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**SUBSIDIARITY PORTFOLIOS
AND SEPARATION COMPACTS
TO ENHANCE THE GOVERNANCE OF STATE-OWNED BANKS**

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ABSTRACT

This paper sets forth a new approach to state-owned banks grounded on portfolio theory and the principle of subsidiarity, so as to improve the governance of such institutions. Firstly, it defines what is meant by portfolio of portfolios and the separation feature, which leads to setting up what we call a separation compact. Next, the principle of subsidiarity is introduced, highlighting the pathways to its uses and misuses when we deal with state-owned banks. Afterwards, we bring forward the notion of subsidiarity portfolio, stressing how such construct can foster to a great degree key governance variables, namely accountability, control, transparency, management, checks and balances, as well as the fulfillment of the fiduciary role. Finally, it is laid down a new viewpoint for state-owned banks, from which they come to be regarded as separation compacts.

JEL: H10, H20, H5, G11, G21.

Key words: state-owned banks, portfolios, governance, principle of subsidiarity, separation compact, subsidiarity portfolios.

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Disclaimer

By no means the University of Cema holds itself responsible for any statement or opinion contained in this working paper.

INTRODUCTION

Whereas the systematic study of public and corporate governance goes back to the 70s in the last century, some of the most distinctive issues have been researched for the last decade only. This is not to be surprising, since earlier stages in the development of the field of learning and practice called governance¹, were devoted to laying the grounds and seeking for empirical evidence in the macro issues. After the spadework, it came the need of inquiring into particular areas of the private and the public realms. Such is the case with cooperatives and venture-capital firms in the so-called corporate governance. And we also find new strands of research that address the governance of state-owned firms and financial institutions under the umbrella of public governance inquiries.

This paper brings forth a proposal² to sharpen up the governance of state-owned banks, a case in point for the study of mixed governances, because we face here a state-owned firm which at the same time carries out the bulk of its activities performing like a commercial financial institution.

We are to split down our research and expand on our proposal following the subsequent line of analysis:

In section 1, an outline of portfolios is supplied to lay the foundations for section 2, which copes with the concept of portfolios of portfolios. Section 3 enlarges upon the principle of subsidiarity, which plays a key role to understand how state-owned banks use and misuse the process of granting subsidies in their daily decision-making.

It is for section 4 to enlarge upon on the first contributory concept we are introducing in this paper, the one of separation compact. Section 5 handles a second contribution of this paper, the subsidiarity³ portfolio that intends to become a functional device to change the governance

¹ I dealt with the semantics of governance elsewhere (Apreda 2003, 2006a).

² This working paper is embedded in a wider research program at the Center for the Study of Private and Public Governance, at the University of Cema. The program has so far produced this paper, and a former one (Apreda, 2005a), ending with a third paper to be published in April 2006.

³ The idea of the subsidiarity portfolio was introduced, for the first time in Apreda (2005a). It was presented by the author in November 2005 at the Regional Meeting on Social Responsibility and Corporate Governance (held at the Buenos Aires Stock Exchange and managed by the Center for the Financial Stability of Argentina (CEF).

of a state-owned bank. Lastly, section 6 sets up a new viewpoint of state-owned banks as separation compacts.

1. PORTFOLIOS

Let us assume that, at date t , we have an initial endowment of wealth

$$w(t)$$

which can be valued in monetary terms⁴.

We intend to allocate $w(t)$ for purchasing, or keep on holding, a collection of assets from an available list

$$A_1, A_2, A_3, \dots, A_N$$

with the purpose of holding them till date T . That is to say, we choose a planning horizon

$$H = [t; T]$$

If we allocated⁵ w_k out of $w(t)$ to purchase asset A_k , and followed the same procedure with any and all of the listed assets to the extent of wholly depleting the amount $w(t)$, it would hold then

$$w(t) = w_1 + w_2 + w_3 + \dots + w_N \quad (1)$$

In all likelihood, if we did not want to buy A_j , then we should put

$$w_j = 0$$

If we got rid of monetary expressions, not only would we simplify further developments, but also we would get access to comparisons and contrasts. Hence, dividing both sides in (1) by the amount $w(t)$, we can write

$$1 = x_1 + x_2 + x_3 + \dots + x_N \quad (2)$$

or, equivalently,

⁴ We follow the classical setting as can be found in Sharpe (1970). The most updated reference is Elton-Gruber (2005).

⁵ For the ease of notation, we usually drop the date in the expression $w_k(t)$, writing down w_k only.

$$\sum x_j = 1 \quad (j : 1, 2, 3, \dots, N)$$

In this context, x_j stands for

$$x_j = w_j / w(t) \quad (3)$$

which measures up the proportion of $w(t)$ that is ultimately allocated to purchase asset A_j . In fact, we have taken a consequential step, since (2) and (3) provide a definition of the portfolio P we are trying to build up⁶.

$$\left\{ \begin{array}{l} P = \langle x_1, x_2, x_3, \dots, x_N \rangle \\ \text{such that } \sum x_j = 1 \end{array} \right. \quad (4)$$

We should say that (4) will perform as “**the definition of P up to a scaling factor**”. What does this mean?

Let us suppose that two economic agents

$$G_1, G_2$$

are initially endowed with wealth balances at date t :

$$w(t; G_1), w(t; G_2)$$

such that

$$w(t; G_1) \neq w(t; G_2)$$

and they choose the same proportions x_j for each asset A_j . That is to say, they end up designing the same portfolio P .

At date T , they will be collecting their returns, and the wealthier agent will pocket more money than the counterpart.

Now, if we asked to ourselves, how could we track the monetary value of their portfolios at date t , we should argue as follows:

For G_1 , we work out the monetary value of his portfolio by doing

⁶ We are going to use the vectorial frame, that is to say, an ordered list of numbers.

$$\mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \mathbf{P}$$

that requires to multiply the scalar $\mathbf{w}(\mathbf{t}; \mathbf{G}_1)$ by the vector $\mathbf{P}$. Taking advantage of (4), it holds

$$\begin{aligned} \mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \mathbf{P} &= \\ &= \mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \langle \mathbf{x}_1, \mathbf{x}_2, \mathbf{x}_3, \dots, \mathbf{x}_N \rangle \end{aligned}$$

or

$$\begin{aligned} \mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \mathbf{P} &= \\ &= \langle \mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \mathbf{x}_1, \mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \mathbf{x}_2, \dots, \mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \mathbf{x}_N \rangle \end{aligned}$$

and, finally, we get

$$\begin{aligned} \mathbf{w}(\mathbf{t}; \mathbf{G}_1) \cdot \mathbf{P} &= \\ &= \langle \mathbf{w}_1(\mathbf{G}_1), \mathbf{w}_2(\mathbf{G}_1), \dots, \mathbf{w}_N(\mathbf{G}_1) \rangle \end{aligned}$$

The same procedure applies to agent $\mathbf{G}_2$.

