8,700 versus US\$ 46,700), reflecting its social priorities, particularly providing banking services to low-income sectors.

Bringing New People Further into Banking / Product Massification

Since the late 1990s, BancoEstado has expanded its services into untraditional markets, such as microbusiness and insurance. In the microbusiness field, the bank has developed a special program to encourage entrepreneurs in sectors traditionally ignored by private banking, offering complete services that include advice and credits.

In the insurance market, the bank created a subsidiary that in a short time has become a leader among bank brokers by number of policies (2,725,000), with 1.3 million customers and an intermediated premium of around US\$ 100 million.

Figure 5.13 – Number of BancoEstado Insurance Policies, 2000-2005



Source: BancoEstado

To reinforce development, in 2004, BancoEstado's insurance subsidiary, *BancoEstado Corredores de Seguros S.A.* joined forces with Metlife, to achieve good results for both firms, reflected in the implementation of a series of new projects and products, such as *rentas vitalicias* (annuities), insurance for firms and institutions, accidental death, cars and others. To continue to offer insurance to a wider public, the Bank designed a new product "Incredible Insurance", covering the risk of accidental death at a cost of just US\$ 7.80 per year, or about 60 cents per month. This offers holders coverage worth more than US\$ 6,200. In 2005, the Bank sold 132,000 of these policies.

Bringing New People into Banking: the 21st Century

In the 2005 fiscal year, the Bank worked to develop new projects to extend and deepen the provision of banking services to unbanked Chileans. The first new products to be offered in 2006 include the *Caja Vecina* (neighborhood teller), *Cuenta RUT* (account based on national Chilean ID/tax number), and Transantiago. Through the *Caja Vecina* (neighborhood teller), users can operate in stores in small towns and villages lacking regular banking services, thus complementing current services. At the same time, the *Cuenta RUT* involves offering Chilean and foreign residents in Chile or abroad with an electronic means of payment or account, with no requirements and minimal transaction costs, to receive income (wages,

pensions, subsidies, service payments, grants, allowances) and make different payments (utilities, taxes, purchases through the Redcompra system, BancoEstado deposits, or cash withdrawals).

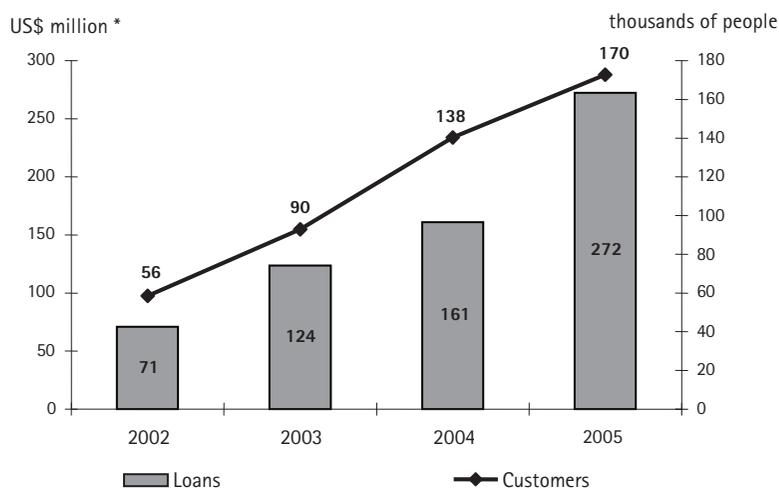
The Chilean government and the private sector joined forces to create an integrated project to modernize bus transportation in Santiago. BancoEstado became majority partner in financial management of Transantiago through the *Administrador Financiero del Transantiago* or AFT, which will handle the electronic payment card and provide the technology for managing the bus system. The system is expected to have four million users, with BancoEstado participating actively in managing means of payment. New technology required by the transportation system will make Chile one of the few countries with a public transit system using electronic payments and an integrated fare serving different forms of transportation.

Micro-business

As mentioned, BancoEstado has made a major effort to promote entrepreneurs. Since micro- and small businesses face the most barriers to accessing the financial system, because of their often informal nature, lack of information or low quality information, and low profit per credit, raising the costs of risk and potential risk, the bank has focused on this segment, achieving excellent results. In 1996, in the micro-business segment, a subsidiary was created whose commercial design involved a field evaluation, credit scoring and no guarantee requirement, the creation of specialized branches and products according to the customer segment, providing integrated service to the sector. The subsidiary's technological design uses integrated network and information management systems (business intelligence). Moreover, to ensure optimum field performance, a georeferencing system is used to optimize planning and organizing executives' visits and work time; at the same time, a mobile unit is used to allow field evaluations, particularly in farming areas.

The success of this program was reflected in the record portfolio achieved in 2005: 170,000 microbusiness customers and a balance of loans outstanding worth US\$ 272 million, through 124 specialized service platforms.

Figure 5.14 – BancoEstado Micro-Business Loans and Clients, 2002–2005



*US\$, as of December 2005

Source: BancoEstado

From 2002 to 2005, the number of customers tripled and loans rose 3.8 times, with annual growth averaging 45% and 57%, respectively. The specialized model serving microbusinesses stands out for its client-specific responses, achieved by segmenting services. In this context, work done in the fishing, wholesale and retail, transportation and agricultural sectors stood out. Executives in this area worked closely with customers and their families, visiting them in their workplaces. This support helped to develop microbusiness and improve the quality of life of the business person and family. Thus, more than 10,000 entrepreneurs saw their dream of owning their own home come true thanks to a mortgage, at the same time as their children were able to pursue a post-secondary, education financed by loans from the bank.

A study conducted by the University of Chile “*Evaluación de Impacto de Crédito a Microempresarios*” concludes that micro-business credits are good for entrepreneurs. It noted that entrepreneurs typically using BancoEstado credits had seen their sales rise 20% annually and their productive capacity increase 45%. The level of microbusiness compliance with servicing stood at 99%. Six of every ten paid off their loans in advance and half of these customers were women. The BancoEstado’s commitment was also reflected in its active participation in consultancies, national and international forums for sharing and enriching experiences with microfinancing. In 2005, in particular, it organized the Regional

Summit on Microcredit for Latin America and the Caribbean, held in Santiago, attended by 1,200 delegates from 38 countries, including public figures such as Spain's Queen Sofia, Muhammad Yunus, and Chilean President Ricardo Lagos.

Neighborhood Teller

Finally, the Neighborhood Teller project was designed to make the most of the current banking distribution network, by offering a low-cost, operating alternative (e.g., Brazil's Lottery Shop / *Caixa Economica Federal*). This expanded, low-cost coverage makes possible to offer financial services to low-income individuals in rural and urban areas that currently have no banking services. They include a teller's window and deposit, withdrawal and payment services, through a Point of Sale (POS). The pilot project started up in Quilleco and El Carmen, in Chile's 8th Region, in 2005, with considerable success. The Bank's goal is to achieve 300 service points in 2006 and 2,500 by 2010, distributed in 130 municipal areas without bank services to benefit 1.2 million people, as well as in 141 municipal areas where the Bank is the only service provider, offering this alternative to another 3.5 million people; and in densely populated urban neighborhoods, where there are no banks nearby. The saving in transaction costs should total around US\$ 400 million.

Chapter 6

Reform of Brazilian Federal Public Banks: Policies, Program, Doctrinal Basis and Theoretical Affinities¹

Carlos Augusto Vidotto²

At year-end 2003, public banks accounted for 40% of total bank credit in Brazil. The expansion of this variable during 2003 resulted from the leadership of these banks during adjustment and recovery, corroborating a monotonic trend starting in July 2001, after the reform of federal banks. From 2001-2003, credit from private institutions increased 14%; the credit offer from state-owned banks recorded a 58.5% increase in nominal terms. Considering the slow growth rate of this period it can be said that state-owned banks showed a countercyclical behavior, both in relation to GDP and to other banks. Note should be taken, however, that this did not adversely affect their asset condition. Indicators of loan portfolio soundness, especially, stayed close to private sector ones.

At least in the Brazilian context, such facts present important questions about the presence of the State in the financial markets, where, besides its regulatory action, the State acquires an entrepreneurial nature. As such, the State acts not just as an economic policy instrument, but also as an agent driven by typically private criteria. These questions appeared in the controversy that accompanied the development and the implementation of the program that restructuring of Brazilian federal government banks, conducted in parallel to the broader process of public sector asset restructuring. This chapter examines the doctrinal grounds and affinities between official discourses, and the content of policies, and the theoretical arguments underlying controversies.

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2 The author wishes to thank the comments made by Hugo E. A. from Gama Cerqueira, Luiz Fernando de Paula and Pedro Paulo Zahluth Bastos on a prior version of the text, exempting them from any responsibility for this paper.

As broadly known, the control of financial institutions by the State is not restricted to local conditions. It is rather a recurring phenomenon in the international experience that, a little more than a decade ago, entered a stage of marked change. Decreased state participation in domestic financial systems stands out as a common feature of recent change. Furthermore, these institutions increasingly enforce private management criteria, which is sometimes construed as illustrative of public sector submission to market discipline. Thus, before proceeding, this paper presents a brief overview of state presence as recorded in the literature.

La Porta et al. (2000), for example, underline the significant presence these institutions had in less developed economies. According to a study on the restructuring of region financial markets (BIS, 2001), Europe is included in the trend referred to above. Besides harboring a diversified set of institutions, the European experience is marked by organizational and operational strategy changes which could already be perceived in the middle of the last decade (Gardener; Williams, 1996). Starting in the seventies in East and Southeast Asian countries, the privatization of public banks progressed gradually (Arun; Turner, 2002), with the Japanese Postal Bank represents an important contrast with the trend observed in the region until recently.³

In India, the joint share of the State Bank of India and privatized banks was 80% in 1999, with no significant variation in the three previous decades. And, despite the existence of an excessive cost structure (Arun; Turner, 2002) it was just recently that actions targeting an increased participation of the private sector in the system have been seen. As to the previously socialist economies of the former USSR and Eastern Europe, it would be just natural to see privatization appearing as part of the transition to capitalism itself. In many of these economies state participation is declined towards irrelevance or even extinction, in a process combining the entry of foreign capital in domestic financial markets and, in several cases, preserving strong ties between privatized banks and the public sector, as shown by Sherif; Borish and Gross (2003). Inside the Russian Federation, however, the state presence has been increasing since the 1998 crisis and the share of total deposits had reached 58% by the end of 2000.⁴

To conclude this overview, reference is made to China that preserves an almost fully state-controlled financial system and late structural changes, an

3 In this case, the state presence increased, with total deposits in the postal system increasing from US\$ 1.8 trillion in 1996 to US\$ 2.2 trillion in 2000. "With deposits amounting to 2.2 trillion, the Japanese postal system is, in practice, the largest bank worldwide. The bankers conceived a plan to privatize it. Nobody pays attention to them, but, yes, they should be heard." (Business Week, 2001). This has become the focal point of current administration liberal reforms.

4 According to the authors, "late in 2001, more than 460 banks are state-owned and public institutions (including the Central bank) own stock or interest in the capital of 679 of these banks (Sherif; Borish and Gross, 2003, p. 46) and, although the government had plans for a large divestment program, specialized credit entities and the largest state-owned banks, the largest of which (Sberbank) accounted for 45% of the deposits and 25% of total system loans would be preserved (by the closing of year 2000).

example of which is the formal establishment of a central bank as late as in 1995. Cull & Xu (2000) argue that mainly in the eighties, the Chinese banks were more efficient than state bureaucracy in the analysis of investment projects from state companies. By the end of 2002, just the “four large” state banks accounted for 71% of all deposits (Shih; Zang; Liu, 2004). Despite being dominant, these banks carried significant portfolio quality problems, having resorted to significant capital contributions in 1998 and 2002 (Woo, 2002), and again in 2004. Besides, once China joined WTO, in 2001, liberalization actions were required. Among these actions, a partial opening to the entry of foreign capital stands out, leaving the course of this process undefined.

Although brief, the overview presented above already hints that, far from being uniform or having a pre-determined horizon, the process of State withdrawal from financial markets allows significant qualifications. And more, the range and the duration of such phenomenon show that it should not be defined as an external State “intervention”; instead, it deserves to be seen as typical of most capitalist formations in some the stages of their development, living side by side with the specificities presented or standards compounded by several historical experiences.

We do not intend to redesign the approach the specific literature has given to the phenomenon of state-owned banks, but we could point to the predominance of empirical studies linked to mainstream economics. Such studies, in general, highlight a correlation relatively easy to make between the presence of the state and economic “delay”. The correlation is then assimilated to a causality from the first to the latter, whose empirical foundation, on the rare occasions in which it is attempted, is made vulnerable by the degree of simplification imposed by the models.

Among the works that best represent this point of view, is the already mentioned paper by La Porta et. al. besides Barth; Caprio Jr. and Levine (2000), who synthesized their results as follows:

Fifth, greater state ownership of banks tends to be associated to more poorly developed banks, non-banks, and stock markets. Thus, while state ownership of banks may in theory help to overcome informational problems and direct scarce capital to highly productive projects, the data analyzed here tells a different story. On average, greater state ownership of banks tends to be associated to more poorly operating financial systems. (p. 3).

A certain theoretical condescendence towards the role played by the State in the solution of informational problems, compensated, by the argument that this does not happen in practice, is part of discussion below. First, we return to the domestic scenario.

In Brazil, despite the significance of state-owned banks in the banking and financial system, the literature on the subject remains scarce and focused on recommendations of a pragmatic nature. This may reflect the idea that financial institution capital control, either private or public, national or foreign, is not a good subject for theoretical consideration. According to Delfim Netto (2000), handing out the control of retail banks to foreign capital, for example, would be a question

for which there is no scientific answer, either from a theoretical or an empirical point of view. Likewise, according to Bacha (1989, p.9), the choice would have to be "... decided in practice, once theory teaches us that there are serious problems both in a fully private financial market and in markets where public intervention is predominant". In fact, offering a comprehensive contribution on the subject is probably not a trivial task, as evidenced by the reiterated promise made by Fraga & Werlang (1995, p. 275) of bringing to light an "economic theory of public banks", which, unfortunately, remains in the "preparation" stage.

Instead of starting by discussing the conceptual framework, the next section presents a summary of the operational profile of federal banks and a synthesis of restructuring measures and effects, with the limited objective of providing a reference to support the other sections. The second section touches on the debate about state-owned banks in the period that preceded the Real Plan. The third section discusses the program of the reform of the federal banks and the fourth, a discussion of correspondences in economic theory. A summary of results is presented in the last section.

Brazilian Federal Government Banks, 1990–2005

The nucleus of the set of public federal banks⁵ is formed by heterogeneous institutions: *Banco do Brasil* (BB), *Caixa Econômica Federal* (CEF), *Banco do Nordeste* (BNB), *Banco da Amazônia* (Basa) and *Banco Nacional de Desenvolvimento Econômico e Social* (BNDES). Together, these institutions account for almost the totality of the transactions of the so-called federal public financial institutions.

