ICR Review
Operations Evaluation Department

Report Number: ICRR11092

1. Project Data:		**Date Posted:**	02/28/2002	
PROJ ID:	P065596		**Appraisal**	**Actual**
Project Name:	Fin Sectr.adj.In Ii	**Project Costs (US$M)**	600	600
Country:	Peru	**Loan/Credit (US$M)**	300	300
Sector(s):	Board: FSP - Non-compulsory pensions insurance and contractual (27%), Compulsory pension and unemployment insurance (27%), Banking (18%), Central government administration (15%), Other social services (13%)	**Cofinancing (US$M)**	300	300
L/C Number:	L4497			
		Board Approval (FY)		99
Partners involved:	JBIC	**Closing Date**	07/31/2000	12/31/2000
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2. Project Objectives and Components

a. Objectives

The objectives of the loan were to strengthen the government's capacity to manage the impact of future economic shocks on the financial system, to promote the longer term development and resiliency of the system, and to enhance its contribution to overall growth and stability of the economy.

b. Components

There were three main components:

(1) Banking sector reforms, to empower regulators to more effectively manage the impact of economic shocks to the system. The central focus was a strengthening of pre-emptive supervision through a modernized Bank resolution framework, including a more orderly and efficient process of surveillance.

(2) Capital markets reform, consisting of an action plan to promote the development of capital markets, and institutional development aimed at restructuring the public debt management unit.

(3) Pension reform, aimed at eliminating employer arrears, improve administration of the Public Pension System, encourage people to transfer from the public to the private system, and ease the rules on the percentage of allowable investments overseas.

In addition, the loan was designed to provide a mechanism to protect social sector spending from adverse economic shocks: the loan included a list of programs to be protected from budget cuts; it also included a social contingency plan due to come into effect when some identified triggers went off.

c. Comments on Project Cost, Financing and Dates

No major changes were made. This was an adjustment operation. The short delay in the closing date was required primarily to complete some of the studies.

3. Achievement of Relevant Objectives:

The Banking Superintendency (SBS) has developed an operational manual internalizing the new regulations under a reformed banking resolution process. SBS contracted an external advisor to assist in strengthening its supervision procedures and practices, and has adopted and issued regulations regarding measures for detecting Bank problems and undertaking prompt corrective action. The FSAL helped push along successful bank resolution, and some insolvent banks were closed as a result.

In capital markets reform, the Government has issued a policy action plan to address the impediments found to hinder development of the domestic capital market. A program was approved to strengthen the Government's debt management function.

With regard to pension reform, enforcement of employer payments of contributions has been intensified through field

inspections. (The ICR provides no evidence on the effectiveness of this measure).The tax agency, SUNAT, has become involved in contribution collection with the objective of improving the administration of the Public Pension System.
The percentage of allowable investments overseas was raised to 7.5%.
A procedure has been instituted whereby new work force entrants are automatically assigned to the Private Pension System. (However, there is still the option to join the public system within a certain time period .)
The social expenditures, that were part of the Government's commitment under the loan, were included in the 2001 budget.

4. Significant Outcomes/Impacts:

The loan, together with Japanese cofinancing ($300 mn) and a parallel operation by the Inter-American Development Bank ($300 mn), provided significant budget support, which helped maintain government social spending levels for some time. The banking resolution framework was further strenghtened and facilitated the orderly restructuring of some banks.

5. Significant Shortcomings (including non-compliance with safeguard policies):

The loan had major shortcomings. First, the timing of this loan was questionable, for reasons explained in (1) below. Second, the main structural reforms in the Banking sector were introduced in the early 90s and in 96: the loan accomplished important fine-tuning in an already robust banking system, but other important needed reforms were either left out or proved ineffective in a context of weak governance . Banking resolution that took place did so in a non-transparent manner.
(1) The loan was approved in June 1999. However, unlike what is implied in para. 7.4 of the ICR, the key architects of Peru's reforms had been replaced by then. In the beginning of 1999, the team of technocrats in the Ministry of Economy and Finance, that had implemented the successful reforms of the early 1990s, was replaced by political acolytes, as were the heads of Foncodes (the main social fund) and Sunat (the tax agency), among others. The Bank knew about this politicization of several technical positions . It is highly questionable whether the Bank should provide budget support for social expenditure while a government is eroding its tax base, weakening macro -economic management, reversing structural reforms, and deteriorating governance . Furthermore, economic policymaking in general had been deteriorating steadily since 1997. In addition the second tranche of the loan was disbursed in Sept . 2000, by which time it was clear that the end-March IMF performance criteria had not been met: the IMF review of the EFF was on March 29, 2000. (Technically the EFF was not cancelled until after President Fujimori's removal in Nov . 2000.) It should be added that the QAG assessment that the [limited] reforms of the 99 loan were technically well designed but that their success depended on political factors was correct, but it underestimated how serious the political crisis was already: given the situation in Peru at the time, the reforms in question were not the most urgent .
(2) The loan itself did not address some of the main issues . (a) A primary reform recommended by the Bank's 1999 Financial Sector Assessment was to provide the staff of the Banking Superintendency (SBS) with immunity from prosecution (a basic Basle principle of Banking supervision). This was not addressed by the loan . (b) The pension sector component of the loan did not address some major problems already identified in the 1997 Pension sector reform Loan. It did not index public system pensions to inflation -to break the implicit indexation to public sector salaries. On the private pension system, it did not focus on the main aspects of the issue of weak incentives to join the private system: IMF estimates show that the replacement rates for the average worker in the public system are more than twice as high as in the private system . The incentives to join the private system were further weakened when public system pensions were in fact increased by 16 percent, in line with public sector salaries, not inflation . The increase in allowable overseas investments by pension funds (to 7.5%) was very modest given the limitations of the domestic capital market and the need to diversify the portfolios to improve performance . Moreover, the increase was illusory (ICR, p.14, para 27): it was introduced to allow for private pension funds to continue to hold on to the Telefonica del Peru shares after they were bought by Telefonica de Espana and thus became "foreign". The net result was no diversification in portfolio.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Highly Satisfactory	Moderately Satisfactory	Efficacy was satisfactory since the major objectives of the loan as approved by the Board had been met; efficiency was marginal since the size of the operation was large in relation to the quality of the reforms; as to relevance, it should be viewed as modest if not marginal given the evidence of deteriorating economic management and governance.
Institutional Dev .:	High	Modest	Institutional development Impact was modest at best, given the severe governance concerns.

Sustainability :	Likely	Likely	The few improvements in capacity are likely to be sustainable.
Bank Performance :	Highly Satisfactory	Unsatisfactory	Bank performance is rated unsatisfactory, because the deteriorating economic policy performance of Peru was not adequately accounted for, major needed reforms were left out of the conditionality package, which also suggests that the operation was overfunded, and second tranche disbursement took place when corruption was no longer just an allegation.
Borrower Perf .:	Highly Satisfactory	Satisfactory	Borrower performance is rated satisfactory: the package of reforms fell short of expectations, but all agreed reforms were implemented.
Quality of ICR :		Satisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

It is difficult for the Bank to effectively protect social expenditure in the absence of a strong government commitment to do so. Lending in such a scenario can allow a government to continue eroding its tax base, reducing social expenditure, and still meet the Bank's social expenditure floor, financed by Bank lending .

8. Assessment Recommended? ● Yes ○ No

Why? There are major questions pending about relevance .

9. Comments on Quality of ICR:

The ICR is well written, but does not give a complete picture of the macro -situation surrounding the loan. There is also very little concrete evidence on progress . Given the complexity of the circumstances surrounding this operation, it might have been more appropriate to produce an intensive learning ICR .