Hence, they purchase or intend to purchase, the same portfolio $\mathbf{P}$, although apportioning different monetary values to attain the same proportions of assets.

We have brought to light the rationale behind the former statement that (4) was “the definition” of a portfolio up to a scaling factor.

2. PORTFOLIOS OF PORTFOLIOS

Now, instead of a list of financial assets, we are to consider a list of available and computable portfolios⁷

$$\mathbf{P}_1, \mathbf{P}_2, \mathbf{P}_3, \dots, \mathbf{P}_q$$

⁷ That is to say, we deal with a finite listing of portfolios whose nature is well known to the analyst, to the extent he can purchase them all in terms of the initial wealth endowment.

Profiting from section 1, we can stretch out the scope of relationship (4) so as to define a portfolio consisting of the portfolios recorded above:

$$\left\{ \begin{array}{l} \mathbf{P} = \langle \mathbf{x}_1, \mathbf{x}_2, \mathbf{x}_3, \dots, \mathbf{x}_q \rangle \\ \text{such that } \sum \mathbf{x}_j = \mathbf{1} \end{array} \right. \quad (5)$$

In this case, $\mathbf{x}_j$ stands for how much wealth we are ready to allocate to portfolio $\mathbf{P}_j$ out of the starting endowment $\mathbf{w}(\mathbf{t})$.

The logic behind this engineering follows from the fact that, in actual practice, a portfolio of assets can be regarded as another financial asset on its own, albeit it is more complex than the latter. Moreover, it conveys the same basic features than any financial asset:

- changes in value along the span of the planning horizon are likely to take place;
- expected rewards stemming from each constituent financial asset actually amount to an expected reward coming out of the portfolio;
- as $\mathbf{P}$ is a portfolio to all intents and purposes, both its expected return and risk measure can be worked out following the methodology employed with simple portfolios consisting of single financial assets⁸.

3. THE PRINCIPLE OF SUBSIDIARITY

The principle of subsidiarity, as we have developed elsewhere⁹, turns out to be a double-edged expression.

a) On the one hand, it conveys the meaning of both “devolution” and “entitlement”.

⁸ More background and details on this interesting issue can be found in my latest book *Differential Rates, Residual Information Sets and Transactional Algebras*, Nova Science Publishers, New York, 2006.

⁹ Apreda, R. (2005) *The Principle of Subsidiarity and the Negative Spread. A Case in Point for State-Owned Banks*. University of Cema, Working Paper Series, number 308.

For instance, devolution arises when the federal government hands over the management of schools or the collection of taxes to lesser units at the local level, either states or municipalities. As the old saying goes: "locals know better".

By the same token, entitlement follows when the government grants incorporation to a company, or empowers certain community to set up cooperatives for running their local utilities (see Exhibit 1).

This dimension of subsidiarity goes back to the core tenets of Federalism and features the following targets:

- To downsize central governments, making them more efficient.
- To strengthen Public Governance¹⁰, delivering better accountability, transparency, and political practices.
- To stick with the well-known approach to decision-making usually labeled "from the bottom to the top".

Although it is usually attached to the public realm, subsidiarity pervades the private realm as well, being advocated for many innovative strategies and policies in organizations, from empowerment to outsourcing, from co-optation to horizontal subsidiarity.

b) On the other hand, the principle of subsidiarity also refers to a different meaning that encompasses both the idea of "granting subsidies" and "achieving social solidarity".

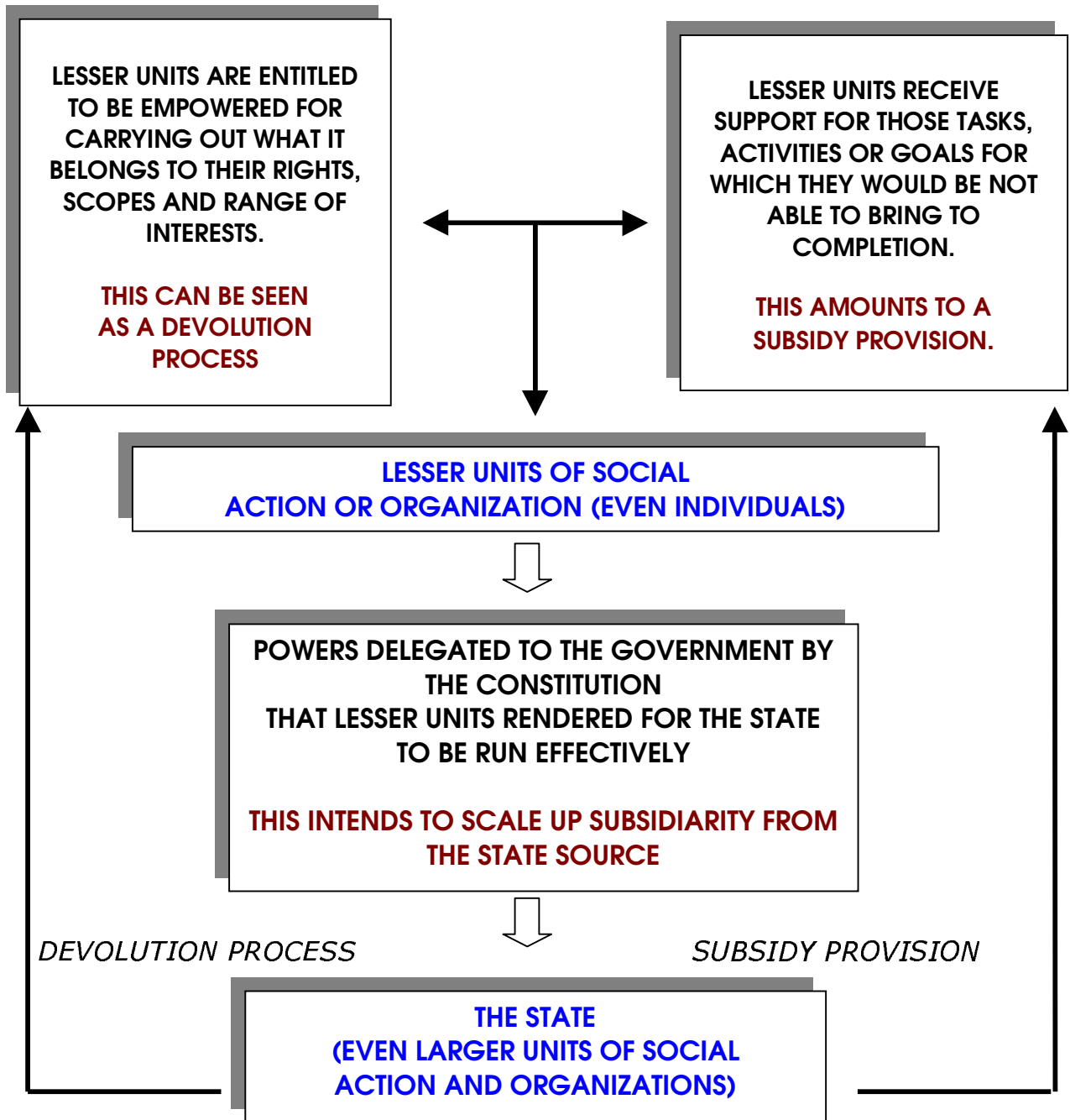
It must be acknowledged that a wide variety of wrongdoings and unfair practices have been redressed for the last two centuries through a sensible and prudential exercise of the principle of subsidiarity, in the dimension of "devolution" as well in the one pertaining the idea of "granting subsidies"¹¹.