From a banking stand point BNDES is the only one not involved in the process of creating currency once it does not receive deposits from the public. As to the legal framework and capital structure, CEF and BNDES are public corporations, with their whole capital provided by the Treasury, while BB, Basa and BNB are mixed private and public joint stock corporations. That is, joint stock companies, as banks are required to organize themselves in Brazil, with the specific feature of having the National Treasury as their controlling shareholder. Out of the three, BB, Basa and BNB, just BB has a significant portion of its capital effectively traded in stock exchanges. With the exception of BNDES, which is subordinated to the Ministry of Development, Industry and Foreign Trade, all the federal banks are subject to the Ministry of the Treasury.

5 Once the almost full liquidation of state government banks was completed, federal public financial institutions (*Instituições Financeiras Públicas Federais*, IFPFs) acquired an even larger majority in the set of public banks. The IFPFs comprise, besides the federal banks, the federalized state government banks and *Financiadora de Projetos e Pesquisas* (Project and Research Funding Agency) - Finep, excluded from this analysis either because of their limited relevance in the set, or because, in the case of FINEP, establishments of this kind this are not part of the bank theme itself.

The difficulties this institutional puzzle poses to systematization are compounded by the heterogeneity of operational profiles, starting with the fact that each bank is linked to a specialized credit sub-system or to a regional sphere of action. CEF, for example, funds urban infrastructure, till now a duty of the states and municipalities, and provides funding to housing and civil construction projects developed by the public and private sectors; this role was firmly established after acquiring the former Banco Nacional da Habitação (National Housing Bank), in 1986. Services are rendered basically with funds from *Fundo de Garantia do Tempo de Serviço* (Unemployment Insurance Fund) – FGTS, judicial deposits (made by the parties of a suit in court), over which CEF enjoys a constitutional monopoly and funds mobilized from savings accounts. With the same purpose, combined to commercial objectives, CEF does business in the so-called fund “industry”. This institution also grants general credit to the public and is the leading federal administration agent for a diversified set of social programs. CEF also manages federal lotteries and uses lottery sales outlets as bank counterparts, controlling the largest network of this type in the Brazilian market. CEF practically does not look for funding abroad and is not involved in currency exchange services; CEF actions are focused on the domestic market, although there are some initiatives to overcome this shortcoming.

BNDES is the main internal long-term loan source of the Brazilian economy, based on parafiscal fund pass-through and recycling (returns rated as own resources from an accounting point of view). BNDES funding structure is supplemented with international market funds. Two decades after BNDES was established, that is, under military government, public institutions started to distance themselves from funds from this bank, at that time called BNDE (Cruz, 1994). Radically distinct solutions were enforced for the mobilization of financial resources for investment in the public and private sectors. To the author, such distancing is all the more serious as “./.../ the true Gordian knot of long-term loan in the Brazilian economy has been historically associated to public investments, particularly those from state-owned enterprises” (Cruz, 1994, p. 77). Back in the 1980s, the bank focused its private sector credit offer on exporting businesses, which explains its sounder asset status as compared to other IFPFs.

In the 1990s, the BNDES was firmly established as the federal government privatization program manager (except in the case of financial institutions, conducted by Brazil Central Bank) - a strategic role that marked a new stage in the bank’s track record (Cintra et al., 2000) –, thus gaining an outstanding position in the capitalist development project attempted at that time, according to the authors. On the other hand, the bank also diversified its funding sources with the addition of financial resources from the FAT - *Fundo de Amparo ao Trabalhador* (Workers Assistance Fund). These innovations turned BNDES into a state-owned “business bank” or investment bank, with a critical funding and managing role

in the privatization of public sectors. More recently, however, it has been showing signs of a new strategic focus aimed at redirecting financial resources to the public sector and emphasizing its historical development bank profile.

The BNDES system also includes *Financiadora de Máquinas e Equipamentos* - Finame Machinery & Equipment Funding Agency) and BNDESPAR, through which BNDES holds an equity interest in many Brazilian enterprises. This threefold role enables the BNDES system to have a strategic connection with both the capital market and the remainder of the public and private banking system; this also diversifies its competitive financial instruments by earning revenues and bearing the credit risk of the pass-through to end borrowers receiving funds from standardized lines.

Basa and BNB are regional federal banks focused on the Amazon and the Northeast Region, respectively. On a much smaller scale than the BNDES, these institutions combine features of a development agency – selecting regional projects – and development banking. These banks direct part of their resources to micro and small businesses – with a specific service structure – and also operate as commercial banks. The resources for their financial restructuring in the 1990s came from Constitutional Funds; in addition, they operate international pass-through credit lines and mobilize public funds.

The *Banco do Brasil* is the system's largest asset holder and most diversified federal bank, being directly or indirectly present in virtually all sectors of the banking, insurance, capitalization and social security industries, besides operating as main financial agent for the National Treasury. It is the key agent of the rural credit system, accounting for more than half of bank loans; BB is also an industry leader in the segment of loans to small business and in the foreign exchange market, foreign trade credit, and leading third-party fund manager. Moreover, the *Banco do Brasil* has business in the major overseas financial centers. Its funding consists of official and foreign fund pass-throughs, particularly, in the case of financial resources, competitively purchased in domestic and foreign markets. In the 1986-1988 budget reform, the *Banco do Brasil* lost the monetary authority status it had shared with the Brazilian Central Bank since 1964 (Vidotto, 1997). In 1996, following the stabilization of prices, experienced a crisis that demanded an R\$ 8 billion capital provision, mainly subscribed by the National Treasury (Vidotto, 2000).

To underline what has been suggested, the most important new feature of federal banks in the nineties is that they were not privatized. Unlike other industries marked by the presence of the public sector, the institutional mission of federal banks was reaffirmed. Despite the aggravated fiscal scenario existing in the country, federal government banking was able to find new financial resources and were capitalized. In other words, the federal banks experienced significant asset reinforcement and unmistakable financial revitalization. Assuming participation in the supply of credit as a “synthesis variable” of public bank reform, the track record of these banks from 1988 to 2003 is shown in table 6.1 below.

The growing share of state participation in credit experienced until the late 1980s was replaced from the early 1990s with a growing trend towards participation by private institutions that lasted until mid-2001. Since 2001, official banks have expanded credit and increased market share first by recovering credit allocated to the private sector and - as of 2003 - from reversal of the drop in the credit directed to the public sector. Within this broad movement, periods and sub-periods appear as intervals marked by unique events in public finance, sectorial policies, etc. Thus, following the 1994 foreign debt renegotiation, the role of state-owned banks shrunk when BB was released from the domestic public sector-foreign debt funding circuit. On this matter, it must be underlined that the drop in the stock of credit of the official banks during the 1990^s was headed by a particularly pronounced pull back by the BB. In 1995-1996, BB bank credit portfolio clean-up meant the recognition of an accrued loss amounting to R\$ 12.5 billion; soon afterwards, BB was again hit by the beginning of rural debt securitization. The slight recovery of state participation that reached its peak in 1999, is, in turn, primarily associated with BNDES involvement in the privatization program.

The share of credit offer according to its sectorial distribution provides additional hints on the changes made to the management of these institutions. Federal banks prevailed in sectors such as rural and housing credit. Considering also that public banks included institutions owned by state governments - almost entirely extinguished by the end of the 1990^s - we can conclude that the track record of federal banks is somewhat underestimated. Less rural credit on one side and the service sector credit cycle on the other, mostly coinciding with the privatization program, account for the contrast between BB and BNDES track records in that decade.

In 2001, a steep drop occurred in the participation of public banks in rural, housing and industrial credit activities as a result of a comprehensive policy package targeting these institutions. Having slowed for a decade, home loans were "deflated" and problematic credits were transferred to a new *Empresa Gestora de Ativos* - Emgea (Asset Management Agency) for management and recovery. Besides mere portfolio clean-up, part of such credits were securitized. The Federal Financial Institution Reinforcement Program (MP 2.196, dated June 28, 2001) also represented the continuity of BB clean-up and capitalization in 1996 and the actions for the restructuring of the housing financial system and CEF in the late 1990^s. The actions also involve BNB and BASA. Because of its sounder asset status, BNDES was not included in the package. However, the atypical appropriation of 75% of the 2003 profit - the highest in the bank's history - may be seen as the missing piece that completed the process of capitalization.

As we can see, federal banks have undergone changes related to capital requirement criteria, swap of credits by National Treasury bills, and treasury assumption of official credit line risks, among other benefits. Before long, however,

such measures soon found their counterpart as credit management turned to more sophisticated instruments and stricter fund granting criteria – reflected in portfolio quality indicators (Table 6.1).

Table 6.1 – Brazilian Federal Government Bank Asset and Financial Restructuring Program (June 2001)

	CEF	Banco do Brasil	Banco do Nordeste	Banco da Amazônia
Adjustment to Provisioning Rules (Res. 2.682)			Reclassification of pre-1995 own portfolio operations. Provisioning in the amount of R\$ 1.375 mn, Additional provisioning in the amount of R\$ 375 mn. Classification of post-1998 FNE operations in the amount of R\$ 300 mn	Reclassification of pre-1995 own portfolio operations. Classification of post-1998 FNO operations
Capitalization	R\$ 9.3 bn: Central Bank credits with CEF, purchased from the National Treasury and converted into capital		Provisioning in the amount of R\$ 2.1 bn	Capitalization approved up to the amount of R\$ 1,050 mn => Reference Asset raised to R\$ 675 mn
Credit to States, Municipalities and Enterprises owned by Brazilian States	R\$ 13 bn: State and Municipal credits renegotiated in 1993 will be exchanged for LFT		Exchange of State and Municipal credits renegotiated in 1993 for National Treasury bills; Approval of R\$ 1.375 mn provisioning	Exchange of State and Municipal credits renegotiated in 1993 for National Treasury bills in the amount of R\$ 311 mn; Acquittance of debt in the amount of R\$ 257 mn with CAPAF pension fund.
FGTS and FCVS	Liquidation of liabilities with FGTS based on CVS bonds in the amount of R\$ 6 bn			
PROER Credits	Assumption by the National Treasury of R\$ 9.3 bn debt with the Central Bank due to acquisition of private bank credits			
Brazilian Foreign Debt Bonds		Exchange of Brazilian bonds overseas for National Treasury bills, in the total amount of US\$ 3,059 mn		

	CEF	Banco do Brasil	Banco do Nordeste	Banco da Amazônia
Rural Debt Securitization – Own Resources		Acquittance of BB R\$ 5,244 mn co-obligation (credit risk); R\$ 2,662 mn APR reduction	Will be benefited from. Amount not specified	Will be benefited. Amount not specified
Rural Debt Securitization – Third-Party Resources		Risk waiver, acquisition and accord and satisfaction of operations in the amount of R\$ 2,060 mn with BNDES resources, funds, National Treasury; same APR reduction	Will be benefited. Amount not specified	Will be benefited. Amount not specified
Constitutional Funds		FCO assumption of risk of operations up to Nov 30, 1998, in the amount of R\$ 695 mn. Same APR reduction	FNE assumption of risk of operations up to Nov 30, 1998. New provisioning impact for operations post-Nov 1998 (50% of risk) amounts to R\$ 300 million.	FCO assumption of risk of operations up to Nov 30, 1998, involving operations in the amount of R\$ 1,432 mn and R\$ 358 mn provisioning waiver. 50% Share of operational risk after the above date, resulting in R\$ 160 mn provisioning reduction.
Funcafé and Prodecer II		Accord and satisfaction agreement with the Union regarding Funcafé – R\$ 921 mn – and Prodecer II – R\$ 268 million – operations. Same APR reduction		
PESA (Programa Especial de Saneamento de Ativos)		Assignment of BB asset portfolio to the National Treasury, in exchange for federal bonds in the amount of R\$ 4,129 mn and R\$ 414 mn APR reduction		
Capital Classification		Inclusion of balance of FCO operations as level II capital in the amount of R\$ 2,810 mn	Inclusion of balance of FNE operations as level II capital (amount not specified)	Inclusion of balance of FCO operations as level II capital. PR increase of approximately 50%

	CEF	Banco do Brasil	Banco do Nordeste	Banco da Amazônia
Others			R\$ 425 mn: Provisioning to pay up civil, tax and labor debts.	
Result	R\$ 6.980 mn APR and R\$ 768 mn PLE reduction. R\$ 2.810 mn PR increase and CAR adjustment to 11.5%		CAR (capital adjustment requirement) adjustment to 19% from 7,7%	Asset increase to R\$ 675 mn from R\$ 288 million

Notes: FGTS *Fundo de Garantia do Tempo de Serviço*; FCVS: *Fundo de Compensação de Variações Salariais*; CVS: *títulos federais trocados por crédito contra o FCVS*; PROER: *Programa de Estímulo à Reestruturação. e Fortalecimento do Sistema Financeiro Nacional*; Prodecer: *Programa de Desenvolvimento do Cerrado*; LFT: *Letras Financeiras do Tesouro (TN)*; APR: *ativos ponderados pelo risco*; PLE: *patrimônio líquido exigido*; PR: *patrimônio de referência*; CAR: *requerimento de adequação de capital*; FCO: *Fundo Constitucional do Centro-Oeste*; FNE: *Fundo Constitucional do Nordeste*.

Sources: Ministry of Finance website. Relevant facts published by institutions and *Gazeta Mercantil* newspaper. Prepared by the author.

Table 6.2 – Brazilian Public and Private Bank Credit Operation Risk (December/2003)*

Sector	Total Balance (2)	Risk Levels								
		AA	A	B	C	D	E	F	G	H
Public	166,756	47,111	50,741	27,452	14,860	11,710	3,484	1,539	1,202	8,657
(%)		28	30	16	9	7	2	1	1	5
Provisions	13,827	0	258	293	501	1,397	1,067	809	859	8,643
(%)	8.3	-	0.5	1.1	3.4	11.9	30.6	52.6	71.5	
Private	243,070	67,166	94,412	35,740	23,073	7,264	3,425	2,334	1,599	8,057
(%)		28	39	15	9	3	1	1	1	3
Provisions	16,014	60	701	572	1,144	1,467	1,283	1,444	1,245	8,098
(%)	6.6	0.1	0.7	1.6	5.0	20.2	37.5	61.9	77.9	100.5
Total	409,826	114,277	145,153	63,192	37,933	18,974	6,909	3,873	2,801	16,714

* Includes leasing operations Balances in R\$ million and % interest .

Source: Brazilian Central Bank. Monthly Newsletter, Mar. 2004. Prepared by the author.

Operational line accounting segmentation by origin of funds was clarified, in an attempt to avoid cross-subsidies, and personnel management criteria were also redesigned with its most significant impact on those banks that had a larger number of employees. If this set of measures enabled getting the management criteria enforced by public banks closer to those adopted by private institutions, it doesn't seem appropriate, however, to assume that these two groups had the same operational rationale, considering, among other elements, the credit behavior of public and private banks had in recent years, Furthermore, this convergence has not been a linear process, varying according to policy areas, specific institutions, and management periods in the time under analysis.

Initiatives prior to the Real Plan

While macroeconomic instability increased during the eighties, the State started to design a new banking and financial system framework. Within the scope of the National Congress, the 1988 Federal Constitution determined that the system was to be regulated by a single complementary law to cover the full range of issues related to banking, insurance, capitalization and private pension funds.⁶ In the following legislatures representatives tried to define this determination in a specific law. Successive administrations, however, acted to prevent the debate from escaping executive control, and eventually, the subject was removed from the Constitution in 2003.⁷ Therefore, despite close public scrutiny, Congress had no significant autonomy in the design of the regulatory process.

