



How to harmonize activities of the Federal Development bank with its objectives?

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Development Bank of Federation of B&H and its objectives

The Development bank of Federation of Bosnia and Herzegovina (DBFBH) is a financial institution with its main purpose to implement the economic policy of the Federal Government, improve economic development and employment through stimulation and differentiated interest rates, previously set lower than the usual commercial interest rates.

With its current capital of around 200 million BAM, and planned capital of around 400 million BAM, Development Bank of Federation of Bosnia and Herzegovina is one of the scarce resources that Bosnian government has at its disposal to fight against poverty, and unemployment. Taking into account that Bosnian GDP is around 26 billion BAM, resources which are at disposal to the DBFBH, are not negligible. DBFBH is one of the key mechanisms for the Government of Federation of Bosnia and Herzegovina, especially in areas that are of minor interest for commercial banks e.g. infrastructure, water supply, environmental protection and projects that require longer repayment periods with low interest rates. Also, with its focus on the more coherent economic development, structural, and regional balance, the DBFBH is designed to provide the most attractive financing conditions, specific credit lines for reconstruction and development of small and medium enterprises.¹

However, the first and the most important objective of the Federal Development Bank in this sense, is fight against the unemployment. The Law on The Development bank of Federation of Bosnia and Herzegovina in the Article 4 (Objectives of the DBFBH), clearly states the first objective of the DBFBH: financing the reconstruction, and development of Federal economy, and employment growth.

Firmly standing at the official rate of around 40%, unemployment is probably the biggest problem in Bosnia and Herzegovina. This is one of the highest unemployment figures not only in Europe, but also in the world. High unemployment rates represent a vast underutilization of human resources; the unemployed, who are most often young, urban and educated individuals, are a potential source of social turmoil and political discontent.

Rising unemployment and falling income help confirm the pessimism initially generated by the economic downturn. For these particular reasons, it is expected that the DBFBH loans may be one of the government tools that may be used in boosting the aggregate demand in the strategic parts of the national economy, especially in areas where it is not expected that other i.e. commercial banks, see themselves as crucial players.

What is the problem? Incapacity of the Development Bank of Bosnia and Herzegovina

Current DBFBH loan policy is not in line with the Law on Development Bank of Federation of Bosnia and Herzegovina, and its statutory requirements, where it is clearly stated that the primary objective of the DBFBH is to generate employment. DBFBH performs just as any commercial bank, paying attention only to the profitability and reducing risks of their projects, not taking into account other aspects of development banking e.g. generating employment. These practices serve as the leverage tool for selected companies in achieving financial targets, increasing profitability, but not having any major effect on employment.

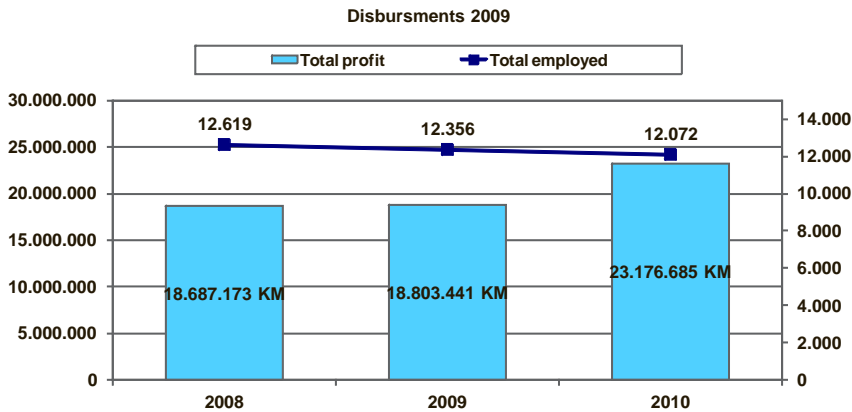
In assessing the existing DBFBH loan policy on employment in Federation of Bosnia and Herzegovina, the most important is the impact of the DBFBH loans disbursed in 2009, and 2010 on the number of employees, and financial performance of a population of approximately 270 companies that were granted such a loan in 2009, and 2010. From the tables below, we can see the decrease of number of persons employed in companies that have received loans from the DBFBH in 2010, and 2009, respectively. In percentages, for companies that have received loans in 2009, the change from 2008 to 2010 is **-4,33%**, and for companies that have received loans in 2010, **-5,61%**.

At the same time, profits in these companies have soared. Profits increased 24% in companies that have received loans in 2009, and 35% in companies that have received loans in 2010. The revenues for both years stagnated, which indicates that the number of employees was directly dependant on the revenues.