¹⁰ We have expanded on the subject of Public Governance in Aprea (2005b).

¹¹ On this account, landmark achievements in the United States and England were the offsprings of Liberalism. In Continental Europe, the main developments can be traced down to the Catholic Social Thought (from the encyclical *Rerum Novarum* in 1891 till the *Centessimus Annus* in 1991), and also to socialists and reformers, ending in the Maastricht Treaty that placed the principle of subsidiarity second to Human Rights only.

EXHIBIT 1

THE TWOFOLD NATURE OF THE PRINCIPLE OF SUBSIDIARITY



In contradistinction to this positive development that “righted so many wrongs”, we must point out that in the name of subsidiarity groups of interest and politicians systematically cover up deviant patterns of behavior, among which we wish to highlight the following¹²:

- political clientelism;
- rent-seeking;
- soft-budget constraint;
- crony capitalism practices;
- the capture of the state;
- corruption.

3.1 THE CURRENT USAGE OF THE PRINCIPLE OF SUBSIDIARITY IN STATE-OWNED BANKS

When a state-owned bank is chartered, most often than not the principle of subsidiarity is invoked, albeit to not being explicitly embedded in the charter. The distinctive feature remains, however, whether the principle is used or misused. In the latter case, the key issue is how the principle becomes a device for concealing rent-seeking, soft-budget constraints or political clientelism.

It is when the bank steps towards the commercial field of practice that backs up its activity and decision-making processes on the principle of subsidiarity (see how the subsidy center box plays in Exhibit 2).

These activities can be embedded into a distinctive portfolio of assets that should be disclosed in its financial statements, and to which we label the **Subsidiarity Portfolio** (see Exhibit 3), and whose definition and properties will be developed in section 5.

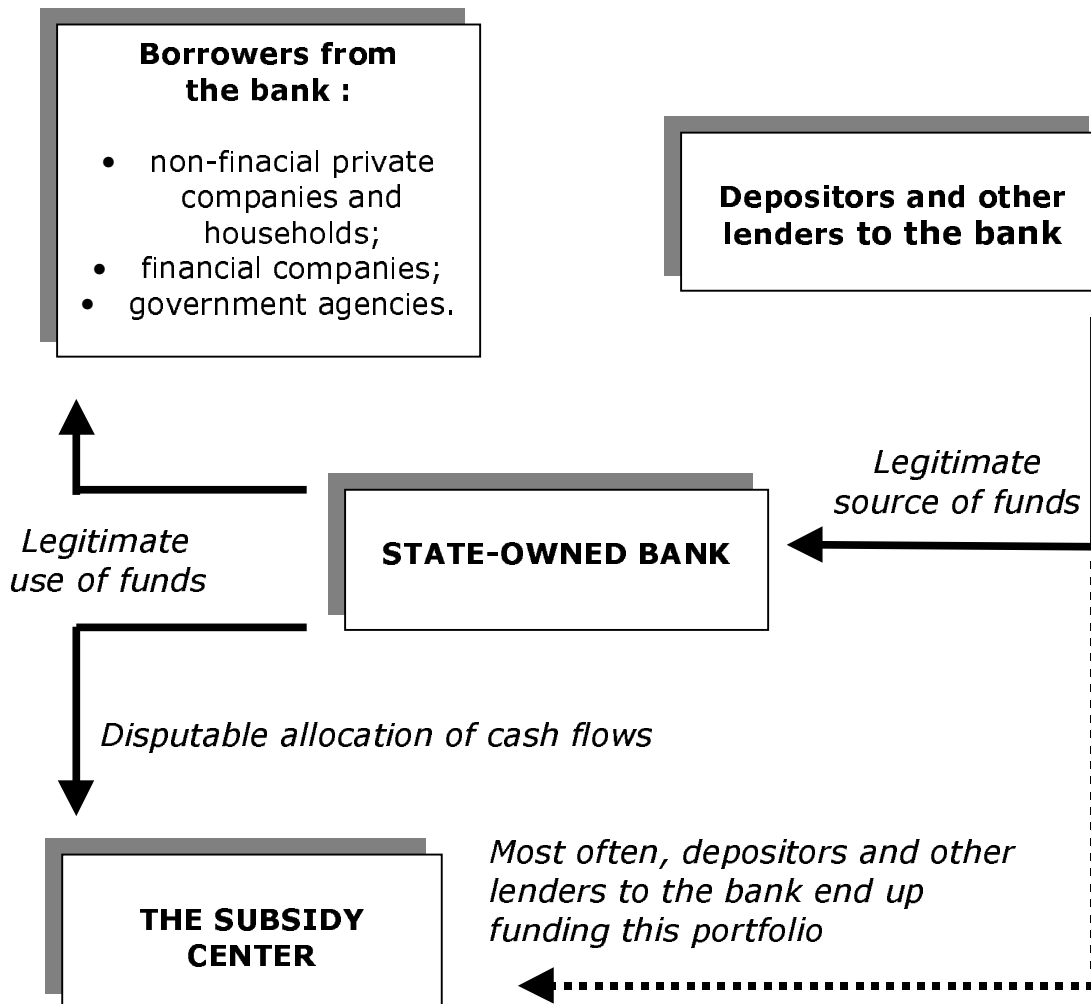
From the bank perspective, subsidiarity should be tracked down either through an outright transfer of resources to third parties, the granting of loan guarantees, exchange-rate insurance, or bail-outs to underperforming companies, among other items that lead to quasi-fiscal activities and the accounting of contingencies.

