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OED Review of Bank Assistance For Financial Sector Reform

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Abbreviations and Acronyms

ADB	Asian Development Bank
AFR	Africa Region
AMC	Asset Management Company
CAS	Country Assistance Strategy
CPIA	Country Policy and Institutional Assessment
DEC	Development Economics Vice Presidency
EAP	East Asia and Pacific Region
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia Region
ECAL	Economic Competitive Adjustment Loan
EFSAC	Enterprise and Financial Sector Adjustment Credit
EFSAL	Enterprise and Financial Sector Adjustment Loan
ERSO	Economic Recovery Support Operation
ESW	Economic and Sector Work
FESAC	Financial and Enterprise Adjustment Credit (general name)
FESAL	Financial and Enterprise Adjustment Loans (general name)
FSAC	Financial Sector Adjustment Credit (general name)
FSAL	Financial Sector Adjustment Loan
FSAP	Financial Sector Assessment Program
FY	Fiscal Year
GDP	Gross Domestic Product
ICR	Implementation Completion Report
IFC	International Finance Corporation
IFI	International Financial Institutions
IMF	International Monetary Fund
LCR	Latin America and the Caribbean Region
LOC	Lines of Credit
MNA	Middle East and North Africa Region
NPL	Non-Performing Loan
OD	Operational Directive
OECD	Organization for Economic Co-operation and Development
OED	Operations Evaluation Department
OP	Operational Policy
PRSC	Poverty Reduction Support Credit
QAG	Quality Assurance Group
QEA	Quality at Entry Assessment
SAC	Structural Adjustment Credit
SAL	Structural Adjustment Loan
SAR	South Asia Region
SFO	Special Financial Operations
SIMA	Statistical Information Management & Analysis
TA	Technical Assistance
WDI	World Development Indicators
WDR	World Development Report

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Foreword

After more than a decade of borrowing from the Bank for financial sector reforms, most of the 96 borrowing countries have witnessed improvements in their financial sectors, in terms of ownership of banks, efficiency measures, financial sector depth, and access to credit. These improvements can be associated with Bank borrowing: financial sector outcomes in countries that borrowed from the Bank are generally significantly better than in countries that did not borrow from the Bank for financial sector reforms. Nevertheless, in most of the countries, although the trend has been in the right direction, the financial sectors remain relatively shallow, and private sector access to credit remains low. These findings suggest that although reforms supported by Bank lending over the past decade can be associated with improvements, they have not been sufficient to bring about the ultimate objective of well-developed financial systems.

Between FY93 and FY03, Bank assistance for financial sector reforms was supported by some US$56 billion dollars in lending, or 24 percent of the Bank's total commitments; most of this lending was embedded in multi-sector loans. Over this period, lending for financial sector reforms declined, due mainly to the sharp drop in lines of credit (LOC); apart from LOC, support for financial sector reforms has declined only slightly.

This Operation Evaluation Department (OED) review of World Bank assistance for financial sector reforms finds that the objectives of Bank assistance generally followed good practice in terms of reducing government ownership of financial intermediaries, improving prudential regulation to be consistent with international norms, and strengthening banking supervision to adhere more closely to international principles. This review also finds, however, that consistency within a country – for example, advocating the privatization of banks while simultaneously supporting the expansion of government ownership of banks – should be improved, as could the coherence of the Bank's approach to financial sector reforms across countries – for example, advocating rapid privatization in one transition country while recommending a slow, gradual approach to privatization in another transition country. Other areas where there has been wide variation in Bank support and what seems to be an ad hoc approach to the priority for Bank support include payments systems, deposit insurance schemes, and capital market development. The combination of on-going debates within the Bank (e.g., whether and how to support deposit insurance schemes), absence of "good policy" notes, and the decentralized nature of Bank operations have all contributed to a situation in which the Bank speaks with many voices on important matters of financial sector policy, a difference which cannot be fully explained by differences in country circumstances or willingness to reform.

Outcomes of loans under the financial sector board were significantly better than outcomes of financial sector components of multi-sector loans, which points to the need

for a stronger role in quality assurance by the sector board as well as the need to ensure strong support from financial sector officials in the client country.

Bank assistance for financial sector reforms to countries experiencing crisis constitute some 50 percent of the lending reviewed here. Crisis lending differs from non-crisis lending in several important respects: the former is prepared under stressful conditions; speed is important; sometimes without prior analysis or dialogue with the government about issues; and is typically part of large, publicly announced international rescue package. Because of these exceptional factors, OED examined crisis lending separately, in 14 countries.