The first and the most important objective of the Federal Development Bank is fight against the unemployment.- The Law on The Development bank of Federation of Bosnia and Herzegovina in the Article 4 (Objectives of the DBFBH)

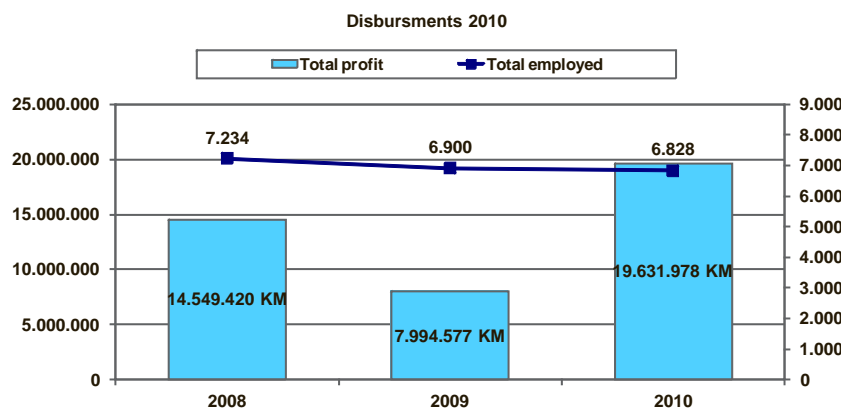
¹(<http://www.rfbih.ba/razvojna/bs/txt.php?id=255>).

Table 1
Number of employees, revenues, and profits in 2008, 2009, and 2010 in companies that have received loans from the DBFBH in 2009:



	2008	2009	2010	Change in % 2010/2008
Total employed	7.234	6.900	6.828	-5,61%
Total profit	14.549.420	7.994.577	19.631.978	34,93%
Total revenues	666.092.361	527.208.847	593.281.665	-10,93%

Table 2
Number of employees, revenues, and profits in 2008, 2009, and 2010 in companies that have received loans from the DBFBH in 2010:



	2008	2009	2010	Change in % 2010/2008
Total employed	12.619	12.356	12.072	-4,33%
Total profit	18.687.173	18.803.441	23.176.685	24,02%
Total revenues	1.404.661.483	1.212.722.270	1.354.570.866	-3,57%

Table 3
Number of total registered employed persons in Federation of Bosnia and Herzegovina:

	2008	2009	2010	Change in % 2010/2008
Total registered employed persons in Federation of BH	430.745	426.197	424.598	-1,43%

In the same period, the number of registered employed persons in the Federation of Bosnia and Herzegovina (population in general) was decreased by **1,43%**, which is significantly less than in companies that have received loans from the DBFBH.

The fact that the number of employees in companies that have received loans from the DBFBH was decreasing at significantly higher scale than in general population clearly shows a complete failure of the DBFBH to fight the unemployment.

The major cause for this may be that the current Internal Auditing Service (IAS) evaluation system, does not allow the assessment of the compliance of the DBFBH's operations with its strategy and objectives, and that the primary concern for the IAS is the profitability of the investment, or to reduce DBFBH's risks to acceptable level, not taking into account other important aspects of the development banking e.g. its legal obligation to increase employment.

How to harmonize activities of the DBFBH with its objectives?

In accordance with the methodology and criteria developed by the most important multilateral development banks, developed on a global scale and based on the fact that the current Internal Auditing Service (IAS) evaluation system, does not allow the assessment of the compliance of the DBFBH's operations with its strategy and objectives (which is also shown in the DBFBH inability to assess the scale of the employment generated by its operations), the following set of policy options for the DBFBH is proposed:

The governance structure of the IAS

IAS should have a mandate statement approved by the DBFBH Assembly, designed to ensure independence and relevance. This mandate would provide that the Assembly oversees IAS's work and that the IAS's reporting line, staff, budget and functions are organizationally independent from the DBFBH's departments and related decision-making departments. In addition, this mandate should specify that the Assembly has the ultimate decision authority for (1) hiring and terminating IAS head and staff; (2) IAS head's appointment terms and reporting structure; (3) IAS head's and staff's grading, performance reviews and salary increases; and (4) the IAS's budget.

The mandate should provide that IAS transmits its reports to DBFBH's Assembly after the review and comments by the management, but without management clearance or any management-imposed restrictions on their scope and contents.



Evaluation timing, population, coverage and sampling

Taking into consideration information on project maturity status provided by other departments, IAS should determine the population from which the investments to be evaluated each year, are to be drawn. This population consists of the investments that will have reached early operating maturity during the year. Early operating maturity is reached when (a) the project financed will have been substantially completed, (b) the project financed will have generated at least 18 months of operating revenues for the company and (c) the DBFBH will have received at least one set of audited annual financial statements covering at least 12 months of operating revenues generated by the project.

Annual Supervision Report (ASR) should be prepared on a random, representative sample of sufficient size, to establish, for a combined three-year rolling sample, success rates at the 95% confidence level, with sampling error not exceeding ± 5 percentage points.

Guidelines, execution, and independent validation

In consultation with operations departments, IAS should prepare, refine and disseminate guidelines for the preparation of ASRs in sufficient detail, to promote consistency and objectivity in execution scope, analysis and ratings. The guidelines should include rating guidelines with benchmarks and standard reporting templates that include the performance ratings matrix. IAS should maintain these guidelines on its website.