Whereas each of these commitments could be explained in terms of the outright application of the principle of subsidiarity, there are several thorny and daunting questions for which state-owned banks charters and boards of directors must be held accountable, among which we could highlight three of them.

¹² Further analysis of these deviant patterns of behavior in Apreda (2005b).

EXHIBIT 2

MONETARY FLOWS THROUGH THE COMMERCIAL SIDE OF THE STATE-OWNED BANK, AND TO THE SUBSIDY CENTER



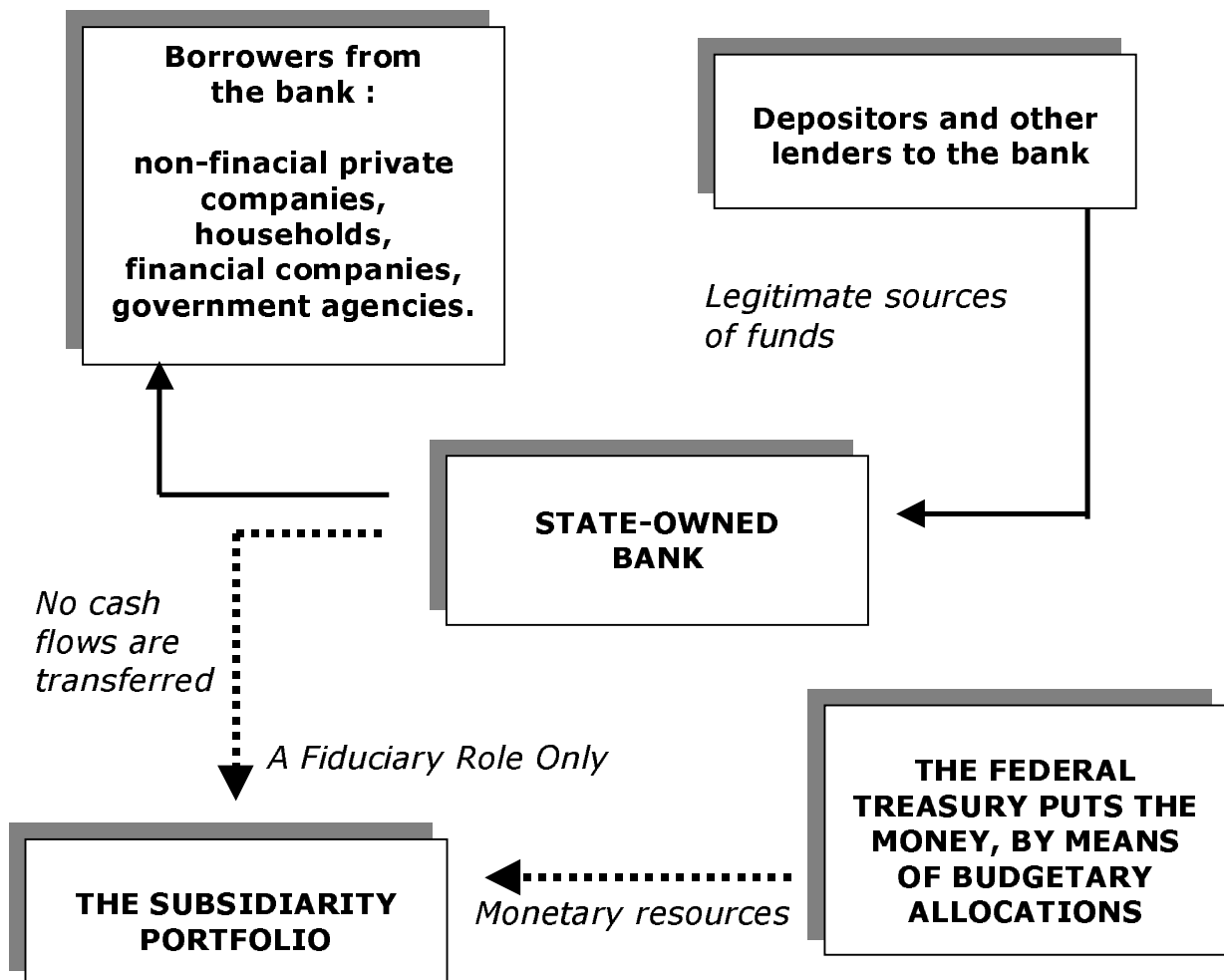
a) Where should the bottom line be drawn?

b) When is the threshold of fairness ultimately trespassed, wedging open a gap that nurtures discretionary decision-making, pervading soft-budget constraints, widespread political clientelism, law infringement and corruption?

c) How does the bank become accountable for decisions that make use of public and depositors' resources?

EXHIBIT 3

MONETARY FLOWS THROUGH THE COMMERCIAL SIDE OF THE STATE-OWNED BANK, WHEN THE SUBSIDIARITY PORTFOLIO IS FINANCED BY THE TREASURY



We ought to ask to ourselves: why is this subject matter so important when we deal with state-owned banks? Because those banks become a clear-cut example of mixed governance, where the realm of the public overlaps with the one of the private in a disturbing fashion.

The principle of subsidiarity turns out to be the rationale that allows the bank to accomplish transactions or transferences on the public side, albeit the resources to be used may be diverted from the private side. Let us expand further on this point.

Funding sources for any bank stem from depositors and other lenders to the bank (see *Exhibits 2 and 3*). Those monetary inflows are applied to meet the needs of borrowers from the bank, while idle cash balances may be allocated to a portfolio consisting of temporary investments, mainly through purchases of government bonds, as well other financial assets within the boundaries of the regulatory framework enforced in each country.