In practice, the regulatory framework and restructuring of the federal government banking system were based on resolutions from the National Monetary Council (CMN), administrative acts by the Central Bank and “provisional measures” issued by the Executive branch. Law from the 1964 reforms (Law 4.595/64) continued in force as the basic regulatory framework, subject, however, to numerous amendments that significantly changed their original content.

While the subject was still being examined by the Constitutional Assembly, the Brazilian government hinted to be inclined to redesign the financial system as part of an adjustment project submitted to the World Bank (IBRD) to which a loan was coupled. In generic terms, planned measures would:

- a) end government interference in the credit markets and develop the private capital markets and long term loan instruments;
- b) make the legal reserve requirements equal for all instruments and financial institutions /.../
- c) strengthen the operational environment, by furthering competition between banks and introducing a deposit insurance system;
- d) support Central Bank institutional reforms /.../;
- e) restructure the banking system in states by liquidating or privatizing state government banks;
- f) reform the housing finance system by eliminating direct credit and the development of sources of funds in the market (World Bank, 1988).

6 Including the organization, operation and roles to be assigned to Central Bank and other public and private financial institutions, the presence of foreign capital, insurance, reinsurance, social security and capitalization, the geographic distribution of national savings, credit cooperatives and allocation of public funds destined to regional programs.

7 The attempt to remove system regulation from the Federal Constitution, by suppressing article 192, and the possibility of having the regulation made “in parts”, was proposed as a Constitutional Amendment submitted by Senator José Serra (PSDB-SP) in 1995 and approved in 2003 thanks to the efforts made by the current administration.

Rather comprehensive, this financial liberalization program was focused on three basic targets, starting with the instruments of monetary policy. Other actions targeted the general organization of the banking system, as for example, the opening to foreign capital and strict capital adequacy requirements. The third group targeted credit allocation instruments, the main focus of the federal banks: “ii) reduce official directed credit programs and subsidized credit and its broad range of interest rates”. Besides the housing finance system, also rural credit transactions should enforce positive real interest rates, which, by the way, was already the purpose of changes made to this credit sub-system in the 1980⁸. As to the long term purpose, the phasing out of public sector interference in financial markets, by means of privatization or extinction, was clearly spelled out just for *state* government banks.

The foundation underlying the government-IBRD project appears as a version of the hypothesis of the efficient markets. As it is well known, it fell to the so-called “financial- repression theory” the task of establishing the theoretical concepts that were firmly established as the rationale of liberal reforms in several Latin American countries.⁸ Given reduced interest rates in developing countries, in absolute or relative terms (a phenomenon understood also as a deficiency of savings) the diagnostic identifies a scenario of broad state intervention in the financial markets that would keep them “repressed”. By distorting the allocation of resources, specifically capital, intervention would push it away from an efficiency level in which its pay back, the interest rate, by reflecting factor scarcity, would match its marginal productiveness.

From this perspective, the various forms of intervention identified in the “repressive” framework form a diversified etiology in which compulsory allocation of credit mechanisms stand out. Determined by extra-economic reasons – either the development agenda in Latin America or the practices of the Asian crony capitalism – capital allocation ignores the risk/return compositions the market would have determined if repression did not exist. Thus, the enforcement of ceilings for interest rates, the existence of public funds and state government banks contributed to inefficient allocation.

From this diagnostic it is inferred that the two faces of financial liberalization, that is, opening to the world abroad and domestic deregulation, should lead liberalizing reforms; other fundamental reforms would follow, like trade opening, privatization, social security reform and flexibilization of the labor market. However, after this experience led to the weakening of several economies, resulting in banking crisis and recessions, the project of reforms grounded on the theory of financial repression was subject to several changes. As a result, the importance of

8 On the experience of South Cone countries and for a review of this theory, refer to Cintra (1999); for a precise survey we suggest Carneiro (1995).

“sequencing” grew, and the argument that financial liberalization does not open, but rather culminates reforms gained significance.⁹

In Brazil, with the government-IBRD agreement subject to delays, guidelines were anticipated by the Central Bank in the 1988 mini-bank reform, among which is the end of the letter patent regime and the regulation of the juridical framework of the multiple bank. The significance of the 1988 IBRD project lies in the fact that its agenda was, largely implemented in the state government bank domain. This multilateral agency continued to advocate these policies and agendas for the evaluation and continuity of their implementation. Evidence of this are the Seminar on the Evaluation of the Privatization of State Banks, held in Washington, in 2003, and the persistent influence of that agenda is revealed by the fact that the monetary authority still listed the flexibilization of mandatory credit allocation as the first additional measure to reduce bank spreads (BCB, 2004).

In the early 1990^s, the fate of federal public banks gradually acquired more precise contours inside the administration. Establishment of the Managing Committee of the Federal Public Financial Institutions (Comif) in 1993 suggested the way economic authorities had devised to centralize control of credit policy instruments. These institutions appear in several economic plans. The Short Term Plan, designed by Minister Paulo Haddad, for example, recorded that more than half of the system showed an excessive participation of the State; the Prompt Action Plan, launched when Cardoso became the Minister of Finance, suggested “control and strict supervision of state government banks and “clean-up” of the federal ones.

Brazilian policy makers thereby established doctrinal grounds for their intervention. The canonic view that grounded the official approach of the reform of public banks was presented in Lundberg (1993), where the following disjunctive was established. Either public banks restrict themselves to the role of development (assigning priority to passing through tax resources and being deprived of business autonomy for a new commercial and competitive phase) a circumstance in which they appear as a case of public finance; or we have a financial system case, subordinated to Central Bank regulations and without differences that could give them advantage *vis-a-vis* banking institutions. The purpose of this formulation, evidently, was to delimit the field of analysis of fiscal and parafiscal issues, on the one hand, and the management of the monetary and credit policy, on the other – both subordinated to the approach that would ground the stabilization program under consideration.

For monetary authorities, the public federal and state government banks served as a transmission channel for the losses incurred by the private sector

9 McKinnon (1993), one of the most representative works of this current, envisages this course correction. In the nineties, the vision of sequencing gained space to the proposal that prescribed a simultaneity of reforms.

and for state budget imbalances that eventually found their way into the Federal budget. The asset deterioration of state government banks and the remediation with funds from the central government led the Central Bank (BC) to see them as “currency issuing institutions” conflicting with monetary policy objectives: “... they can’t continue as twenty five virtual currency issuing banks, in parallel to the Central Bank”. (BCB, 1993, p. 33) Diagnostics mixed, when Central Bank President Loyola said that the federal banks would be “... another manifestation of the same phenomenon /.../” but, “... the most significant difference between these two segments of public institutions lies in the economic-financial scale of each one of them (Central Bank Brazil, 1993, p. 31-32). A similar study goes back to this approximation, as stated below:

The official federal banks act as independent federal expenditure generation units, and in them we can detect problems similar to those observed in the state government banks. Obviously, once the final control of such expending units is in the hands of the federal executive branch of the government, the problem posed by lack of coordination may be mitigated, but not entirely avoided.” (Fraga; Werlang, 1995).¹⁰

Strictly speaking, the problems of each group of institutions was distinct because federal banks were principally focused on funding the private sector, while most state government banks, got to the point of serving predominantly to fund their controlling shareholders – state governments. Furthermore, Federal Treasury securities were obviously better than their provincial counterparts. Therefore, a hypothetical small federal bank practically, or conceptually, would correspond to a large state government bank. But, at that time, the official proposition was not groundless, considering that it served the objective of subjecting the whole issue to the same conventional framework.

Behind the “public finance x financial market” disjunctive, was the model of inflationary financing of the public deficit that served as the theoretical center of gravity of official banking theory. Bacha (1994), particularly, whose diagnostic influenced the formulation and the official discourse of the Real Plan, presents the inflation existing at that time as an “*ex-ante*” deficit as the gap of payments corrodes the value of budgetary expenses and makes them compatible with revenues.

Last, that an unexpected convergence must be observed. Naturally, bills that competed in Congress for regulation of the financial system tackled the issue of the intersection between the fiscal and banking domains. It is significant to note that the proposal advanced by the Central Bank incorporated the wording of the Workers Party’s bill,¹¹ establishing for public banks a principle of transparency

10 According to the authors, the paper was written in 1992. Noting that it was published in 1993 and in 1995.

11 The so-called “Central Bank project”, prepared by the same Eduardo Lundberg and others, did not bear the official seal, but publication was authorized as coming from “a group of civil servants”. Bill 117/19 was viewed as the leading project from the left wing, was submitted by Congressman

based on the accounting segmentation of funds from a public source (either fiscal, budgetary or compulsory savings) *vis-a-vis* those funds mobilized and invested under commercial criteria. This principle would later inform policies of the administration (1995 - 2002) for federal banks.

The restructuring program under the real

The restructuring of public banks comprised two distinct programs, one for state government banks and another for federal bank.¹² In 1994 the Central Bank placed the largest of all state government banks, Banespa, under federal intervention,¹³ and in the following year the Program of Support to the Restructuring and Fiscal Adjustment of the States (Parafe) was launched,¹⁴ establishing conditions and adjustment targets in exchange for financial aid lines for the states and their respective banks. The final step would be taken in 1996, with the Program of Encouragement to Phase-out of the Role Played by the Public Sector in Provinces (states) in Banking Activities (Proes),¹⁵ whose main objective was privatization, extinction or transformation of state government banks in non-banking development agencies, foreseeing allocation of resources to the states to fund their debts with their respective banks. Together, the Parafe and the Proes represented to the states financial aid that added up to R\$ 103.3 billion; the declining participation of the state government banks in the financial system suggests how these programs transformed the banking sector.¹⁶

In the case of the federal banks, the centralization of command was less traumatic. The election of Cardoso to the presidency in 1994 was followed by disputes over the appointment of top management of these banks; once this obstacle was overcome, the economic authorities started to command them directly through their respective Board of Directors, chaired by its representatives. This relegated the Comif to a secondary role. From this point on, the content and the doctrinal basis on which the reform of these banks was grounded in an approach that differs from the one enforced for the state government banks.

José Fortunatti (at that time PT/RS) and drafted by the current executive secretary of the Ministry of Finance, Bernard Appy.

12 For a more general analysis of the indebtedness of state banks in the nineties, in which the privatization of these banks is inserted, see Lopreato (2000). Ness Jr. (2000) analyses the privatization of the state banks from the stand point and, if it has the merit of highlighting the different treatment given to federal and state banks, fails to present to any explanatory hypothesis.

13 Intervention that meant removing the Board and placing the institution under a Special Temporary Administration System (RAET); also in 1995 three other state banks were placed under the Raet system: Bemat, in Mato Grosso, Beron, in Rondônia and Produban, in Alagoas.

14 (14) Cf. CMN vote 162/95 and subsequent ones, later on expanded by MP 1.560, issued on December 19, 1996, changed into Law 9.496/97.

15 Originally MP 1.514, issued on August 7, 1996, subsequently regulated in February 1997.

16 Just in the 1997-1998 biannual period, the relative weight the sector had come down from 20,2% to 11,6%, mostly because of the privatizations (Brazil Central Bank).

The documentary evidence of the program designed for the reform of federal banks is found in the Technical Note MF-020,¹⁷ which comprises a comprehensive set of guidelines targeting the establishment of “the strategic missions of these corporations, their objectives, adjustment parameters and action lines.” Four sets of issues are identified in this document: Reason for existence and entrepreneurial nature; efficiency; the identity and mission of each bank, and last; diagnostic and recommendations.

Reason for existence and entrepreneurial nature

The most important novelty in comparison to the position existing prior to the Real Plan was the explicit recognition of a strategic role for the federal banks. The document stated:

(...) federal administration financial agencies, within the current context and in the foreseeable horizon, are justified as tools for the enforcement of its credit policy and as National Treasury agents, complementary to the financial system, for reasons of strategic safety (NT020).

Such recognition may have been facilitated by the 1995 banking crisis, when the large federal banks welcomed depositors that were running away from small and medium size private banks and provided liquidity to large banks facing difficulties. The complementary nature assigned to their strategic status was, strictly speaking, inappropriate from the point of view of financial repression theory; either because the federal government banks are responsible for an expressive share of the credit offer, or because there is an organic and dynamic relationship between the federal government banks and the remainder of the system.

The intertwining of the development action of the federal government banks and the commercial actions of private agents – either the articulation in a microeconomic point of view via pass through of BNDES lines through the public and private banking systems, or in a macro one, via the multiplying effect of the activities funded by BB and CEF in the establishment of a demand for the other banks – implies recognition of the central role the federal government banks play in the system. Their counter or pro cyclical action affects liquidity in the economy as a whole, making hard to understand the evolution of private banks observed separately. In doctrinal terms, it would be more appropriate to recognize the mixed nature of the system in terms of capital ownership, origin of funds and intermediation

17 Technical Note 020 issued by the Executive Secretariat of the Ministry of Finance, on July 23, 1995, is a succinct document signed by the executive secretary with the “agreement” of the Minister of Finance, respectively Pedro Parente and Pedro Malan. Originally an internal document of the federal administration, it became public in 1995, when it was disclosed and discussed in the National Congress. Hereinafter called simply NT-020 or Note, in this section the highlighted texts are quotes from this document.

channels. In any case, the context and the buffering become accessories when the strategic condition of the federal government banks is recognized.

Another issue that stands out in the Finance Ministry Note is the statement that federal administration credit policies should be conducted by public banks, assuming the task of maintaining such policies, which, in turn, only make sense in different conditions from those enforced by the private sector. Here also the official position conflicted with the theory of financial repression.

On the other hand, “the social bank, a figure non-existent in doctrine or practice” was disclaimed. Or yet: “Social role is autarchic, moored on the fiscal budget. Be it public or private, a bank is a bank. A bank must generate results, profit, which in the case of public banks, is changed into tax income the government can use to achieve its social targets.” Thus, in dialog with some stealth version of economic populism, the thesis of the disjunctive between public finance and the financial system reappears; now, however, the accounting segmentation of resources and lines managed in the interest of the government enters the very structure of state-owned banks.

It can easily be seen that the issue just moved to the dividend and investment policies. Although the functionalist reasoning of the document is not conducive to the understanding of the contradiction between the public and private dimensions of the state-owned bank, what is actually important is that it does not fail to grasp the indirect public meaning of competitive action: state banks generate profit, but the destination of this surplus is subject to decisions that are not necessarily derived from a drive for “private” accumulation. Another passage has the same meaning:

“Thus, the redefinition of the functions of the federal banks *assigning priority to the strategic mission, and their consequent adjustments and redesign.*”

Therefore, the public nature, the strategic mission and related expressions indicate that ownership of capital state or private instead of being innocuous, affects the rationality, the operational profile, the performance and the dynamics of the expansion of Federal government banks.