OED found that the Bank was ill-prepared to respond quickly in the earlier crises in Mexico (1994), and Thailand, Korea, and Indonesia (1997); and better prepared in Argentina, Russia, and Turkey. Even in countries where it recognized signs of vulnerability (Indonesia, Turkey), official Bank documents gave sanguine assessments of risks. Although the stated objectives of the loans were similar in scope and nature to financial sector reforms pursued in non-crisis situations, outcome ratings of these closed operations (US$18 billion) are lower by some 15 percentage points than outcomes of non-crisis lending. This is a somewhat surprising finding given the high relevance of the objectives and the fact that crises often induce or strengthen commitment of governments to addressing the problems. It is likely the result of the need to state overly-ambitious objectives to justify the large loans that are necessary to fulfill the pre-announced assistance package.

Collaboration with the IMF in countries that experienced a crisis was not always smooth, particularly in Indonesia, Mexico, Russia, and Thailand. Following the Asian experience, the Bank and the IMF reached agreements in principle to improve collaboration, although the boundary between the two institutions is not always clear. In addition, regional development banks often play a role in the rescue, which needs to be coordinated as well. Collaboration among the IFIs in countries experiencing a crisis remains a challenge. Finally, recommendations from an earlier, high-level internal Bank review suggested that the Bank prepare guidelines for crisis situations on triggers for actions and clear lines of responsibility; these recommendations have not been implemented and remain valid today.

Recommendations

- The Bank's financial sector anchor should provide more guidance for Bank staff and client countries, in areas such as restructuring of banks (if, when, and how); asset management companies (if, when, how); privatization of banks; promotion of capital markets (if, when, and how, in conjunction with IFC on this); and for topics related to the strengthening the legal, regulatory, and supervisory environment, a particular focus on implementation. In addition, the financial sector network should become more pro-active in quality control of financial sector components in multi-sector loans.

- The Bank should develop monitorable indicators to assess progress on objectives in the area of prudential regulations and supervision for financial intermediaries.

- On support for countries prior to and following crisis, the Bank should develop a rating system, in partnership with other relevant institutions, for vulnerability to crisis, making use of readily available information that can be used to engage countries in crisis prevention measures and issues in crisis response. The Bank should also do a better job than in the past of presenting assessments more candidly in documents. Finally, the Bank should make internal arrangements to respond better to crisis by developing guidelines for dealing with crisis, which should include the possibility, if circumstances warrant, of lending liquidity support to countries experiencing a crisis without stipulating ambitious reforms (that may not be realized) as justification for the loan.

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Preface

This evaluation presents an independent assessment of the Bank's support for financial sector reforms over the period FY93-03. It is the second part of a two-part evaluation; the first part of the assessment covered lines of credit.

This volume focuses on Bank lending for financial sector reforms, including both lending categorized under the financial sector and financial sector components of multi-sector loans. The assessment examines trends in lending, the quality at entry of Bank assistance; and the outcomes of individual loans and components addressing financial sector reforms. It also assesses the extent to which the objectives of Bank assistance were achieved, including reducing government ownership of financial intermediaries, decreased market concentration, increased competition and efficiency, healthier and more stable financial intermediaries, and deeper, more developed financial systems. Finally, the assessment examines Bank support for financial sector reforms in countries under crisis.

The basis for the evaluation consists of a data base developed by OED on all Bank's lending for financial reforms, background papers on selected topics, and case country studies based on desk reviews.

The report has been circulated to Bank management involved in financial sector support, the Financial Sector Board of the Bank, and the Financial Sector Operations and Policy Department (OPD).

This evaluation was discussed at the Committee of Development Effectiveness (CODE) meeting held on March 30, 2005, and the Chairman's Summary is attached as Attachment 2. The Management Response is attached as Attachment 1 to this report.

This evaluation was written by Laurie Effron, with the assistance of Robert Cull (DEC), Nicolas Dujovne (consultant), Ilka Funke (OEDCR), Jeremy Ghez, Manuel Hinds (consultants), Gulmira Karaguisheva (OEDCR), Miguel Kiguel, Fred Levy, Millard Long, Dan Mozes (consultants), Brandie Sasser, and Barbara Yale (OEDCR). Roziah Baba (OEDCR) provided administrative assistance. The evaluation has also benefited from the comments of three peer reviewers: Patrick Honohan, Roberto Rocha, and Stijn Claessens (OPD), and an External Advisory Panel of outside reviewers: Andrew Sheng, Charles Goodhart, and Narayan Vaghul.