When the bank is state-owned, it fulfills a subsidiarity role whose actual nature is lessened to the extent of meaning nothing else but outright subsidy giving.

Still more worrying, however, granting subsidies calls for opportunistic behavior and political clientelism, even sheer lack of transparency. To make things worse, in some Latin American countries for instance, accountability processes seem bluntly disregarded, while the flouting of the law becomes, in the public eye, a signal of political skill and prowess.

4. THE SEPARATION COMPACT

In this section, we are going to deal with portfolios of portfolios

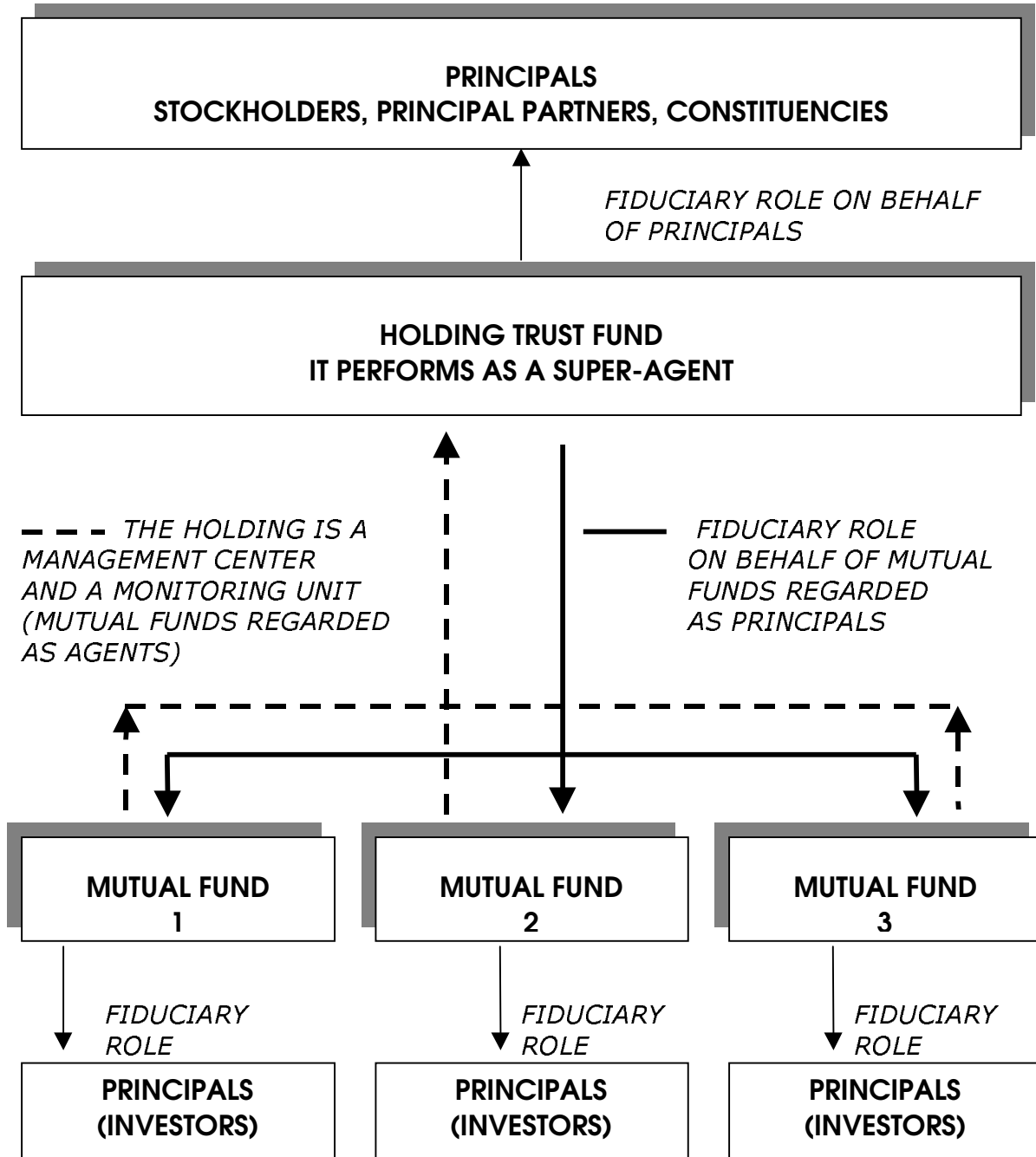
$$\left\{ \begin{array}{l} \mathbf{P} = \langle \mathbf{x}_1, \mathbf{x}_2, \mathbf{x}_3, \dots, \mathbf{x}_q \rangle \\ \text{such that } \sum \mathbf{x}_j = \mathbf{1} \end{array} \right. \quad (6)$$

where $\mathbf{x}_j$ stands for the proportion of initial wealth that we allocate to portfolio $\mathbf{P}_j$.

It is our purpose here to focus only on those portfolios that meet a distinctive constraint that will be labeled a “**separation feature**”. For the sake of illustration, we start developing a concrete environment with all the characteristics that will be displayed by the portfolios we have in mind. Let us proceed by stages, keeping an eye on Exhibit 4.

EXHIBIT 4

THE HOLDING TRUST FUND AS A SUPER-AGENT



a) CHOOSING WELL-DEFINED PORTFOLIOS

- P₁** it consists of short-term financial assets that qualify as risk-free ones, like T-Bills, or term deposits issued by top-rated banks;
- P₂** which comprises mid-term bonds issued by companies rated as “investment grade”;
- P₃** that includes profitable shares of listed companies.

b) DRAWING UP A SCHEMATIC ORGANIZATION¹³

At level 1, we shape a holding trust fund structure that will perform as a management center and monitoring unit.

At level 2, there will be three mutual funds

MF1, MF2, MF3

each managing, respectively, portfolios **P₁**, **P₂**, and **P₃**.

On the other hand, mutual funds at level 2 carry out their tasks and purposes independently from each other, while perform as principals of the holding fund placed at level 1 (see Exhibit 5).

Finally, the holding trust undertakes a fiduciary role on behalf of each mutual fund at level 2.

This two-tiered scheme of organization can be followed in Exhibit 4 .

c) THE UNDERLYING LOGIC OF THE SCHEMATIC ORGANIZATION

At this juncture, it seems advisable to put forth the purposive connections of this blueprint of organization.