Microeconomic efficiency

Note MF-020 also refers to the role microeconomic efficiency assumes within this conceptual space. Contrasting with the social nature of public banks, the document highlights the need to achieve results that are compatible with private financial activity. Such requirement, however, appears as a *condition* for the very existence of state-owned banks: “Without losing sight of the political factor which naturally touches these institutions, their soundness as enterprises is critical to enable them to achieve assigned objectives”. This requirement is translated into criteria applicable to the performance of each banking business segment: commercial, investment and service rendering. In the commercial segment, the Note prescribes that profitability indicators must be equivalent to those achieved

by the average of private banks; therefore, added value is required. In the case of the development or investment action, banks should at least preserve their assets; therefore they would not be fully subject to the business imperative. As to service rendering: “the tax function enforced, to the interest of the controlling shareholder, should be a budgetary burden of the government”.

This hermetic separation between the three segments can be understood as part of the objectives of imparting transparency to the internal flow of resources and curtailing the cross-subsidy possibility; preventing state-owned banks from using the returns from commercial operations in other dealings with an allegedly social interest, consequently draining away the discretionary power of business bureaucracy. Without touching on background issues, mention should be made of the limitation of such a principle given the possibility of combining instruments (commercial lines, investments, assorted services) in more complex operations. Ensuing results could even be the opposite of the ones the official discourse claimed to avoid: use of the lines and social resources to *further* commercial results. The summary of the path followed by federal banks presented in section 2 of this paper does not consider this hypothesis, although theses such as “hidden privatization” theory (Cecon-Unicamp, 2000) come close to it.

Identity and mission

As to the institutional identity or mission of each federal bank, under NT-220, BB would remain as “a federal financial conglomerate” with specific functions of agricultural-industrial development, foreign trade furthering, relationship with the international financial market and acting as the main financial agent of the National Treasury”. CEF, in turn, would be kept as “the federal financial agent in charge of urban and housing development, sanitation and infrastructure; provision of services, including management of funds and programs; and also acting as a retail bank focused on support to its essential activities”. BNDES was to continue to be a development agency, “with national reach, with a special focus on the development of the productive sectors and infrastructure”. However, *Banco do Nordeste* and *Banco da Amazônia* would be turned into development agencies, losing their commercial activities and respective operational structures – which eventually was set aside because of the strong resistance faced.

The official program, therefore, intended to redesign the pre-existing structure of the federal banks, with the exception of Banco Meridional (Meridional Bank), which was privatized in 1999. The framework defined by the program is enough to establish a clear difference from the proposals that targeted state government banks. Certainly, the renewal of the “strategic mission” assigned to those banks was conditioned to forceful adjustments; notwithstanding, privatization and the replacement of some of their duties by private institutions, received, at most, little attention.

Diagnostic and prescriptions

Last, a picture of multiple dysfunctions was drawn in finance ministry NT220: overlapping roles, deleterious competition between the federal government banks, self-destructing and inefficient network of offices and branches, burdensome administrative and structures, etc. Besides the accounting segregation between banking and fiscal functions, the Note recommended modernization of management, particularly for the cost system and credit recovery efforts, aggregating the establishment of a risk central internal to the banks, rating of borrowers and curtailment of the political factor in the process of granting of resources. The oversized network, with deficit burdened branches in small and medium size towns, should be revised and given increased flexibility, exploiting the complementarity that existed between Federal government banks. Exceptional treatment for balance sheets and for doubtful transactions should be eliminated.

A crucial point was then reached, that is, the financial relationship and asset adjustment with the Treasury. First it was said that explicit or non-explicit funding to the controlling shareholder should be stopped or, given the fact that these banks by law were prevented from granting loans to the controlling shareholder (BB, since 1964), the issue was basically the compensation of the use of bank resources in transactions of interest to the government. Reciprocally, any credits held by the banks against the National Treasury and other entities would be subject to an adjustment of values, which was critical to the financial health of Federal Government Banks. This was to be carried out just after the redefinition of roles and adjustments.

In conclusion, with Technical Note MF 020/95, the government itself presented a structural justification for the existence of federal banks and designed actions targeting a future capitalization of these banks, conditioned to the administration of a high dosage of enterprise rationality to the *modus operandi* of this set of institutions. The text also stated that issued guidelines should be deepened by a study to be carried out by a consulting firm, preferably by an international firm.¹⁸ Seen in perspective, the Note is confirmed as the “guiding thesis” of the process of restructuring of federal banks in the last decade. Even if its enforcement had to face the vicissitudes of the period, it has anticipated with reasonable accuracy the most relevant aspect of that process.

Program theoretical affinities: the “efficient intervention”

As to state government banks, the theoretical and practical debate converged to their virtual suppression. In the case of federal government banks, the program

18 Carried out only in 1999 by the consortium Booz Allen & Hamilton – Fipe-USP –, which was not taken into account here because within the scope of the research for this paper no relevant result linked to it was detected. Costa (2000) discusses the study based on used methodology.

put into practice by the mid-nineties reaffirmed in several senses that these institutions were necessary, conditioned to microeconomic efficiency criteria. More than just a document, the relevance of the program outlined in Technical Note 20 lies in the fact that it actually guided the process of restructuring and reform of federal banks in the last decade. In the absence of explicit references to theoretical grounds, we start from the assumption that the theses on federal banks differ from the theoretical focus that guided the minimization of the state banks.

On the one hand, the public sector economy of the restructuring of the state government banks, governed by a monetary focus on the deficit, relied on a political and federative analysis according to which state government banks were less controllable and, hence, potentially more prejudicial to fiscal adjustment that was said to be critical for stabilization. The hypothesis of efficient financial markets contained in the financial repression theory appeared to corroborate that approach, anchoring a proposal of liberalization that would suppress instruments capable of distorting interest rates and efficient capital allocation.

On the other hand, in the case of IFPFs, maintaining federal government owned institutions and instruments, their strategic role, compulsory savings funds, and directed credit allocation, which had been preserved in the official project, were economic policy decisions requiring correspondence in another theoretical field. Their tacit assumption is that Brazilian financial markets are so far from efficiency conditions to the point of requiring the presence of the State in enterprise form, although the performance of the public sector should be itself subject to efficiency criteria. We are, therefore, considering the theory of efficient intervention and if any theoretical body must be presented as its substrate, the natural candidate is the approach to market failures, more specifically the agenda grounded on the information asymmetry concept.

Conventional economic theory considers government intervention in cases like offerings of public assets, natural monopoly and market failure. The current in the literature that starts from information asymmetry broadens the scope of the latter possibility, enriching the theoretically legitimate forms in which the state should act in various economic spaces including even, at the extreme limit, direct state intervention when development requirements face inexistent or incipient markets. Although not all market failures require state intervention, they represent its fundamental justification. And to the orthodox counter criticism of “government failures” the standard rebuttal is that just any intervention is not enough. Intervention must be well designed and implemented.¹⁹

When discussing the hypothesis of efficient financial markets, Stiglitz (1994) assumes that possessing information entails costs and is, thus, asymmetrically distributed among economic agents. As a consequence, information-intensive

19 A competent review of this discourse, from the evolutionist stand point, can be found in Chang (1994).

markets are not perfectly competitive, but inherently flawed. As, qualitatively speaking, financial markets depend more on information than the other ones, they are endemically affected by flaws; furthermore, as it corresponds to the “brain” of the economic system and chief decision making *locus* when it comes to investment and production in other markets, the economy as a whole is incapable of efficient operation. Thus, with a conventional micro-foundation of a sub-optimum balance in the hypothesis of informational costs, Stiglitz progresses to prescriptions of diverse state action where, note should be taken, the direct enterprise presence, is said to play a quite subsidiary role.

Stiglitz also criticizes the inability of adepts of financial repression to distinguish, in theoretical terms and in their practical consequences, a moderate repression, generally desirable, from a deleterious degree of financial repression. To financial repression in some segments – real estate financing in a cycle that could pose a threat of significant appreciation of these assets – could correspond the credit encouragement to other production sectors, emphasizing that counter-cyclical state policies could both foment and prevent repression.

The boundaries of the new-Keynesian agenda seem to be close to this point. This recommends, first, a relativization of the exercise of extracting grounds for the process of restructuring of federal banks from the above theories. Second, a view of a corrective or supplementary intervention in the flaws and gaps of the market would hardly serve as theoretical defense of a set of enterprises which, once adjusted to the parameters of an efficient intervention and with the context of its public character duly updated, would point to the *adequacy* of the state to the role of major banker or financier of the Brazilian economy. Before that, these arguments could subsidize a criticism that would curtail the action of these institutions, emphasizing an alleged state of susceptibility to the problems of adverse selection, moral hazard and others. The analysis of how “efficient management” could make public banks less prone to credit rationing, for example, would tend to put limits on that agenda. Moreover, and ultimately, a survey of the strategic role of these institutions in financial markets and in the Brazilian economy, among other pertinent issues, would require a reconstruction of problems within another conceptual framework.

Conclusion

This paper demonstrated that the approach to the issue of public banks adopted by the Brazilian government was, initially, inserted in the framework of a broad reform of the financial system, conceived late in the 1980^s, with inputs from the financial repression theory. In the first half of the 1990^s, official banking doctrine delved into the macroeconomic the relations between fiscal and monetary policy, appearing as a by-product of the dominant view on the subject. It was precisely this view that subsidized the restructuring of state government banks after the

Real Plan. Partially following that same approach, the restructuring of federal government banks, however, broke away from the hypothesis of the efficiency of financial markets. Its program imparted a strategic character to the existence of public banks, conceiving them as instrumental for credit allocation policies. Thus, a relationship can be identified between the way in which the process was conducted and a current of the new-Keynesian approach, in the light of an implicit thesis we call efficient intervention.

Note should be taken that theoretical affinities or gaps between the bank restructuring policy enforced by the Brazilian government and several economic theory matrices were identified. Naturally, no single set of official proposals claims such links, nor mirrors, in pure form, the underlying theoretical hypothesis. Also, no survey of the academic production of policy makers and other economic policy topics was carried out. In order to identify affinities, in this paper the author decided to focus on the dominant traits of each of the moments of the restructuring of public banks, from the end of the 1980^s to the beginning of the current decade.

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Chapter 7

Still the Century of Government Savings Banks? A Case Study of the Brazilian Federal Government Caixa Econômica Federal¹

Kurt von Mettenheim

“The function of a savings bank, in fact, is not to serve as an institution for investing money. Its business is to enable people to put money aside and even to build up a little capital. But when this capital has been formed, if the depositors wish to invest it – that is to say, to make a profitable use of it – they have merely to withdraw it: the rôle of the savings bank is ended, and it rests with other institutions such as we have already studied in dealing with banks and credit establishments, to take charge of it.”

Charles Gide, *Principles of Political Economy*, London: George G. Harrap & Co. Ltd. 1924, p. 510 (1st ed. 1906)

The original intent of savings banks was to teach popular classes the habit of saving, increase the liquidity of capital, and spur economic growth.² Government savings banks were founded in France (1818), Austria (1819), and several German states (1835) while government guarantees provided incentives for a variety of private, community, cooperative, and mutual savings banks in the Netherlands, England, Italy, and the United States. In 1906, almost a century after the *Caisse d'Épargne* was founded in France, Charles Gide argued that savings banks should serve a limited role, comparable to piggy banks in terms of collecting small amounts of capital and savings. What happened? The first Brazilian government

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2 The author thanks Lourdes Sola, Maria Rita Loureiro Durand, Eduardo Kugelmas, Maria Antonieta Del Tedesco Lins, Laurence Whitehead, Leslie Bethell, Valpy Fitzgerald, Peter Evans, Mariano Laplane, Jenny Corbett, and faculty and students of both the Escola de Administração de Empresas de São Paulo - Fundação Getúlio Vargas and University of Oxford Centre for Brazilian Studies for comments. Suggestions by an anonymous reviewer of the RBEP were especially helpful. Financial support for research was provided by the Núcleo de Pesquisas e Publicações of the EAESP-FGV and the University of Oxford Centre for Brazilian Studies. André Carvalho and Tatiana Benítez provided research assistance.

savings bank (*Caixa Econômica e Monte de Socorro*) was founded in 1860. If savings banks are temporary and limited in character, why are an estimated 70 percent of Brazilians still *sem conta*, that is to say bankless, without checking accounts, savings deposits, or bank cards? If other banks and credit institutions are more efficient, why do government savings banks still provide roughly 20 percent of credit in Brazil and retain over 20 percent of savings deposits? And why, after two decades of a Washington Consensus about the need to privatize state firms and liberalize (especially financial) industries, is the *Caixa Econômica Federal* still the third largest bank in Brazil (depending on measure)? In June 2004, the *Caixa* maintained 60,402 employees, 2013 branches, more than R\$82 billion in deposits, and over R\$166 billion in assets.³

Like corporatism, government savings banks appear to have outlived their predicted usefulness on the road to developed markets, societies, and polities.⁴ Are these institutions still necessary to counter the imperfections of markets and private banking? Alternatively, are critics of government banking right that these institutions cause financial repression and reproduce underdevelopment? For La Porta and theories of financial repression in the tradition of Gurley & Shaw, it is precisely the continued presence of government credit that crowds out more efficient allocation of resources through markets.⁵ These opposing theories about government banking frame this chapter.

This chapter reviews both government savings banks in Brazilian history and the reorientation of the *Caixa* since capitalization in 2001. Secondary accounts and primary data suggest that government savings banks expanded under Empire from 1860-1889 but declined during the economic liberalism of the Old Republic (1889-1930). After the 1930 revolution, government savings banks became central to national populist strategies of capital mobilization and industrialization. Balance sheet problems during the late 1950s appear to be due primarily to the impact of rising inflation that led depositors to withdraw funds from savings accounts (earning fixed six percent annual returns), while administrative costs also suggest management errors. After the breakdown of democracy, the indexation of savings led to a recovery of deposits at government savings banks while reforms in 1970 centralized control over bank policies. During the 1980s, the *Caixa* dramatically increased its market share of domestic lending to public and private sectors, suggesting that high inflation and macroeconomic instability left the bank as one of the few major lenders. Since costly capitalization of the bank in 2001, the *Caixa*

3 Caixa Econômica Federal, "Demonstrações Contábeis", June 2004, p. 2.

4 The reader will note the title of this paper paraphrases: Schmitter, Philippe. "Still the Century of Corporatism?" *Review of Politics*. Vol. 36, (1974), pp. 85-131.