EXECUTIVE SUMMARY

1. This Operations Evaluation Department (OED) review of World Bank assistance for financial sector reforms finds that the objectives of Bank assistance generally followed good practice in the areas of reducing government ownership of financial intermediaries, improving prudential regulations to be consistent with international norms, and strengthening banking supervision to adhere more closely to international principles. This review also finds, however, that consistency within a country and most especially coherence of the Bank's approach to financial sector reforms across countries should be improved, particularly with respect to the priority for Bank support for payments systems, deposit insurance schemes, and capital market development. The combination of on-going debates within the Bank (e.g., whether and how to support deposit insurance schemes), absence of "good policy" notes, and the decentralized nature of Bank operations have all contributed to a situation in which the Bank speaks with many voices on important matters of financial sector policy, a difference which cannot be fully explained by differences in country circumstances or willingness to reform.

2. After well over a decade of borrowing from the Bank for financial sector reforms, most of the 96 borrowing countries have witnessed improvements in their financial sectors. These improvements can be associated with Bank borrowing (see paragraph 7 below). Nevertheless, in most of the countries, the financial sectors deepened only modestly and remain relatively shallow, and private sector access to credit remains low.

3. Between FY93 and FY03, Bank assistance for financial sector reforms was supported by some US$56 billion dollars in lending, or 24 percent of the Bank's total commitments; these figures take into account lending that is categorized by the Bank under the financial sector board as well as components of multi-sector lending categorized under other boards (mostly Economic Policy). The support aimed at bank restructuring and privatization, strengthening prudential regulations and banking supervision, improving the regulatory and institutional framework for capital markets and insurance, and capacity building in specific financial intermediaries.

4. Most of the lending for financial sector reforms was embedded in components of multi-sector loans; out of 385 loans containing support for these reforms, only 36 percent (137 loans) were in the financial sector, and the remainder, were components of adjustment and technical assistance loans and lines of credit in other sectors. Over the period FY93-03, lending for financial sector reforms has declined, due mainly to the sharp drop in lines of credit (LOC). Apart from LOC, support for financial sector reforms through adjustment and technical assistance lending has declined only slightly, with a more noticeable drop in (formal) non-lending assistance.

5. Excluding LOC, which are analyzed in a separate OED review, outcomes of all lending for financial sector reforms (adjustment plus technical assistance (TA) loans) averages 75 percent satisfactory, slightly below the 79 percent average for all (adjustment and TA) lending excluding financial sector. However, the outcomes of loans under the financial sector board were significantly better than outcomes of financial sector

components of multi-sector loans, which points to the need for a stronger role in quality assurance of financial sector components by the sector board as well as the need to ensure that the financial sector reforms embedded in multi-sector loans have strong support from financial sector officials in the client country.

6. In addition, adjustment loans and components of adjustment loans have better outcomes in countries with modest institutional capacity when they are accompanied by TA loans than when TA loans are absent. In higher capacity countries, however, adjustment loans have worse outcomes when TA loans accompany them than when they don't. One explanation for this is that a TA loan in a higher capacity country may be a signal that the government is not fully committed to carrying out the reforms.

7. At a country-level, OED examined whether Bank borrowing could be associated with changes in outputs, outcomes, and impact. Output was defined as a decrease in government ownership of banks and stronger regulatory and supervisory frameworks for banking. Outcomes were defined as: (i) market structure measured by concentration rates; (ii) contestability measured by ease of entry and absence of restrictions on activities – freedom to compete – in banking; (iii) efficiency measured by interest rate spreads; and (iv) health of the banking system measured by capital adequacy and non-performing loans. Finally, impacts were defined as: (i) financial sector depth in banking, measured by the money supply as a proportion of GDP and preference for cash as an indicator of the lack of confidence in the banking system; (ii) size of the capital markets, measured by capitalization and turnover as a proportion of GDP; (iii) credit to the private sector, and (iv) financial sector stability (absence of systemic banking insolvency). Because financial sector developments are so closely linked to other country characteristics, for much of this analysis, an econometric model was used to control for country conditions, including growth rates, inflation rates, fiscal deficit, and institutional capacity. OED also tested whether the results were different for countries that borrowed from those that did not borrow for financial sector reforms over the period under review. Because countries that borrow from the Bank may be self-selecting, and more likely to be reform-oriented than those that don't borrow, the results of the econometric analysis show association of Bank borrowing with outcomes, rather than causality, although further econometric tests (including treatment effects regressions that explicitly account for self-selection, and propensity score matching techniques) provided evidence that reinforce the main findings.