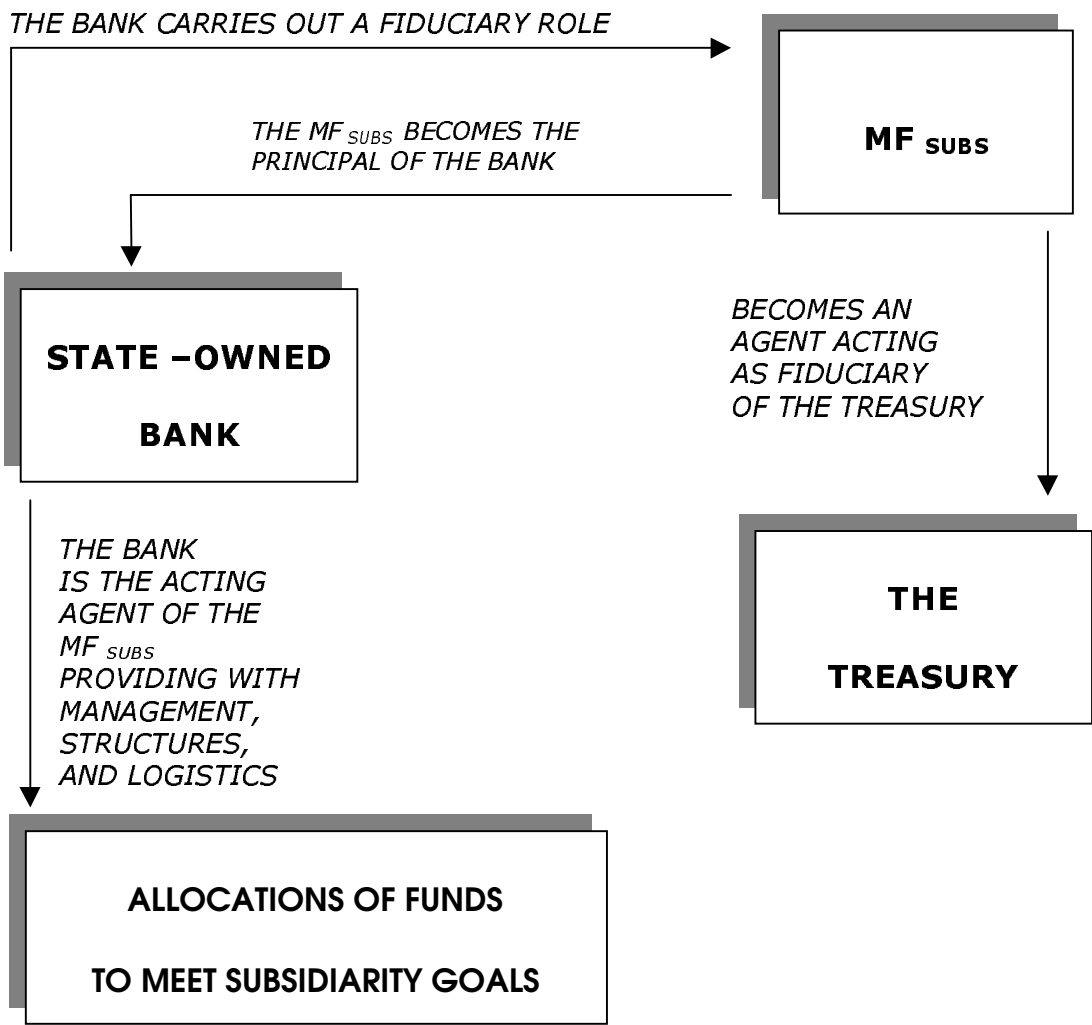
- The holding trust fund behaves like a super agent.
- To begin with, it is an agent towards its direct principals. For instance, they can be stockholders, as well principal partners

¹³ “Schematic” for the purposes of this section only, in which we attempt to introduce a holding company with affiliated mutual funds, in a very simple setting.

(as in venture capital organizations), even constituencies (like in cooperatives, or in the ownership structure of state-owned companies with minority stockholders from the private sector).

EXHIBIT 5

PRINCIPALS, AGENTS, AND THE FIDUCIARY ROLE



- On the other hand, the holding undertakes a fiduciary role by becoming agent of the mutual funds.
- However, the link between the holding trust and each mutual fund is one of a dual nature.
- The former is to claim from the latter the right to handle management and control devices through, respectively, a management center and a monitoring unit.
- From this viewpoint, the holding carries out a principal role. In fact, it plays a double-side function, as super-agent and principal.

d) ATTACHING A SEPARATION FEATURE

We are going to add a further constraint to this schematic organization:

**each constituent portfolio in portfolio P
has to be financed as a self-contained unit.**

Such constraint, that will be called “**a separation feature**”, can be attained when each mutual fund issues participation rights that place in the capital markets, and receive from investors the money that will purchase its financial assets.

From the moment each portfolio is built up, the mutual fund will be its own master, albeit it will keep acting as an agent towards the holding trust on account of management fees, overhead costs, disclosure of information, transaction costs, and the like.

e) THE HOLDING TRUST BECOMES A PORTFOLIO OF PORTFOLIOS

If we denote the holding trust as

HT

then its portfolio structure comes out of the following vector:

$$\mathbf{HT} = \langle \mathbf{x}_1, \mathbf{x}_2, \mathbf{x}_3 \rangle$$

where x_j stands for the proportion of total wealth allocated to portfolio P_j .

Because of the separation feature, each mutual fund is self-contained as regard financing. Therefore, for each fund we can work-out its initial stock of wealth

$$w_j$$

By putting

$$w(t) = w_1 + w_2 + w_3$$

it holds that

$$x_1 + x_2 + x_3 = 1$$

Hence, HT is a well-defined portfolio of portfolios in the meaning of conveyed by (6).

4.1 DEFINING THE SEPARATION COMPACT

Let us assume that, for the purposes of analysis, we can choose a family of well-defined and relevant portfolios

$$\Pi = \{ P_j \mid j: 1, 2, 3, \dots, L \}$$

Besides, let us suppose that we build up a portfolio P of portfolios chosen from Π . That is to say:

$$\left\{ \begin{array}{l} P = \langle x_1, x_2, x_3, \dots, x_L \rangle \\ \text{such that } \sum x_j = 1 \end{array} \right.$$

and to which we can attach a "separation feature" **SF**.