5 La Porta, Rafael (et al). "Government Ownership of Banks." *Journal of Finance*, Vol. 57, no. 1 (2002), pp. 265-301, J. Gurley & E. Shaw "Financial aspects of economic development", *American Economic Review*, Sept. 1955, pp. 515-38.

continues to focus on core business in housing, urban development, sanitation, and as agent for government social policies. Since 2001, a sanitized portfolio combining high interest bearing government paper and low interest savings deposits has helped produce strong profits,⁶ permitting the bank to pursue a dual strategy of expanding both investment bank operations and new popular credit and savings programs. The *Caixa* thereby provides a critical case study for the ability of governments to encourage popular savings without crowding out market forces or succumbing to the politicization of credit. This chapter is necessarily exploratory because no academic study of this institution or its predecessors appears available since manuscripts left by administrators of the bank decades ago.⁷

This case study is also constrained by the need for broader reassessment of banking in Brazil. Liberalization, privatization, and a wave of direct foreign investment during the 1990s have produced a new Brazilian financial system. However, far from confirming assumptions about the superiority of foreign banks (or similar fears of imperialist domination) both the content and consequences of reforms during the 1990s differed in important respects from neo-liberal theory and policy. In 1995, the Cardoso government reduced protection of domestic finance set in the 1988 Constitution, permitted foreign participation in privatization auctions, and provided new incentives for foreign investment in financial industries. From 1994 through 2002, direct foreign investment in the financial sector summed to US\$19.8 billion (fifteen percent of total DFI). Meanwhile, the adjustment of banks to the end of high inflation required government programs to save and sell failed private banks (PROER, 1995-97), to privatize deeply indebted state government banks (PROES, 1997-99), and to capitalize and reform federal government banks (PROEF, 1999-2001). The Central Bank of Brazil also introduced a variety of new initiatives to improve the supervision and monitoring of banks and credit risk.⁸

Banking itself has also changed dramatically, especially in terms of substantial cost savings through electronic card technology, the introduction of automated teller machines (ATM's), and electronic transfers. Paradoxically, Brazilian banks modernized quickly during the late 1980s and 1990s because of large gains under

6 I thank a RBEP reviewer for this reading of Caixa balance sheets.

7 Souza, Henrique A. *O Crédito Imobiliário da CEF*. Masters Dissertation, Escola de Pós-Graduação em Economia, Fundação Getúlio Vargas, 1992, Lyra Filho, *O Estado Monetário*. Rio de Janeiro, Irmãos Pinotti, 1948, Henrique, João. *Estrutura e Conjuntura das Caixas Econômicas Federais*. Rio de Janeiro: Conselho Superior das Caixas Econômicas Federais, 1960 and De Plácido e Silva, *As Caixas Econômicas Federais: Sua História, Seu Conceito Jurídico, Sua Organização, Sua Administração e Operações Autorizadas*. Curitiba: Empresa Gráfica Paranaense, 1937. Analysis of primary sources such as the *Revista das Caixas Econômicas Federais* (1949-?), Annual Reports (1935?-), and the *Boletim Estatístico*, (published by the Consultoria Técnica das Caixas Econômicas Federais) will be needed to better understand the evolution of government savings banks in Brazil.

8 Study of the Central Bank of Brazil is beyond the scope of this study. See: Whitehead, Laurence and Lourdes Sola, eds. *Statecrafting Monetary Authority: Democracy and Financial Order in Brazil*. Oxford: Center for Brazilian Studies (Forthcoming 2005).

high inflation. As Goldfajn et al note, strong earnings from investing consumer deposits in indexed instruments: “induced banks to expand, open new branches, offer “free” bank services and develop a high degree of technological progress, especially aimed at enhancing the speed of transactions.”⁹ This trajectory of banking before 1994 helps explain the different impact of financial liberalization thereafter: The modernization of Brazilian banks – private and public – occurred not because of financial liberalization but prior to it during the prolonged period of high inflation and indexation during the 1980s and early 1990s. Timing matters because seemingly minor differences can create enduring comparative advantage.¹⁰

Bank change sets the context for this study, but the primary focus is on the political economy of savings banks and social inclusion. This chapter explores the viability of shifting credit and banking policies toward a fundamentally new direction that accelerates social inclusion by basing policies on core concepts of social justice and citizenship as well as market utility and property rights. Recent studies of micro-credit suggest that risks associated with popular credit differ from risks involving middle class groups, large economic interests, and political machines. Commercial banking in Brazil and abroad has found that higher default rates in popular credit are more than compensated by higher profit margins and the greater pulverization of risk across a larger number of clients. From this perspective, new programs of popular credit appear more viable and less prone to default than past experiences with program lending, subsidized middle class housing loans, and large loans to select enterprises that have haunted federal bank balance sheets. These broader concerns about banking are at the center of public policy debates and economics. Since the landmark contribution of Stiglitz & Weiss, economists have attempted to understand the impact of private bank lending practices on social exclusion in advanced economies.¹¹ In 2001, the US Senate Banking Committee commissioned inquiry into predatory lending practices while, in 2004, the American Political Science Association commissioned a task force to study the causes and consequences of increasing inequality.¹²

These matters cross the disciplines of political economy, political sociology, political theory, financial economics, and banking studies. However, far from proposing radical reform, this chapter is based on a gradualist conception of politics that emphasizes the opportunities for building on existing social policies and institutions. Given the creation of new social policies since transition from

9 Goldfajn, Ilan (et al). “Brazil’s Financial System: Resilience to Shocks, no Currency Substitution, but Struggling to Promote Growth,” Central Bank of Brazil Working Paper 75, June 2003, p. 5.

10 Zysman, John. “How Institutions Create Historically-Rooted Trajectories of Growth,” *Industrial and Corporate Change* Vol. 3, (1994), no. 1, pp. 243-283.

11 Stiglitz, Joseph and Andrew Weiss, “Credit Rationing in Markets with Imperfect Information,” *American Economic Review*, (1981), Vol. 71, pp. 353-376.

12 Jacobs, Laurence et al. *American Democracy in an Age of Rising Inequality*. Washington, DC: American Political Science Association, 2004 available at www.apsanet.org.

military rule in Brazil, and new realities of information technology, banking cards, and well organized data bases in government agencies, the gradual expansion of existing programs of popular credit and grants toward broader policies of basic income seems compelling in terms of social justice, sound in terms of economic theory, and essential in terms of political socialization.¹³

This study thereby combines a historical-institutional approach with concerns of empirical democratic theory. Historical institutionalism explores compelling problems about politics and society through analysis of institutions (such as the *Caixa*) across time.¹⁴ Empirical democratic theory focuses on how social classes are, or are not, incorporated into political institutions during modernization.¹⁵ Although often perceived as conservative or elite oriented, empirical democratic theory draws attention to the unfinished business of popular incorporation in Brazil. It is precisely the dramatic distribution of Brazilians in terms of IBGE social classes – more simply the persistence of poverty -- that suggests the importance of institutions such as the *Caixa* as agents for social inclusion. These matters converge on questions about democracy in political sociology because of the reality that social classes C, D, and E form a large majority of Brazilian voters. In sum, if statecraft shall continue to deepen the attachment of Brazilians to representative government, democracy, and markets, then more dramatic policies of money, credit, and income are necessary. In this respect, the *Caixa* (and other federal government banks) appear to provide considerable comparative institutional advantage for deepening financial markets, citizenship, and democracy in Brazil.

Government Savings Banks in Brazilian History

The first Brazilian government savings banks were modeled after European banks, especially the French government savings bank, *Caisse d'Épargne*.¹⁶ Private savings banks appear to have been created as early as 1831¹⁷ to encourage

13 Van Parijs, Philippe. "Basic Income: A Simple and Powerful Idea for the Twenty-First Century." *Politics & Society*, (March 2004), Vol. 32, pp.7-39, Pateman, Carole. "Freedom and Democratization: Why Basic Income is to be Preferred to Basic Capital." in Dowding, Kieth, et.al. (eds.) *The Ethics of Stakeholding* London: Palgrave, 2003 and Barry, Brian. "Real Freedom and Basic Income." *The Journal of Political Philosophy*. Vol. 4, (1996), pp. 242-276, Suplicy, Eduardo M. "Renda Básica: A Resposta Está Sendo Soprado pelo Vento," *Brazilian Journal of Political Economy*. (2003), Vol. 23, no. 2/90, pp. 47-62.

14 Mahoney, James and Dieter Reuschmeyer, eds. *Comparative Historical Analysis in the Social Sciences*. Cambridge: Cambridge University Press, 2003.

15 Dahl, Robert Alan. *Polyarchy*. New Haven ; London: Yale University Press, 1971, Huntington, Samuel P. *Political Order in Changing Societies*. New Haven, CT: Yale University Press, 1968.

16 On savings banks in Europe, see: Butzbach, Olivier. "Varieties within Capitalism? A Comparison of French and Italian Savings Banks, 1980-2000." Paper presented to the Society for the Advancement of Socio-Economics, Aix-em-Provence, June 2003.

17 Founded by José Florindo de Figueiredo Rocha, according to Rocha, Alfredo. *As Caixas Econômicas e o Crédito Agrícola*, Rio de Janeiro, 1905.

the gradual accumulation of savings among laborers.¹⁸ Thirteen private and public savings banks appear to have been created during the Empire.¹⁹ The *Caixa Econômica e Monte de Socorro* was founded in 1861 as part of a series of provisions concerning banks of issue, money, and regulation of financial institutions set in Decree 1083 of August 1860. The impact of this decree has been widely debated, but it set three simple rules for government savings banks: Deposits were limited to Cr\$4:000 per week; total deposits were limited to Cr\$50:000; and interest on savings was fixed at six percent per year. In 1861, the government guaranteed *Caixa* deposits, subordinated these banks to the Finance Ministry, and described their mission as: “...responsibility for receiving deposits of popular savings and capital reserves across the Brazilian territory to increase their liquidity, encourage saving habits, and facilitate the development and circulation of wealth.”²⁰ Government refusal to increase the Cr\$4:000 weekly and Cr\$50:000 total limits to deposits suggests that popular savings remained the core business of *Caixas*.²¹

The fate of *Caixas* during the Old Republic (1889-1930) appears to confirm the limited role of these institutions granted by economic liberalism. Although data is short, the *Caixas* appear to have “returned to a corner of some public agency” during this period of oligarchic machine politics and orthodox economic policies.²² Legislation passed in 1915 apparently increased the limit for weekly deposits and loans (after a period of high inflation) and freed the bank to conduct other types of financial business. In sum, bank change and policy debates appear not to fit cleanly into the standard chronologies of Brazilian history. Debates during the Old Republic led to measures after the 1930 revolution designed to expand public savings banks and credits. Furthermore, these proposals appear to have been developed during

18 José Francisco Sigaud, *O Homem Benfazejo ou das Vantagens que Resultam da Fundação da Caixa Econômica dos Povos Civilizados*. Rio de Janeiro: Tipografia Imperial e Constitucional de Seignot-Plancher & Cia. Vol. XII Biblioteca Constitucional do Cidadão Brasileiro, 1832.

19 De Placido e Silva cites the following dates and institutions: Caixa Econômica de Campos (1834), Caixa Econômica da Capital da Província da Bahia (1834), Caixa Econômica de Ouro Preto (1838), Caixa Econômica ou de Socorro da Província (Pernambuco, 1847), Caixa Econômica de Valença (1860), Caixa Econômica e Monte de Socorro (Rio de Janeiro, 1861), Caixa de Economias, (Salvador, 1853?), Caixa Econômica da Cidade de Nazaré (1854), Caixa Econômica da Cidade de Maceió (1856), Caixa Econômica de Santos (1857), Associação Econômica Auxiliar, (Rio de Janeiro, 1872), Caixa Econômica Auxiliar da Associação Mútua de Seguros Sobre Vidas Perseverança Brasileira, (Rio de Janeiro, 1874), Caixa Auxiliar da Sociedade Anônima Garantia do Futuro, (Rio de Janeiro, 1874).

20 Decree 2723 January 1861, cited in De Placido e Silva, op. cit.

21 *Caixas* expanded from the center to the provinces during the Empire. In 1867, Finance Minister Visconde do Rio Branco authorized Provincial Presidents to retain one percent of lottery receipts to offset administrative costs of savings bank agencies, while reserving one percent of deposits for the treasury. Legislation in 1874 encouraged pawn services at agencies (reversed after 1892 under republican government in several states). In 1886, an initiative sought to place government savings bank agencies within or alongside already existing government bureaus and post offices, while 1887 legislation called for creation of *Caixas* at all *Mesas de Rendas Coletas* and/or postal agencies.

22 De Placido e Silva, *Caixas Economicas Federais*, p. 70.

the 1920s by Alfredo Rocha and Leopoldo de Bulhões, economists traditionally associated with more orthodox liberal ideas about economic development.

Caixas Econômicas and National Populism

After the 1930 revolution, government savings banks were perceived as critical agents for social inclusion, the mobilization of savings, and economic growth. Caixa president Solano Carneiro da Cunha sought to streamline administration and expand services. In 1934, savings banks were brought under new administrative and executive councils, new financial services were launched such as mortgage credits and loans to state and municipal governments (credits to the federal government date from 1915), while the *Caixas* won both exemption from taxes levied on commercial bank transactions and official monopoly on pawn services. The bank developed guidelines for “independent” and “associated” agencies, set new procedures for administration, staff, capital reserves, and loan approval, and created promotional campaigns to encourage citizens to open savings accounts.²³ From 1934 to 1940, Caixas increased share of domestic credit markets from 6.0 percent to 10.5 percent, with loans increasing from Cr\$444.912.000 to Cr\$1.372.698.000. In sum, instead of the more limited and temporary role envisioned by Gide, policies after the 1930 revolution sought to redefine the *Caixas* as more permanent institutions capable of both encouraging popular savings and providing social assistance.

From the perspective of national-developmentalism, government savings banks were seen as institutions capable of bringing popular savings into circulation to increase the pace of economic growth through credit and investment. De Placido e Silva reports twenty-fold (nominal) increases in the value of savings deposits at *Caixas* after the 1930 revolution.²⁴ Furthermore, *Caixa* balance sheets suggest the focus of these institutions remained on urban development and low-income home loans. In 1936, of the 1623 housing loans reported by the Rio de Janeiro *Caixa*, 1050 were at the minimum value of 50 Contos, while 306 loans were made between 50-100 Contos, and 112 loans between 100-200 Contos.²⁵

Caixas Econômicas and Democracy, 1945–1964

Understanding the trajectory of savings banks after 1945 is critical given the negative perception of government banking in the systems of patronage, clientelism, corporatism, and populism that are associated with the period of competitive electoral politics that ended in military coup on 31 March 1964. The first characteristic of government savings banks from 1945-1964 of note is their sheer size. Although their

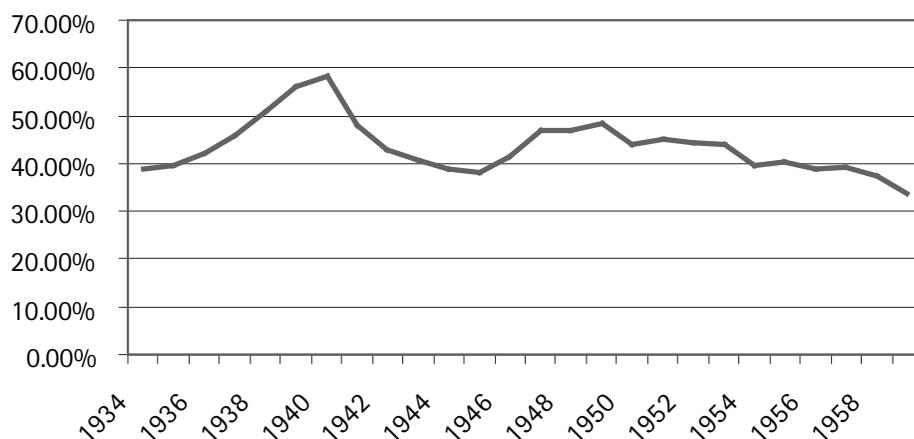
23 *ibid.* p. 232

24 *ibid.* p. 80

25 *ibid.* p. 82

share of total domestic bank deposits declined from peaks during the 1930s and 1940s, deposits at the *Caixas* during the 1950s still summed to roughly one third of the paper money circulating in the Brazilian economy. The value of deposits at government savings banks as a percentage of total domestic money supply from 1934 through 1959 reported in Table 3 suggests that these institutions remained at the center of Brazilian political economy during the post-war period of democracy. Deposits at government savings banks peaked during the national-populist regime during the 1930s at almost sixty percent of the total value of paper money reported by the IBGE.

