ICR Review

Operations Evaluation Department

Report Number : ICRR11312

1. Project Data:		Date Posted : 08/13/2002		
PROJ ID:	P010563		Appraisal	Actual
Project Name :	Financial Sector Development Project (FSDP)	Project Costs (US$M)	1157.2	1351.8
Country:	India	Loan/Credit (US$M)	700	383.7
Sector(s):	Board: FSP - General finance sector (90%), Central government administration (10%)	Cofinancing (US$M)		
L/C Number:	L3856; L3857; L3858			
		Board Approval (FY)		96
Partners involved :		Closing Date	10/31/2001	10/31/2001

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2. Project Objectives and Components

a. Objectives

Original objective : At inception, the project aimed to foster greater market orientation, allocative efficiency, technical competence, and competition in India's financial system and contribute to meeting the long -term financing needs of its investors as a means of stimulating economic growth . It aimed to assist the GOI to sustain financial liberalization, institutional development of public sector commercial banks and integration into global capital markets . It was intended to facilitate expansion of private equity ownership in public sector commercial banks and development of term foreign currency lending.

Revised objective : At a mid-term review in mid-1998, the scope of project objectives was narrowed (but not formally with a communication to the Board, so OED will evaluate in relation to original objectives) so that the primary objective of the project became strengthening the (original six minus one) Participating Bank (PBs) financially and institutionally, with a secondary objective of providing a "catalyst for the transformation of the Indian banking system . The institutional development objective was intended to enhance their efficiency and profitability through the introduction of modern commercial banking skills.

b. Components

At inception, the project consisted of three components, with the Bank contribution shown in parentheses : **1. Capital Restructuring Loan** (CRL, US$300 million): Lent to the GOI, and on-lent as a subordinated loan (long-term, subordinated to all other creditors) to 6 PBs to strengthen their capital base (such debt is considered Tier II capital and can be used to meet up to half the Basle Accord minimum capital adequacy ratios); (the 6 PBs had around 20% of total assets of all Public Sector Banks --PSBs). **2. Modernization and Institutional Development Loan** (MIDL, US$150 million): Provided to the Industrial Bank of India (IDBI) and on-lent to PBs (but under the coordination and supervision of the central bank) to cover the cost of annual business programs to improve strategic planning, automation and computerization of payments and accounts, human resource development, organizational improvements, and improved treasury and credit management; **3. Back Stop Facility** (BSF, US$200 million) provided to IDBI to provide a fund from which PBs could borrow in the event of market disruption . In September, 1996, this component was dropped from the project due to a lack of demand .

c. Comments on Project Cost, Financing and Dates

US$200 million was removed from the project when the BSF was dropped . One PB, Indian Bank, experienced very poor financial performance and was removed from the project in 1998 with a resultant decrease in the CRL loan amount of US$50 million. The MIDL was reduced by US$51.3 million in April, 1999, due to slow disbursement, and then by a further US$15 million in March, 2001. Thus the total loan amount became US$383.7, which was completely disbursed by project close . It should be noted that the GOI contribution was US$1,052 million, and that of PBs US$7.5 million, for a total project cost of US$1,443 million. The project closed as scheduled on October 31, 2001.

3. Achievement of Relevant Objectives:

- Four of the six PBs substantially increased the proportion of their branches that are completely computerized
- Two PBs had significant increases in staff productivity, with three others experiencing smaller increases
- PB usage of IT expanded, exceeding norms set by GOI agencies, and all PBs benefited from training in this area
- Five of six PBs streamlined their organizational structure, and also improved the availability of information key to efficient management

4. Significant Outcomes/Impacts:

As similar improvements also occurred among public banks not associated with the project, spurred by the growing foreign presence of foreign banks and the proactive policy of the central bank, it is not possible to establish the existence or the extent of cause-effect with the project. Nonetheless, under the project:

- the number of computerized branches of PBs increased from 322 in March, 1996, to 2180 in September, 2001;
- during the same interval, the business of the PBs tripled while they reduced staffing by around 17%;
- the median cost to income ratios of PBs declined from 83% in 1995-96 to 76% in 2000-01, while the ratios for other (non-participating) PSBs rose from 53% to 67%;
- four of the PBs offered an average of 25% of their share capital to the public during the project period.