By a **separation compact** we mean the structure

$$\langle P ; SF \rangle$$

It is for section 6 to make use of this notion in the case of state-owned banks.

5. THE SUBSIDIARITY PORTFOLIO

In this section, we define the subsidiarity portfolio and expand on its nature.

Definition

By a **Susidiarity Portfolio**, P_{SUBS} , we mean a portfolio of portfolios

$$\left\{ \begin{array}{l} P_{SUBS} = \langle x_1, x_2, x_3, \dots, x_q \rangle \\ \text{such that } \sum x_j = 1 \end{array} \right.$$

subject to the following constraints:

c1: *subsidiarity is the single and only purpose of this portfolio;*

c2: *it is self-contained.*

Inquiring about the nature of this portfolio amounts, firstly, to the constraints built in the definition and, secondly, to bring forth how the portfolio enhances the governance of the state-owned bank eventually.

5.1 QUALIFYING THE CONSTRAINTS

The first constraint stands for a covenant that safeguards the portfolio from any likely allocation of its resources for purposes alien to the one of subsidiarity.

At this juncture, we need to focus on the organization structure within which the portfolio should be embedded,

MF_{SUBS}

a mutual fund the kind of those developed in section 4.

The constraint **c1** must be included in the **MF_{SUBS}** charter.

In Exhibit 6 we can follow the most important assets and also identify the three portfolios that serve to make up P_{SUBS} :

P_{CASH ASSETS} , P_{SUBSIDIES TO PRIVATE SECTOR} ,

and **P** **SUBSIDIES TO PUBLIC SECTOR**

Turning now to constraint c2, we have to address ourselves the following question: from where does this fund get access to the resources it needs to meet its goals? The answer will be elaborated through the following design.

a) At a foundational stage, the government purchases share-like securities issued by the

MF SUBS

This start-up endowment is funded by means of the Treasury and out of a budgetary provision.

b) As additional resources are needed by the **MF SUBS**, it is for the government to make them available under the guise of budgetary appropriations, and the **MF SUBS** issues bond-like securities in exchange for the loan.

c) The fulfillment of items a) and b) require, of necessity, the approval of the Board of Directors after a due-diligence process to ascertain whether the amounts to be issued, and the subsidiarity needs that the fund attempts to supply are both reasonable. The Board must be held accountable for its primary commitment to the duties of care and loyalty.

d) If the fund yielded net benefits after the fiscal year, then the following distribution mechanism would ensue as a matter of fact:

- the fund must keep at least 50% of net benefits to finance current subsidiarity activities;
- the remaining amount must be directed to the repurchase of outstanding bond-like securities issued by the fund;
- if the last procedure were not feasible, then the fund could distribute dividends to the Treasury, up to a rate of net benefits agreed by the Board of Directors.

In other words, constraint **c2** comprises the whole set of liabilities and capital accounts of the fund, as Exhibit 6 brings to light.

EXHIBIT 6

FINANCIAL STATEMENTS OF THE MF SUBS

ASSETS	LIABILITIES
1. Cash assets	1. Bonds issued to meet loans from the treasury
2. Subsidies to the private sector	2. Special loans or grants from international institutions to fund social programs and regional economies programs
2.1 Discounting facilities	CAPITAL ACCOUNTS
2.2 Preferential loans	
2.3 Guarantees	
2.4 Foreign exchange transactions	
2.5 Assistance to small and medium-sized firms	
2.6 Grants to companies or non-governmental organizations	1. Shares issued to meet government funding at the start-up stage
2.7 Other subsidies	2. Accumulated earnings
3. Subsidies to the public sector	3. Mandatory reserves
3.1 Regional economies	
3.2 Social responsibility	
3.3 Provinces	
3.4 Municipalities	
3.5 State-owned firms	
3.6 Other subsidies	
4. Operating assets of the fund not	

e) In point d), we drafted only an alternative design among others, all of them intending to safeguard the fund from being “kidnapped” by the state-owned bank.

f) It goes without saying that constraint **c2** must be included when drafting the **MF SUBS**’ charter.

g) The argument on the self-containedness of the **MF SUBS** would not be fully expanded if we did not give heed to a troublesome account on the asset side of Exhibit 6. We are speaking of the cash assets account.

In modern portfolio theory, the company’s treasurer builds up a cash-assets portfolio as a “transaction portfolio”. It consists of cash balances and short-term securities issued by governments (treasury bills) or the private sector (bank deposits or commercial paper, for instance).

If we did not set up restraints to the use of cash assets, there would be a wide arrange of discretionary powers on behalf of the bank or the Treasury. In fact, any of them could place their own securities in the fund’s portfolio and draw cash assets out of it. It is to prevent this environment that constraint **c2** becomes a built-in covenant in the fund’s charter.

There are some options open to cope with the problem of choosing a suitable covenant, and we are going to suggest her one for the sake of illustration.

Covenant:

*The **MF SUBS**, when running idle balances of cash assets, it can only purchase the best-rated government securities, among those that have been publicly placed and are currently traded in the market. As soon as the **MF SUBS** has to meet subsidiarity goals, it can choose the best between the two next alternatives:*

a) to sell the security to the Treasury;

b) to sell the security in the open market.

5.2 ENHANCING THE GOVERNANCE OF THE STATE-OWNED BANK.

The introduction of the subsidiarity portfolio brings about noticeable changes in the governance of the state-owned bank.

It's worth comparing and contrasting Exhibit 2 with Exhibit 3:

- a) while cash flows directed to and coming from the subsidiarity portfolio follow a path way independent of the state-owned bank,
- b) cash flows directed to and coming from the Center for Subsidies remain under the control of the state-owned bank;

Focusing on Exhibit 3, we find out a different cash flows pattern, from which we must bring to light the underlying design of governance that is featured in the following items¹⁴:

- accountability;
- control;
- management;
- transparency;
- checks a balances

ACCOUNTABILITY

The **MF_{SUBS}** performs as an agent of the Treasury and becomes the principal of the bank (see Exhibit 5). Therefore, it is held accountable to the former on how well has accomplished its commitments.

Furthermore, the bank is a fiduciary agent of the **MF_{SUBS}** that manages all the transactions the former requires to be fulfilled by the latter. However, the subsidiarity fund, as we discussed in section 4, has to carry out agent duties on the grounds of information production on behalf the bank.