Figure 7.1 – Deposits with Caixa Econômica Federal as Percentage of Total Paper Money in Brazilian Economy, 1934–1959

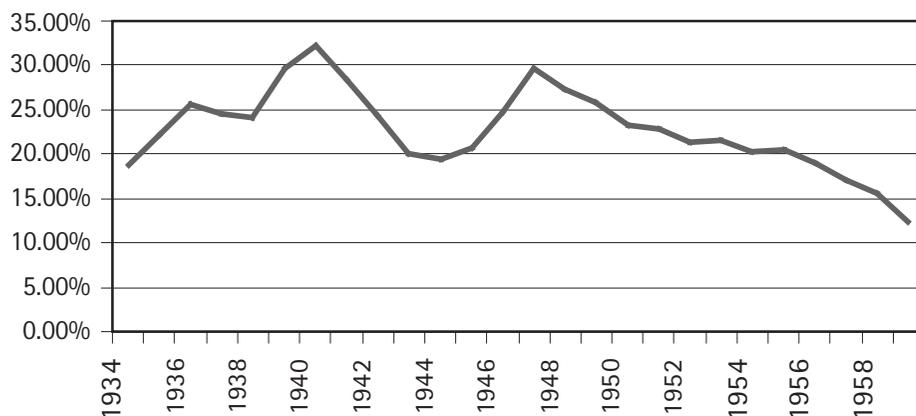


Source: IBGE, *Estatísticas do Século Vinte*, 2003 and *Caixas Econômicas*, Annual Reports, 1934–1959 (from Henrique, *Estrutura e Conjuntura das Caixas Econômicas Federais*.)

Caixa market share of bank deposits also remains at significant levels throughout this period. The share of domestic commercial bank deposits held at government savings banks increased from under 20 percent to over 30 percent during the early 1930s. After declining during the early 1940s, the market share of domestic commercial bank deposits at government savings banks rose once again during the late 1940s. This second period of increasing market share occurred after transition from the *Estado Novo* and return to democratic government. This suggests that the evolution of public savings banks in Brazil is not simply correlated with particular political regimes. Indeed, both the increase of deposits after transition from the Vargas regime in 1945 and the steady decline of the domestic share of bank deposits during the 1950s suggest that other factors (such as inflation) are at work. Given that inflation increased from 2.6 percent in 1947 to between 12 and 25 percent during the mid-1950s, and peaked at an estimated 91.9

percent during 1964, the flight of clients from savings accounts with fixed annual returns of six percent is understandable.

Figure 7.2 – Deposits with Caixa Econômica Federal as Percentage of Total Short-Term Deposits with Brazilian Banks, 1934–1959



Source: IBGE, *Estatísticas do Século Vinte*, 2003 and *Caixas Econômicas*, Annual Reports, 1934–1959 (from Henrique, *Estrutura e Conjuntura das Caixas Econômicas Federais*.)

The scale of government savings banks can also be seen in their extensive branch network that provides both significant competitive advantages and greater costs than commercial competitors. The study of federal government financial institutions commissioned by the Finance Ministry in 2000 argued that Caixa branches unnecessarily duplicated Banco do Brasil branches.²⁶ However, in historical perspective, the Caixa appears to have brought credit and financial services to regions of the country poorly served by private banking.²⁷ Data from the 1959 Annual Report of Caixas suggests that a total of 483 agencies were operating in Brazil, with 226 standard agencies, 149 postal agencies, 100 affiliated agencies, and 8 correspondent agencies across twenty Brazilian states. Data from the 1969 Annual Report suggests that agencies reached the Brazilian interior, notoriously lacking in banking services. Of the total number of 514 agencies, 163 were located in capital cities, while 351 were located in the interior of states (population breakdown not estimated). Terms for creating *Caixa Econômica Federal* Postal Agencies were

26 Booz-Allen & Hamilton - Fipe (Consortium). *Instituições Financeiras Públicas Federais - Alternativas para a Reorientação Estratégica* - Public Hearing. Brasília, DF: Ministry of Finance, June 2000

27 In 1934, Caixa Econômica Federal branch offices existed in the states of Rio de Janeiro, São Paulo, Rio Grande do Sul, Paraná, Pernambuco, Bahia and Minas Gerais. During 1945, new branches were opened in Amazon, Ceará, Espírito Santo, Maranhão, Mato Grosso, Pará, and Santa Catarina states. During 1946, new branches were opened in the states of Alagoas, Goiás, Paraíba, Piauí, Rio Grande do Norte, and Sergipe, followed by December 1956 in the territories of Acre, Amapá, Roraima and Rio Branco (from Henrique, *Estrutura e Conjuntura das Caixas Econômicas Federais*).

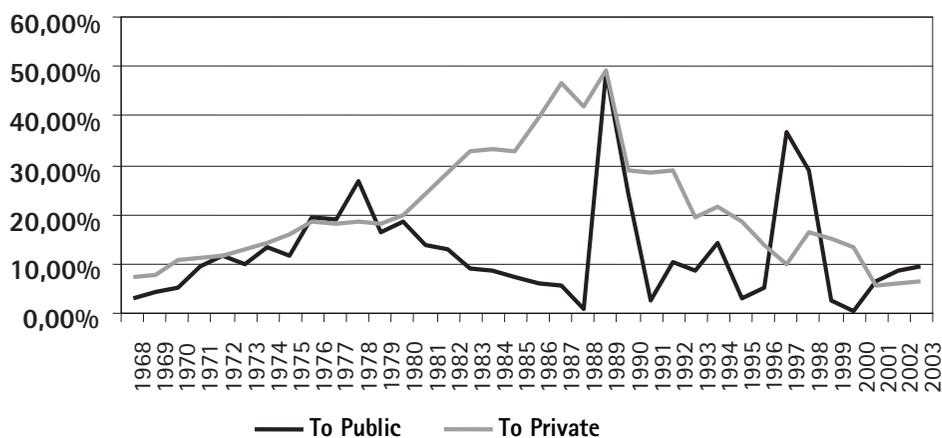
also set in November 1948 (Decree 25.733), echoing initiatives both past initiatives during the 19th century mentioned above and the government concession in 2001 to place ATM's in postal offices.

This organizational expansion appears to have pressured the balance sheets of government savings banks. Administrative costs increased above inflation during the late 1950s, especially personnel costs. From 1955 to 1959, administrative costs increased from R\$739.662.000 to over Cr\$2.3 billion, while personnel costs increased from Cr\$613.783.000 to Cr\$1.9 billion. The latter increase of 284 percent outpaces inflation during this period (228.3 percent). The dual impact of flight from deposits and rising administrative costs first eroded returns then required cash infusions from the federal government. From 1955 through 1959, returns decreased from 0.8 percent of deposits to 0.1 percent of deposits. Upon separation from the *Delegacias Fiscais* in 1946, the sum of the *Contas Patrimoniais* or reserves set aside by savings banks totaled Cr\$274 million. Reserves increased to Cr\$1.17 billion in 1957 before being consumed by deficits. By 1959, thirteen of twenty-one *Caixas Econômicas Federais* had consumed their reserves and required cash infusions from the federal government. In 1959, deficits at thirteen state banks totaled Cr\$480 million (while eight *Caixas* supplied a Cr\$1.39 billion surplus, the São Paulo state branches alone reporting a surplus of Cr\$116 million for 1959).

Government Savings Banks under Military Rule and Transition

The *Caixas Econômicas Federais* were transformed into a single federal savings bank in March 1970, the Superior Council was eliminated, and the bank was redefined as an agent of federal government credit policy directly responsible to economic ministries. After 1970, the *Caixa* also became responsible for the implementation of the official savings program (*Programa de Integração Social*, Program for Social Integration, PIS) and social policy fund (*Fundo de Assistência Social*, Social Assistance Fund, FAS) under the Social Development Council. The bank was also granted a monopoly over lotteries, became the agent for distribution of educational loans, and administered the concession and execution of a variety of domestic housing, sanitation, and infrastructure credits to state and municipal governments, many based on FGTS savings.

Figure 7.3 – Caixa Market Share of Credit to Public and Private Sector, 1968–2003



Source: IBGE, Estatísticas do SéculoVinte, 2003, available at www.ibge.gov.br and Central Bank of Brazil, available at www.bcb.gov.br

The trend of federal government savings bank lending to the public and private sectors from 1968–2003 appears to reflect the rise and fall of the bank as lender of last resort to government agencies and programs under high inflation and macroeconomic instability (See Figure 7.3). Indeed, *Caixa* market share peaks at half of all loans to the public sector during the penultimate surge of high inflation in 1989. Thereafter, the market share of the *Caixa* in loans to the public sector declines to well under 10 percent of the total loans to the public sector by 2001. A similar pattern in the market share of the *Caixa* in loans to the private sector appears from 1968–2003. From 1968 to 1975, the Caixa’s share of domestic loans to the private sector doubles from eight percent to 19 percent, then rises to a full 50 percent of loans to the private sector during 1989. Caixa market share declines dramatically thereafter during the 1990s to six percent of total private sector lending in 2001.

In sum, the indexation of savings against inflation and the centralization of government savings banks under military government were followed by the predominance of these financial institutions in domestic credit markets. The prolonged period of high inflation and the profound disorganization of prices by failed economic packages during the late 1980s left the Caixa responsible for half of domestic lending to public and private sector by 1989. Far from crowding out private lending, the erosion of credit and finance appear to have left the Caixa as one of the few lenders of last resort. Since 1990, and especially after price stability in 1994, the Caixa’s market share of domestic lending to both the private and public sector declined sharply.

After transition from military rule in 1985, Brazilian government savings banks also acquired new portfolios and new roles. With the extinction of the National

Housing Bank (Banco Nacional de Habitação, BNH) in 1986, the Caixa acquired the BNH's considerable (and considerably problematic) portfolio of housing loans. The Caixa also assumed responsibility for administration of the social security fund Fundo de Garantia de Tempo de Serviço (FGTS). By 1993, the Caixa had unified of over 130 million FGTS accounts once dispersed across 76 banks, eliminating over 72 million inactive accounts. In sum, the mission of government savings banks to serve as agent for federal government social policies presents significantly different costs and opportunities compared to commercial competitors.

2001: Capitalization and Reorientation of the Caixa

In June 2001, Finance Minister Pedro Malan announced a refinancing scheme for federal government banks that injected R\$12.5 billion to capitalize these institutions sufficiently to meet both Basel Accord capital guidelines and Central Bank of Brazil resolution 2.682/99 that increased Basle Index levels from 8.0 to 11.0. In 2001, the total government infusion of capital into the *Caixa* was estimated to reach R\$86.7 billion, although final costs to treasury depend on a variety of matters involving law, accounting, budgets, and asset transfers:

- 24.0 billion R\$ to exchange government paper
- 5.7 billion R\$ to shed non-performing BNH loans
- 13.0 billion R\$ to write off state government debts
- 8.0 billion R\$ to purchase the *Caixa's* debt with the FGTS
- 9.3 billion R\$ for capitalization
- 26.7 billion R\$ for transferring risk from housing loans
- 86.7 billion R\$ total estimate

Was it worth it? Has the Caixa pursued sound banking strategies and effective methods of policy implementation? Alternatively, are critics of government banking correct to suggest that subsidized credit and poor supervision crowd out more efficient private lending?

In 2001, four reforms attempted to guarantee the continuity of the *Caixa* as agent of government policies while ensuring against the recurrence of large liabilities. First, a new administrative model was introduced to avert abuses of credit and ensure banking prudence. Second, greater transparency was adopted for distribution of government mandated services, grants, and social programs. Third, a series of measures exchanged assets and restructured bank capital. Finally, non-performing assets and housing loans inherited from the BNH were sold to a specially created independent financial agency of the federal government. Since 2001, *Caixa* executives have pursued a strategic reorientation designed to reinforce its core business and role as agent for government social policies while promoting new programs of popular credit and investment banking. Persistently high interest rates since 2001 have provided further time to modernize because of the large spread

between low interest payed on *Caixa* savings deposits and high interest bearing government bonds. While it remains difficult to assess the longer-term prospects for the new business strategies adopted by the *Caixa*, several observations are in order.

Review of balance sheets and policies since 2001 suggest that the *Caixa* retains its core business in urban development, home loans, real estate, transfer of funds for government programs and services, and lottery administration. However, investment banking, management of third party funds, and the creation of new products and services have both increased profits and, apparently, increased popular access to banking and social services. The bank recorded net profits of R\$1.08 billion during 2002, R\$1.6 billion during 2003, and R\$1.419 billion during 2004. The *Caixa* grew from the seventh to fourth largest domestic investment bank from 2001-2003, while gaining dealer status from the Central Bank of Brazil in primary and secondary markets for government securities. At year-end 2003, the bank retained an estimated R\$76.7 billion of government paper (over ten percent of government paper) in its portfolio, assets earning over R\$13.5 billion that year.

Unlike practices under military rule, financial statements since 2001 suggest that the bank lends very little to the public sector. Total credits to government agencies – including government industries and services – summed to a modest 5.2 percent and 6.0 percent of total loans at the end of first semester 2003 and 2004 respectively. Meanwhile, loans to the private sector sum to 93.9 percent of total *Caixa* credits. A full 56.9 percent of loans as of June 2004 were for home construction or purchase, 21.6 percent were to private firms, and 11.7 percent to individuals.

Table 7.1 – 10 Largest Banks in Brazil, Year-End 2003

Bank	Assets	Credit	Deposits	LqA	LVG	EFC	ROA
Banco do Brasil	230.1	65.6	110.0	12.2	17.9	0.73	19.5
Bradesco	176.0	42.1	58.0	13.6	11.9	0.64	16.8
BNDES	151.9	37.8	1.5	12.8	na	na	12.3
Caixa Econômica	150.5	21.8	81.0	5.7	25.0	0.59	28.0
Itau	118.7	35.5	36.7	12.9	8.1	0.48	16.6
Unibanco	69.6	23.4	25.3	7.9	7.72	0.54	13.1
Santander	58.9	13.1	18.0	7.9	6.37	0.56	21.3
ABN Amro	55.4	21.5	26.7	7.1	6.76	0.67	15.9
Safra	32.9	11.6	8.6	3.0	9.8	0.39	20.1
Nossa Caixa	27.5	3.4	18.9	1.8	14.1	0.54	24.6

Source: *Conjuntura Econômica*, May 2004, p. 28

Note: DEP=Deposits, LQA=Liquid Assets, LVG=Leverage, EFC=Efficiency, ROA=Return on Assets.