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

- The BSF was canceled in September, 1996, due to a lack of demand. GOI policy changes and a build-up of foreign exchange reserves had made it much easier for banks and other firms to access foreign exchange on market terms.
- Project design was flawed (see Section 6); the CRL seemed to be based on a flawed presumption that a one-time recapitalization of PBs together with limited private ownership and involvement in corporate governance would significantly improve PB financial and operating performance.
- Despite their recapitalization, from 1995 to 2000 the median capital adequacy ratio (CAR) of the PBs rose by less than that of PSBs that were not in the program (n=21).
- Median non-performing assets (NPA) as a percent of total assets rose over the project period from 3.6% to 3.9% for PBs, while that for other (non-participating) PSBs fell from 3.4% to 2.6%.
- The median net interest margin of the PBs, while falling by 27% over the period and contributing to poor profitability of the PBs over the life of the project, was still 20% above the margin among non-participating PSBs (which also fell by 9%).
- One bank accepted as a PB--Indian Bank--apparently had a significant proportion of non-performing assets at project inception. Indian Bank's performance deteriorated during the project period--its CAR was negative 14% in 2000-01--and it was removed from the project in 1998.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Unsatisfactory	Unsatisfactory	In addition to modestly relevant objectives (which supported the GOI's desire to retain control of banks instead of their privatization), results have been disappointing on both absolute terms, as well as relative to the other public sector banks.
Institutional Dev .:	Modest	Modest	While there may have been strong capacity building within the PBs, a modest ID impact rating is justified because of the lack of project's impact on the overall incentive framework for the management of public sector banks.
Sustainability :	Likely	Non-evaluable	The inadequacy of the current policies and of the incentive framework for the management of the public sector banks as well as the delays and uncertainty over their future reform bring into question the resilience of even the limited achievements under the project
Bank Performance :	Satisfactory	Unsatisfactory	The Bank should not have supported modestly relevant objectives with a large project with little policy content. This contributed to weakened market discipline

			and moral hazard (para. 8 of Annex 9). The Bank also did not heed the early reservations of the central bank and IDBI about the need for the BSF. Indeed, the ICR rates the project's quality at entry unsatisfactory. It also recognizes that supervision prior to 1998 had an insufficient focus on the project's development impact and did not utilize effective project monitoring indicators. The improved supervision of the last three years could not overturn the fatal flaws in the project's objectives and design and in early supervision and neither can outweigh the unsatisfactory rating for Bank performance through 1998.
Borrower Perf .:	Unsatisfactory	Unsatisfactory	The government's policy views on bank commercialization and privatization had not evolved to the extent necessary for the FSDP to be successful
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:

- An adjustment operation focused on broadly applicable policies is a more appropriate instrument (than an investment operation directed at indivdual banks) to foster market orientation, allocative efficiency, and competition in the financial sector.
- For an operation to be successful in achieving objectives such as those of FSDP, it must close the serious gaps in the legal and judicial framework, address corporate governance, and provide the right incentives for enhanced managerial autonomy and accountability, which in most cases requires a bolder move to privatize the public banks.
- Specific monitoring indicators and performance benchmarks must be part of the design of a project such as the FSDP

8. Assessment Recommended? ○ Yes ● No

9. Comments on Quality of ICR:

The ICR presents an especially candid and comprehensive view of the project . The discussion of the project design and the coverage of important subjects are excellent . Evidence is especially compelling with regard to the financial performance of PBs as compared to PSBs that did not participate in the project . This ICR would have been rated exemplary, were it not for its inconsistency between the rating of overall Bank Performance and the associated discussion. Less striking inconsistencies were also noted with respect to the ICR's explicit ratings for ID impact and for sustainability and the supporting text (para 4.5 describes the improvements in the institutional arrangements as "wide-ranging and significant", with no qualifications, thus implying a rating of substantial, not modest, ID impact) and annexes (paras 3-12 of Annex 9, and especially para. 8, highlight the fragility and the risk, rather than the resilience, of the governance and the operational improvements in the performance of public banks and do not support the ICR's explicit rating of likely sustainability of the project's achievements, however limited).