CONTROL

The Board of Directors of the **MF_{SUBS}** plays an essential role in the governance design:

¹⁴ The design of governance that must be added to the governance of the state-owned bank and proposed here, is not the only one. I suggest such structure as the one that matches better our line of analysis.

- a) It consists of independent directors only.
- b) Directors cannot be appointed on political grounds, neither could they be registered as government officials nor representatives in the Legislature, for the last six years prior to the nomination date.
- c) Directors cannot be registered as members of the state-owned bank for the last ten years prior to the nomination date.
- d) Directors must be paid salaries according to the best levels in the private sector, but they will not enjoy any compensation or incentive programs during or after their tenure.
- e) Directors are appointed for a span of four years, and can be re-elected only once.
- f) The appointment of directors proceeds according to a staggering mechanism.
- g) At the end of each financial year, directors' performance should be reviewed by an independent rating agency from the private sector.

MANAGEMENT

The **MF SUBS** has no management. It is for the state-owned bank to perform such duties, and carry out the tasks involved with the attainment of that role under the guise of a fiduciary agent (see Exhibit 5).

The senior management of the bank, in all matters pertaining fiduciary commitments, becomes fully responsible to the Board of Directors for its duties towards the **MF SUBS**.

On the brink of conflict of interests or breach of the fiduciary role, the Board can call for experts and advisory organizations¹⁵, so that they can produce **Fairness Opinions** on the issue under discussion.

No senior manager of the bank can hold a seat in the Board of Directors.

¹⁵ For instance, investment banks, auditing firms, law firms, international institutions, the Central Bank, and rating-agencies.

After each financial year, the **MF SUBS** must submit the Central Bank a Report of the bank fiduciary's performance.

TRANSPARENCY

The **MF SUBS** must disclose, at the end of each financial year (or at any date in which a decision-making process could trigger material consequences to the fund), the relevant information to the following parties (see Exhibit 6):

- the Treasury;
- the state-owned bank;
- the Central Bank;
- the Federal Audit Agency;
- the External Audit of the state-owned bank;
- an international auditing firm that monitors and certifies the financial statements of the fund.

As relevant information, we can point to

- financial statements of the last financial year;
- budget of cash flows for next year, inclusive of contingent assets and liabilities, as well as off-sheet transactions;
- risk management statement;
- compliance risks statement.

It goes without saying that all relevant information must be certified by the whole Board of Directors under the duties of loyalty, care and due diligence, as well as the international audit firm appointed for the **MF SUBS**.

CHECKS AND BALANCES

At the end of each financial year, the Reporting Committee of the **MF SUBS** must submit performance reviews to the following outside parties:

- the Budget Committee at the Congress;
- the Treasury;
- the state-owned bank's Board of Directors.

6. THE STATE-OWNED BANK AS A SEPARATION COMPACT

Let us assume that, to all intents and purposes, the state-owned bank performs like an international commercial bank. Indeed, in most countries, “their national bank” is the biggest in their financial systems, measured either by deposits or loans; besides the bank usually has representative branches abroad.

Furthermore, and for the last three decades, state-owned banks have successfully entered into manifold lines of businesses like mutual funds, trust funds, insurance services, pension funds, even their own credit card units.

At this juncture, then, we can take advantage of earlier sections to expand on the following statements:

- a) The state-owned bank may be regarded a portfolio of portfolios,

P_{SOB}

into which we can embed the subsidiarity portfolio.

- b) If we endowed each constituent portfolio in **P_{SOB}** with a similar design of governance to the one used in framing the subsidiarity portfolio, the whole portfolio **P_{SOB}** would exhibit the “separation feature”.

- c) Lastly, the **P_{SOB}** becomes a separation compact.

We move on to developing these statements.

- a) For the sake of illustration, let us suppose that we build up a **P_{SOB}** suitable for a representative state-owned bank out of the following portfolios:

CB	commercial bank portfolio
CF	pension fund
MF	mutuals funds
CC	portfolio of a credit card issued and managed by the bank
SUBS	the subsidiarity portfolio

Therefore,

$$\mathbf{P}_{\text{SOB}} = \langle \mathbf{X}_{\text{CB}} ; \mathbf{X}_{\text{PF}} ; \mathbf{X}_{\text{MF}} ; \mathbf{X}_{\text{CC}} ; \mathbf{X}_{\text{SUBS}} \rangle$$

It holds, then, that $\mathbf{P}_{\text{SOB}}$ is a portfolio of portfolios.

There were two key constraints in the subsidiarity portfolio. Firstly, a constraint **c1** that defines subsidiarity as the only goal of this portfolio. Secondly, there was a constraint **c2** that imposed for the portfolio to be self-contained.

As we turn to other constituent portfolios in $\mathbf{P}_{\text{SOB}}$ both constraints seem natural and coherent so as to grant a better governance to each of them. Let us take, for instance, the pension fund portfolio PF.

In many countries, an Act has been passed to regulate and enforce compliance to the Pension Fund System, either in the public or private varieties. In those Acts, a basic covenant always set forth the main purpose of the pension fund, which is a fiduciary one towards their future beneficiaries. What the pair of constraints **c1** and **c2** add to, as we saw in section 5, is a strong governance design that sharpens up accountability, control, management, transparency, as well as checks and balances.

In particular, the second constraint, self-containedness, grants that the state-owned bank neither finances to nor is financed from the fund. The bank only carries out a fiduciary role as manager, logistics provider and controller.

Finally, both constraints are at the root of the separation feature.

c) In terms of a) and b), and by also applying the definition of separation compact, we can sum up this section:

The state-owned bank, from the viewpoint of its underlying portfolio $\mathbf{P}_{\text{SOB}}$ becomes a separation compact.

CONCLUSIONS

This paper brought forth a proposal to improve the governance of a state-owned bank.

Firstly, we established a “separation feature” that holds for portfolios of portfolios, and it led to the notion of a separation compact.

Secondly, and after developing the principle of subsidiarity, we dealt with uses and misuses of this principle with state-owned banks.

Thirdly, the paper showed how to build up a subsidiarity portfolio, and expanded on the changes in governance that follow when we design such portfolio, mainly on the fiduciary role, accountability, transparency, control, management, checks and balances.

Finally, we developed new governance foundations for the state-owned bank by regarding it as a separation compact.

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