EFC=(personell costs + administrative costs) / (financial receipts + service receipts)

LVG=(liabilities-liquid assets) / liquid assets

Comparison of the *Caixa* with the largest ten financial institutions in Brazil at year-end 2003 reveals its second largest share of bank deposits with R\$81.0 billion, sixth largest share of credits at R\$21.8 billion, and fourth largest share of assets at R\$150.5 billion. *Caixa* returns on assets (28 percent) and leverage (25.0) during 2003 were higher than any other top-ten bank. The efficiency rating of the *Caixa* (0.59) was lower than *Banco do Brasil* (0.73), *Bradesco* (0.64), and *ABN Amro* (0.67), slightly higher than *Santander* (0.56), *Unibanco* (0.54), and *Nossa Caixa* (0.54), and significantly higher than *Itaú* (0.48) and *Safra* (0.39). These measures suggest that the *Caixa* appears to allocate resources as effectively and efficiently, on average, as private commercial banks operating in Brazil. This belies theories that see government banks as grabbing hands that cause financial repression.

The second dimension of strategic reorientation of the *Caixa* involved the development of new programs of popular and micro-credit. In 2002, the bank launched a new account for popular savings and banking-services, *CAIXA Aqui*, that requires neither minimum deposit, nor proof of income, nor proof of residence. After three months, clients become eligible for loans up to R\$200.00 at interest rates of two percent per month. By February 2004, 1.27 million new accounts had been opened; by June 2004 accounts surpassed two million.

The *Caixa* has also continued to distribute federal government benefits since 2001. The number and value of benefits granted by the federal government through the *Caixa* is reported in Table 7. Income transfers, social security payments, official savings programs (PIS), bonuses, and unemployment insurance payments total over 243 million transactions and R\$19.4 million during 2002, and 299 million transactions and R\$24.5 million during 2003.

Table 7.2 – Federal Government Benefits Distributed by Caixa, 2003/2002

	2002		2003	
	Transactions*	R\$m	Transactions*	R\$m
Income Transfers	172.4	2.1	225.9	3.1
Social Security Payments	27.8	9.8	29.5	12.3
Bonus	5.3	1.0	6.6	1.5
PIS	17.3	0.8	16.9	0.9
Unemployment Insurance	20.1	5.5	20.8	6.5
Total	243.2	19.4	299.9	24.5

* Million transactions

Source: *Caixa Econômica Federal*, Financial Statements, 2003-2002, available at www.caixa.gov.br

The *Caixa* also remains a central agent for payment of federal government grants, especially since a variety of social policies and transactions were consolidated in Citizenship Cards in July 2003. During 2003, over 172 million transactions involving R\$2.1 million were distributed by the *Caixa* for programs

such as Young Agent, student allowances, gas assistance, food allowances, family and income allowances, crop guarantees, and programs to eradicate child labor (down from 225.9 million transactions valued at R\$3.1 million during 2002). Financial statements suggests that an additional 4.3 million cards were issued during the first six months of 2004, 3.5 million of which are proprietary *Caixa*-Citizenship Cards, with the additional cards being either federal government Citizenship Cards or school grant Citizenship Cards.

A consequence of the *Caixa*'s role as agent for federal government social policy is that the bank retains perhaps the largest data base on social policy in Brazil. During 2003 and 1st semester 2004, the *Caixa* registered 3.6 million households, increasing the total number of households in the data base to 9.2 million. A separate registry of 4.3 million households from the school grants program was also added to the *Caixa*'s social services data set, increasing the grand total of households to over 13 million in June 2004. While President Silva created two new ministerial level posts and a variety of programs to expand social policies, the *Caixa* remains at the center of new social policies because it retains important data bases and an extensive national network.

Table 7.3 – Caixa Social Service Dataset, number of new registered households

	2002	2003
New families registered	5,559,339	2,465,143
Food Allowance	135,092	-
School Allowance	265,306	-
PROFAE	208,358	57,058
Citizen Card/Caixa	18,228,134	3,575,867
Social Security Card	223,909	192,149
Citizen Card/Federal Government	5,353,637	1,884,372
Total cards issued	24,414,436	5,709,446

Source: *Caixa Econômica Federal*, Financial Statements, 2003-2002, available at www.caixa.gov.br

Data from the Central Bank of Brazil and *Caixa* annual reports suggest that the federal government savings bank retains one of the largest national networks of branches and ATM's, while its lottery monopoly appears to have provided a comparative advantage for expanding banking services to the interior and less developed regions of Brazil. At year-end 2003, the *Caixa* reported 2126 branches, 1080 electronic outlets, 8922 lottery stores, 2108 corresponding establishments, and 1,966 ATM's. While the *Caixa* retains the goal of creating agencies in all 5,561 Brazilian municipalities through its existing agreement with the federal lottery system, it should be noted that the Brazilian private bank *Bradesco* won a government concession to provide banking services inside all existing 5,500 agencies of the postal system.

The organizational structure of the *Caixas* today reflects broader trends in Brazilian banking away from branches and mini-branches toward ATM's and the use of correspondent institutions to provide services (See Table 9). The total number of bank branches in Brazil from 1994-2004 has declined from 17,400 to 17,049, while the number of mini-branches has declined from 10,125 to 7,108. In comparison, the total number of ATM's increased from 3,446 in 1994 to 22,428 in 2002. Furthermore, instead of four different types of outpost arrangements in place during the 1990s, the creation (and judicial challenge) of correspondent banking through shops and lottery outlets increased dramatically the number of banking service points after 2000. In sum, the *Caixa* retains a large network reaching across the Brazilian territory that appears to provide significant comparative advantage, but also threatens to erode earnings because of higher administrative costs and unnecessary duplication with other government bank networks.

Table 7.4 – Bank Branches, ATM's, and Banking Outposts in Brazil, 1994–2002

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Branches	17.400	17.181	16.583	16.255	16.002	16.189	16.396	16.841	17.049
PABs	10.125	9.075	8.268	7.787	7.211	6.614	6.562	7.318	7.108
ATMs	3.446	4.596	5.537	6.759	7.719	11.117	14.453	16.748	22.428
Outposts	2.506	2.637	2.311	2.117	2.047	2.074	2.346	2.299	2.376
Correspondents							10.589	12.311	16.453
(Lottery shops)							6.253	7.823	8.961
Total	33.487	33.498	32.707	32.977	33.320	37.562	50.933	56.141	66.070

Source: Central Bank of Brazil, available at www.bcb.gov.br

Note: PAB = Ponto de Atendimento Bancário (mini-branch), ATM = Automated Teller Machine.

Before concluding, a summary of the historical evolution of the *Caixas Econômicas Federais* is in order. From 1861-1889, a variety of government incentives led to the growth of the public savings bank under monarchy. From 1890-1930, more orthodox policies of economic liberalism led to the decline of government savings banks. From 1930 to 1945, the national populist regime of Vargas adopted new economic policies designed to mobilize domestic capital and industrialize through the substitution of imports. Government banks were central to these strategies of popular inclusion and state-led development. During the 1950s, rising inflation eroded deposits while increasing costs reduced earnings and reserves. After military intervention in 1964, both the indexation of savings (1965) and the reorientation of the *Caixa* in 1970 led to an expansion of the bank as agent for public and private credit. During the 1980s, the perverse combination of high inflation and political vacuum during the prolonged transition from military rule appears to have left government savings banks as one of the few sources of domestic credit. Price stability in 1994 forced the *Caixa*, along with other banks, to

adjust to the end of high inflation, while new regulations against capital risk set by the Central Bank of Brazil decreased the *Caixa's* share of domestic credit markets. Since capitalization in June 2001, the *Caixa* has pursued a dual reorientation toward investment banking and the expansion of popular credit and savings accounts.

This historical summary begets a central question: Does capital flow to or from popular classes through government savings banks? Since Gide, the liberal tradition of political economy suggests that popular savings banks permit the accumulation of wealth among those most needing it. More critical perspectives and the Marxist tradition would suggest that savings banks tend to extract value from popular classes. Although further analysis is needed, the initial conclusion from this historical overview is that the fortunes of popular (and other social classes) did indeed change dramatically across Brazilian history. Large gains and losses under the more volatile conditions of dependent development mark the Brazilian experience with markets and government intervention. But the causal process is not uniform. Sometimes value appears to be added in accord with political-economic reforms that favor popular inclusion; sometimes value appears to be dramatically eroded by inflation; and sometimes savings appear to have expanded simply because economic growth creates virtuous cycles.

Conclusion

Social scientists and policy makers differ fundamentally about government savings banks. Theories of financial repression see government presence in banking and credit markets as responsible for reproducing underdevelopment, and privatization and liberalization as policies necessary to free market forces and better allocate resources. Theories of comparative institutional advantage, relational banking, and the commanding heights approach suggest that long-term relations between banks, communities, political forces, and firms large and small are necessary to realize the gains of investments and social policies, especially in late development.²⁸ That these relations be sheltered from market forces is at odds with core ideas about optimal equilibria in financial economics. Advocates of markets suggest that liquidity, transparency, competition, and market pricing produce higher levels of welfare. In opposition, advocates of bank-centered development, government coordination, and late development argue that patient capital, face-to-face networks, social policies, government intervention, and institutions, in the long-term, ensure higher rates of growth and welfare.

The sheer size of Brazilian government banks and the diametrically opposed views of these credit institutions suggest that careful reassessment of assumptions

28 Hall, Peter A. and David W. Soskice, eds. *Varieties of capitalism: The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press, 2001.

about state, society, financial markets, politics, banking, and development is needed. Similar reassessments are underway abroad. For example, instead of liberalization and privatization, large emerging economies such as China, India, and Russia have retained both government and domestic control over banking. National experiences in Europe during financial liberalization and monetary union also provide a rich variety of new comparative references. Indeed, local, regional, non-profit, and government owned credit institutions appear to have maintained or increased their substantial market shares in many European countries, contrary to expectations that big private banks would predominate. Once again, Europeans appear able to craft varieties of capitalism that retain public banks and social policies at their center. Although Brazil may lack the features and policies of other national and regional experiences, this case study suggests that government banks such as the *Caixa Econômica Federal* may provide significant comparative advantages for new policies of economic development, social inclusion, and democratization.

The severe fiscal constraints on Brazilian government spending and the shallowness of domestic bond markets make this question even more critical. Analysts often compare government bank performance unfavorably with private commercial banks. However, in terms of public policy, government banks can do more for less: Almost *ten times more* if one compares cash used as capital reserves by banks to other policies that require budgetary outflows. Central Bank of Brazil regulations require eleven percent (weighted) capital reserves against credit risk. This implies that the *Caixa* (and other government banks) can loan almost ten times whatever profits are retained or funds may be allocated by congress. From this perspective, and given the evidence explored in this case study, the *Caixa* appears uniquely positioned to provide social services and extend credit to those left behind during Brazilian development. Tapping the popular credit channel may accelerate social inclusion and economic development, deepen the Brazilian financial system, and provide substance to citizenship and democracy.

Conclusion

Kurt von Mettenheim & Maria Antonietta Del Tedesco Lins

This volume presents new research on government banking from Europe and South America concerned with strategies of sustainable development and social inclusion. This conclusion reviews arguments and evidence presented in chapters and draws out common themes about government banking relevant to contemporary social science and public policy debates. The introduction opened the volume by reviewing materials presented at the August 2006 international seminar at the FGV-EAESP that explored new perspectives on government banking. The introduction also reported the questions posed to participants about government banking that trespass across the disciplines of economics, finance, banking, political sociology, political economy, and involve complex debates in economic and public policy. After the August 2006 seminar, further studies were commissioned from scholars working on savings banks in Europe and South America. The inclusion of Turner & Gröbl's analysis of savings banks and cooperative banks in Germany during the liberalization and integration of the banking industry provides an important review of new issues in social banking and political economy. Although pressures to modernize and remove subsidies to government banks have created new tensions and challenges for traditional banking institutions, savings banks and cooperative banks remain central agents that act to ensure full access to banking and financial services, especially those worst off. Turner & Gröbl's thus open the volume by providing an overview of savings banks, community banks, and theories of popular economy for the financial sector.

Chapters two and three provide further analysis of savings banks in Europe. First, Jean-Yves Salquin reviews the theory and practice of social responsibility policies in the banking industry, arguing that the French *Caisse d'Épargne* group provides an important case study for a more comprehensive approach to social responsibility than tends to prevail in private commercial banks. This brings an important dimension of corporate governance to the analysis of savings banks as government banks. Second, Olivier Butzbach expands his already published work

on the political economy of savings banks in Italy and France to include discussion of Germany and Spain as well as recent trends. For Butzbach, the rationalization and modernization of savings bank groups in the countries under study suggest that market lending criteria, the integration of domestic operations across local and regional savings bank groups, and the insertion of these traditional institutions in Continental European political economy suggest that they provide a privileged look at how coordinated market economies have reformed during European integration and liberalization.

The commission of three new chapters after the August 2006 seminar also expanded the scope and discussion of government banking in Latin America. First, Carlos Augusto Vidotto's chapter on government banking in Brazil provides a synopsis of the major federal government banks and reviews the ideas and policies behind choosing not to privatize these institutions during the 1980s and 1990s, despite recommendations from the World Bank and other international institutions – most markedly by IMF president Camdessus during the 1999 financial crisis in Brazil. Vidotto's article, previously available only in Portuguese, provides a review of the big three federal government banks, the *Banco do Brasil* (the largest bank in Brazil by all measures), the *Caixa Econômica Federal* (Federal Government Savings Bank, Caixa) that retains dominant market share in housing, savings, and urban development, and the *Banco Nacional de Desenvolvimento Econômico e Social* (National Economic and Social Development Bank, BNDES), a paradigmatic development bank that focuses on infrastructure, long-term lending to strategic sectors, organized privatizations during the 1980s and 1990s, and has been critical in creating domestic capital markets. The federal government regional banks for the Amazon, *Banco da Amazonia* (Bank of the Amazon, Basa), and less developed Northeast Region, *Banco do Nordeste Brasileiro* (Bank of the Northeast, BNB) complete the set of large federal government owned banks that, together, account for approximately 40 percent of domestic lending and finance. Chapter six by Vidotto reviews the ideas, policies, and theoretical affinities behind perceptions of these large institutions at the center of Brazilian political economy.

The second addition to Part II on Latin America is the case study of the Brazilian Federal Government Savings Bank, *Caixa Econômica Federal* by von Mettenheim. This study of the history and current policies of the *Caixa* was included as chapter seven to provide a more in depth analysis of the Brazilian savings bank and increase the comparative focus on savings banks in Europe and South America. Finally, Manfred Nitsch's chapter on the ideas and policies of development finance in South America over the last thirty years links the European and South American case studies by discussing international financial policy and stressing a trend that informs other chapters. Nitsch argues that the core trend in international finance policy toward Latin America is one away from large scale project lending through traditional development banks toward new microfinance

policies designed to create more durable, bottom-up sustainable development and social inclusion. This is consistent with the emphasis in other chapters on savings banks. Instead of emphasizing government banks as agents capable of producing rapid industrialization along the lines of the past, the predominant concern of authors in this volume is with sustainable development and social inclusion. In this respect, savings banks have been brought to the fore, both in Part I on Europe and Part II on South America. Savings banks appear to provide significant comparative advantage for domestic banking and finance in the sense of ensuring or encouraging access to banking services, especially for the poor. Savings banks also appear central as policy instruments in coordinated market economies of Continental Europe and the neo-developmental states of South America, at least in the two case studies reported herein, Brazil and Chile.