The scope of the ASR should include, at a minimum: the **development or transition outcome of the project to the extent provided** in the "results on the ground" relative to the DBFBH's mission, the DBFBH **investment's profitability** (contribution to its corporate profitability objective), and the DBFBH's **work quality** (also referred to as bank handling, operational effectiveness or execution quality).

Indicators and benchmarks for the development or transition outcome, investment profitability and work quality

Assessments of **development or transition outcomes** for each of the development or transition outcome indicators, take into consideration the sustainability of the results. These are based on the following: project's contribution to the company's business success, measured by the real after-tax returns and by the project's contribution to other business goals articulated at approval which

should be project's contributions to economic development (positive or negative), its contributions to the country's private sector development, its development of efficient capital markets and/or its contribution to the transition to a market economy. Performance is assessed not only by the direct economic costs and benefits to the owners and financiers but also by the economic costs and benefits to customers, employees, government, suppliers, competitors, local residents, etc.

DBFBH **investment's profitability** is based upon the investment's gross profit contribution (net of financing costs and loss provisions but before deducting administrative costs) with ratings benchmarks set in relation to corresponding at-approval standards for minimally satisfactory expected performance. Loan and guarantee performance benchmarks are set in relation to the DBFBH's expectations at approval.

The rating for the DBFBH's **work quality** is based partly on its monitoring and supervision quality, i.e., how effectively the DBFBH carries out its work after approval of the investment, and its role and contribution, i.e., the quality of the DBFBH's contributions from inception to evaluation. The rating judgment considers compliance with basic operating principles, the DBFBH's contribution to client capacity building objectives (as relevant), the operation's consistency with furtherance of the DBFBH's corporate, country and sector strategies, and its clients' satisfaction with the DBFBH's service quality.

Assessments of the DBFBH's work quality should be made independently of the ratings assigned for development or transition outcomes and DBFBH's investment profitability. These assessments, which are benchmarked against corporate good practice, reflect the quality of the DBFBH's contributions to good or bad outcomes, not the good or bad outcomes themselves.

Annual reporting and process transparency

IAS should prepare an annual review addressed to the DBFBH's management, staff and Board of Directors. The scope of the annual review should include, inter alia, a synthesis of the IAS's validated findings from all ASRs generated and reviewed during the period covered.

The annual review makes recommendations to the Management and the Board based on the evaluation findings. IAS should maintain a tracking system for recording dispositions by the Management, of each recommendation. IAS should report periodically (at least every three years) to the DBFBH's management, Board and Assembly on the quality and efficacy of the DBFBH's evaluation system, including the self-evaluation system, any gaps in coverage of the DBFBH's operations, the



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A "Policy Development Fellowship Program" has been launched by the Open Society Fund BiH in early 2004 with the aim to improve BiH policy research and dialogue and to contribute to the development of a sound policy-making culture based on informative and empirically grounded policy options.

The program provides an opportunity for selected fellows to collaborate with the Open Society Fund in conducting policy research and writing a policy study with the support of mentors and trainers during the whole process. Eighty one fellowships have been granted since the starting of the Program.

All policy studies are available at www.soros.org.ba

work of IAS, and the generation and application of lessons learned in new operations. In addition, it should submit to the DBFBH's management, Board and Assembly the periodic benchmarking reviews of the consistency of the DBFBH's practices with the international standards.

Identification of lessons, dissemination, and ensuring application of lessons

Lessons should be concise, prescriptive and placed in the context of a material issue that was encountered in the evaluation, so that its relevance to new operations can be determined easily, on a stand-alone basis. The point of view and selectivity should focus on what the DBFBH might have done to obtain better results from the operation. IAS should make available to DBFBH staff, the findings and lessons derived from the DBFBH's evaluation work. The IAS makes available to DBFBH staff a range of user-friendly dissemination products covering the ASR findings, the annual review and IAS special studies.

It is the responsibility of operational department managers to ensure that past lessons have been systematically researched, identified and applied in new operations. In its annual evaluation process report, IAS reviews and reports to management, Board and Assembly the evidence available for judging the extent to which lessons are being incorporated in new operations.

Disclosure

The DBFBH's disclosure policy for evaluation products should be explicit, should be consistent with the DBFBH's general disclosure policy, and should cover all evaluation products. The DBFBH's disclosure policy is disclosed via the IAS's web page, specifically noting any exceptions applicable to evaluation reports. The DBFBH includes an accurate summary of IAS's major annual review findings in its Annual Report. IAS prepares and posts on the DBFBH's external website an abstract of its annual review that accurately summarizes its essential findings, including the outcome, profitability, and work quality ratings profiles, sampling representativeness, ratings criteria, benchmarks, and consistency with international standards. After appropriate reduction to protect commercial confidentiality, IAS should disclose its aggregate evaluation reports.²

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