These findings about savings banks, social inclusion, sustainable development, and policy capabilities provide new perspectives on domestic banking systems. Although the forces of international political economy appear to have led most national governments to promote a select number of very large banks to compete abroad, the domestic structure of banking systems has lacked attention from scholars in comparative social sciences. Since Zysman's work 23 years ago, scholars have indeed clarified how bank-centered and market-centered financial systems work. In this respect, Allen & Gale and many other specialists in financial markets expressed concern about the viability of traditional patterns of household savings and banking after financial liberalization due to increased competition. However, recent studies suggest that most domestic banking systems appear to have retained and indeed reinforced traditional institutions, including non-profit and government owned credit institutions such as cooperatives, mutual societies, and savings banks.

The studies reported in this volume about experiences during European integration, as well as in developing, transition, and emerging countries, sum to suggest the continued importance of differences rather than convergence toward private banking and market-centered financial systems (i.e. away from savings banks). Some traditionally bank-centered financial systems with strong savings banks such as Germany have changed less. Others such as France and Italy appear to have privatized and liberalized their financial and banking systems substantially. However, one conclusion rings clear: (government and savings) banks and markets appear to coexist after financial liberalization to a considerably greater degree than expected by most scholars during the 1980s and 1990s. Domestic financial systems around the globe appear not to have converged toward private banking and equity markets along the lines of the US and UK.

This is perhaps the most important conclusion from the studies presented in this volume: government banks and savings banks remain at the center of most financial systems in Europe and South America. This also appears true in the largest emerging economies. Instead of convergence toward a single model based on private

banks and capital markets through privatization and liberalization, a variety of development paths combining government, private, and foreign banks have been taken in advanced, emerging, transition, and developing economies. Domestic reforms involve a variety of different strategies involving both liberalization and domestic control, with a bias toward national and government control in the largest domestic economies of the developing world such as China, India, and Russia. The distribution of financial labor in most countries thus involves the comparative advantages (and disadvantages) of public, private, domestic, and foreign banks. The comparative data does not support the idea that a broad trend toward private banking and equity market driven financial systems along the lines of the US or UK has been underway since 1990. Indeed, the persistence of government and domestic ownership appears to be related to higher growth levels in emerging economies during the early 21st century.

The persistence of savings banks, government banks, and bank-centered financial systems taps several essentially contested concepts and theories in academic research and policy making debates. Government banking cuts to core differences about government intervention, finance and credit in development, and government ownership and control. Theories of financial repression see government presence in banking and credit as responsible for reproducing underdevelopment, and privatization and liberalization as necessary to free market forces. Theories of comparative institutional advantage (from the varieties of capitalism approach), relational banking (from finance theory), and public banking advocates suggest that long-term relations between banks, local communities, political forces, and firms are necessary to realize the gains of investments and social policies. That these relations be sheltered from short-term market forces is fundamentally at odds with core ideas about financial markets. Perhaps the central dimension of these differences is liquidity; advocates of markets suggest that liquidity, transparency, competition, and market pricing produce higher levels of welfare. Advocates of bank-centered development and government coordination value patient capital, networks, social policies, and institutions that, in the long-run, ensure higher rates of growth and welfare.

However, this volume is not a critical account of financial markets or private banking. Instead, the idea is to shift away from critical perspectives that, for example, emphasize the dysfunctional character of markets or attempt to change the social responsibility policies of private banks. The contributions of this volume are more positive in the sense of improving understanding of the financial performance, social contribution, policy capabilities, and political context of government and, especially, savings banks. Further study is required to specify the social impact of savings banks and other forms of state-owned bank activities. Again, this implies a positive approach rather than a critical one in terms of much of the social accounting debates and policies that seek to altering the behavior of existing

organizations and firms. This volume thereby opens a broad, transdisciplinary field of research that can further improve understanding of public banks toward social inclusion, sustainable development, and social well being (as well as the risks associated with these institutions such as political capture, crony credit, rent seeking, and other problems emphasized by critics of government banking).

Recent research in banking, political economy, public policy, and accounting reinforce this shift toward study of savings banks and government banking. Luez et al suggest the broader framework of accounting theory for what is at stake in recent discussions of social dividend balance sheets, often led by the European Savings Bank Group and World Savings Bank Institute.¹ New ideas and practices about accounting in the 21st century make it possible to rethink practices of benchmark social accounting organizations, and reconsider core ideas about economics, politics, policy, and development. Although advances in information technology, transparency, and corporate disclosure are fundamental, the process of creating internationally accepted social balance sheets is necessarily a *political* process in the sense of involving the interests and perspectives of a variety of institutions, stakeholders and publics in domestic and international institutions. For, as Orderlheide notes:

Accounting is concerned with nothing less than the conceptualization of capital, its concrete expression in numbers, as well as its budgeting and monitoring.

Orderlheide, Dieter. "The Politics of Accounting: A Framework" p. 270

Paraphrasing Orderlheide, further studies on public banking and their contribution for development and social inclusion imply a process of conceptualizing *social* capital, its concrete expression in numbers, as well as its budgeting and monitoring.

Furthermore, there is a broad range of institutions worldwide that provide opportunities for further case studies and comparisons, such as the South African Postbank, the Moroccan *Caisse d'Épargne Nationale*, the postal bank La Poste Tunisienne, and the Indian National Savings Institute, just to mention a few candidates. Regarding the South African case, any attempt to analyze the financial system in South Africa would have to consider the changes that have occurred since the end of the apartheid regime in 1994. And despite government acknowledgement of the central role to be played by the financial sector in development, financial exclusion is still marked. According to Kirsten (2006) data from the FinScope survey (2005) suggests that 53% (16.4 million) of South Africa's adult population is excluded from formal financial services and have no bank account. These 16.4 million people are marginalized or formally excluded from credit. And 99% of those without access are black, 49% live in rural areas and 55% are women.

¹ Leuz, Christian, Pfaff, Dieter, & Hopwood, Anthony. (eds). *The Economics and Politics of Accounting; International Perspectives on Trends, Policy, and Practice*. Oxford: Oxford University Press, 2004

In the case of Morocco, the state remains a major presence in financial system as main actor and regulator. Shortly after independence, in 1959, the founding structure of the financial system was set with the creation of the central bank, currently named “Bank Al-Maghrib”, the *Caisse de Dépôt et de Gestion* (CDG), the *Fonds d’Équipement Communal* (FEC), the *Banque Nationale pour le Développement Economique* (BNDE), the *Banque Marocaine du Commerce Extérieur* (BMCE) and the *Caisse d’Epargne Nationale* (CEN), all specialized state owned institutions. The National Savings Bank of Morocco was established within the national post company. It offers savings accounts through the post’s ca. 1,600 branches. An institutional reform of the financial system in 1993 left the CEN with a different status from other financial institutions due to its characteristic as a post company. The interest rates are fixed by national government. The earnings on savings are exempt of taxes for individuals. Still in North Africa, first provider of financial services, La Poste Tunisienne, in its current structure, was created in 1998, together with its financial services, as a publicly owned company, with financial autonomy. Around 1.7 million citizens have savings accounts, equivalent to one account per household. Gratuity of services and interest rates fixed are by the Tunisian central bank. La Poste Tunisienne offers as well current accounts and traditional bank services and insurances.

The government banking sectors of large emerging economies also beg for more scholarly research. For example, India’s well-developed financial system, which dates back to before political independence in 1947, thrived after the nationalization of the largest commercial banks in 1969, turning them into ‘mass banks’. In the early 1990s, India started a broad set of reforms in the financial system. A number of changes were introduced with the objective to bring greater allocative efficiency to markets and establish a sizable market integrated through existing institutions. On a more concrete level, India tried to liberalize specific segments of the financial market by deregulating interest rates and encouraging existing institutions to be more market oriented. Even if we acknowledge a number of inefficiencies caused by the government’s presence in the Indian financial scene, it is crucial to study the effects of state intervention in social and development policies. Micro-lending, especially, deserves analysis. Naastepad (2004) points out the positive effects of these credit policies, which despite the less attractive returns they provide to the lending institutions, have brought changes in demand, investment, production conditions and income throughout the economy. Habits of saving are crucial to the financial inclusion and income improvement of the poorest social groups. But saving for the low-income households depends on having access to institutions and suitable products.

Given the focus on savings banks in this volume, the National Savings Institute (NSI) is of particular interest. As part of the Ministry of Finance, the National Savings Institute is charged with the mobilization of small savings in

India. The NSI pursues a variety of programs to stimulate savings formation in lower income groups and provides financial instruments and services to these groups. According to NSI, there were ca. 115 million small savings accounts in 2005, which indicates that around 50 million households were depositors. NSI counts on the post network and a variety of savings products while organizing staff training to the officers to improve the savings ratio. Despite the impressive figures in absolute terms and government promotion policies, India's gross domestic savings ratio to GDP maintained around 23% during the 1990s.

These national experiences suggest how microfinance initiatives have opened a broad field for academic research and public policy. Micro-finance activities have emerged as a successful instrument used by public banks to promote poverty alleviation and diminish regional disparities. Microfinance and especially micro credit have gained increased recognition across the world during the last decades. From the Nobel awarded experience in Asia of Grameen Bank launched by Mohammed Yunus to cooperatives in Latin America, micro lending has acquired different forms. Most of these microfinance institutions' clients are informal workers, living on US\$ 2-3 a day and deprived of social welfare. The untapped market for increase in microfinance is immense: according to Soares and Melo Sobrinho (2007), from 235 million of the poorest households, around 8% have had access to microfinance, in Latin America and the Caribbean, Africa and the Middle East, the coverage ratio is circa 6%.

Brazil is a fertile ground for microfinance experiences. The long standing unattended demand for social policies, together with a low credit to GDP ratio, a large share of the population in low income and poverty situation and a large informal sector indicate the chances of success of microfinance initiatives. Most started informally and allowed considerable increases in income to beneficiaries. The estimated demand for micro-credit in Brazil is around 16 million small firms. Despite some initiatives in place, micro-credit institutions in Brazil summed around 5,000 clients in 1998. Mettenheim's chapter on the Brazilian Federal Savings Bank, *Caixa Econômica Federal* refers to the importance of popular credit for federal banks. The number of accounts, loans, and the amount of loan contracts has increased considerably from 2004 to 2007.

The role of micro-credit has also been acknowledged by multilateral institutions that have introduced programs to stimulate lending since the late 1990s. An interesting experience of microfinance implemented by a federal development bank, the *Banco do Nordeste*, was supported by international organizations as well as direct funds from federal government. According to Christen et al.

"In 1996 the World Bank decided to explore the development of microfinance as part of its poverty reduction efforts in Brazil's Northeast Region, the poorest in the country. Since the Inter-American Development Bank was planning a US \$150- million microfinance apex to finance the few NGO MFIs (microfinance institutions) operating in

Brazil, the World Bank task team decided to pursue a complementary approach focused on developing the commercial bank model. (...)

Private banks viewed microfinance as charity work rather than as a commercial opportunity. Public banks were more interested, given their social mission, but seemed to provide a weak basis for a financially sustainable program.” p. 2

The *Banco do Nordeste's CrediAmigo* program was first launched in 1997 supplying in a few branches a type of loan to individual clients with lower interest rates than the informal market but higher than the usual *Banco do Nordeste's*. Despite difficulties in maintaining sustainability and the low value of loans – related to the income level of the costumers – the program is present in very poor regions of Northeastern Brazil and involves good banking practices.

By December 2006, the *CrediAmigo* portfolio had reached 236 thousand customers, (22 percent of total microfinance customers in Brazil) and its loans summed almost 16 percent of total micro-credit. It is undoubtedly a remarkable result for a single state owned institution in the poorest region of the country via one specific program. The effects of microfinance in poverty alleviation and low income regions are a main subject in study and debate at the moment; particularly the role of public institutions in promoting social financing policies.

Further study of government banking is required. However, several conclusions from the chapters and existing research can be made. First, the case studies and focused comparisons reported herein imply a methodological turn away from cross-national statistical analysis to avoid the fallacy of aggregation. This methodological turn, one shared by scholars of comparative financial economics, political economy, public policy, and business administration, is based on a shared mistrust with easy generalizations based on apparent patterns in aggregate data in favor of more focused comparisons and case studies. From J Stuart Mill through Arendt Lijphart, an important component of comparative political analysis has been the use of case studies and the analysis of differences when statistical or experimental methods are inappropriate. Given the variety and complexity of domestic financial systems and the deeply contested theories and concepts about bank credit, equity markets, and bond issues in economic, social, and political development, further case studies and comparative analysis will be needed to understand varieties of financial capitalism and the policies able to maximize comparative advantage. Critics of government banking have identified a series of very real risks faced by these institutions and policy makers. However, strong claims about government banks embodying the grabbing hand responsible for underdevelopment based on aggregate cross-national comparisons is unfounded.

Indeed, government banks in Brazil and financial systems in general can be said to be at a “Shonfieldian” moment involving the reconstruction of domestic policies and development paths. The early 21st century is perhaps not as dramatic as 1945-1950 when Continental Europe and Asia rebounded after war destruction.

However, given the challenges of new democracies after transitions from military, authoritarian, and Stalinist regimes, current financial and economic policies remain at a critical juncture in the sense of substantially reshaping domestic institutions. So far, the destructive impact of financial crises and the mistakes of liberalization and privatizations have not made this easy. The evidence presented in this volume suggests that scholarly advances in comparative financial economics, banking, and domestic financial policy provide important alternative policy agendas for deepening new democracies in emerging, transition, and developing countries. Indeed, this trans-disciplinary agenda is needed to reconsider policies in old democracies that have suffered serious reversals of equality.

This implies that neither financial liberalization nor government ownership is better in principle. Policy makers in advanced, emerging, and developing nations have adopted fundamentally different strategies that vary from overt protectionism to draconian liberalization. However, most policy makers seek to maximize credit and finance through viable strategies that combine the virtues of liberalization with the value of traditional institutions and markets. Allen & Gale note pitfalls of combining financial liberalization and traditional patterns of savings and banking. However, the reform of domestic banking during European integration and the variety of domestic financial systems that retain banks at their center in emerging and advanced economies alike suggest that cohabitation of these apparently opposing principles of finance – markets and banks – may be more possible than Allen & Gale feared. Understanding how government banks and markets may better underwrite development is urgent because the convergence toward private banking and equity markets through financial liberalization expected by Allen & Gale, and many others, now appears less inevitable and less pervasive in the 21st century than it did during the 1990^s.

Market-centered approaches have made clear the risks of crony credit, moral hazard, political abuses of public banks, and other perverse cycles associated with government intervention and control of banking and finance. However, social scientists and policy makers now appear to concur that excessive financial liberalization and unprepared privatizations may fail to produce the positive outcomes associated with efficient and effective private banking and financial markets. Advanced economies across Continental Europe, developing countries in Asia and especially the largest emerging nations retain government banks at the center of their political economies and financial systems. This volume attempts to explain why public banking persists and explores how these institutions can, as in the past, contribute to sustainable development and social inclusion amidst the new forces of globalization and financialization of the world economy.

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