8. Output at the country-level. Between the early 1990s and 2003, Government ownership decreased dramatically in countries that borrowed for bank privatization, and by more than in Bank client countries that were also privatizing their banking system without borrowing from the Bank. Official data mask the full picture of government control of financial intermediaries, however, because governments often retain significant minority ownership in banks that are considered private and many countries have state owned non-bank financial intermediaries that do substantial lending. Thus, reducing governments' role in financial intermediation remains a challenge. Although the Bank often and appropriately supported financial restructuring prior to privatization of banks, Bank support has not consistently focused on the quality of the new owners, and this has contributed to poor results. In addition, the Bank has supported financial restructuring of

banks in the absence of government commitment to change their ownership, and this has led to poor results (re-appearance of poor loan portfolios and insolvency).

9. Improvement in laws and regulations governing the financial sector was uneven in borrowing countries. Between 1998 (the earliest year for which systematic information was available) and 2003, capital requirements remained about the same, while rules on loan classification were stricter; the opposite was true for non-borrowing countries (stricter capital requirements, less stringent loan classification). Among transition countries, the regulatory frameworks for banks and capital markets show more improvement since 1998 in borrowing than in non-borrowing countries. On the critical aspect of implementation of the laws and regulations, there was little information, and thus it was not possible to assess the extent to which laws and regulations were in fact observed. Strengthening banking supervision remains a priority. A number of countries that borrowed from the Bank to strengthen banking supervision are still far from complying with Basel core principles.

10. *Outcome at the country-level.* Concentration levels decreased significantly since the early 1990s for all countries, although more so in non-borrowers, while contestability since 1998 (earliest year for which data are available) increased in borrowing countries as measured by lower restrictions on banking activities and decreased in non-borrowing countries. Interest rate margins (since the early 1990s) narrowed significantly in borrowing countries and did not change in non-borrowing countries. Finally, data on health are not sufficient for a comparative analysis (of "with" and "without" borrowing), but they do point to an improvement (non-performing loans decreased; capital adequacy increased) in the borrowing countries. Thus, overall, Bank borrowing is associated with good outcomes and, where information permits comparisons, to mostly better outcomes than in non-borrowing countries.

11. *Impact at the country-level.* The positive results on outcomes discussed in the previous paragraph do not translate into equally positive findings on impact over the last decade, although developments have been in the right direction. Financial sectors became deeper in countries that borrowed for financial sector reforms over the period, although not significantly more than in non-borrowing countries. In any case, they remain, on average, relatively shallow – M2/GDP, for example, was below 40 percent in the Bank borrowers in 2002 (it is about 80 percent in the Organization for Economic Co-operation and Development (OECD) countries). Liquidity preference (cash as a proportion of the money supply – considered the inverse of public confidence in the banking system) decreased significantly (at roughly the same rate as in non-borrowing countries), which could be the result of the reforms aimed at downsizing, restructuring, and privatizing banks and pro-active efforts by governments to regulate and supervise them.

12. Credit to the private sector (as a percent of GDP) grew at an annual rate of 0.4 percent per year in the countries that borrowed from the Bank for financial sector reforms, less than it did in countries that did not borrow from the Bank (where it grew by about 1.7 percent per year). One explanation of the modest growth in credit is that the process of strengthening both governance and prudential regulations could lead to greater

prudence in lending; thus, although the growth is slower than in non-borrowing countries, it may be more prudent lending. But on average, credit to the private sector remains very low, below 30 percent of GDP in the 62 borrowing countries for which information was available (and in 17 countries, it was below 10 percent; in OECD countries, as a point of comparison, it was over 110 percent). Finally, OED found no pattern in terms of improved stability of the financial system in countries that borrowed from the Bank relative to those that didn't.

13. The findings on financial sector depth and credit to the private sector suggest that the reforms supported by Bank lending over the past decade are closely associated with improvements in the financial systems, but they have not been sufficient to bring about well-developed financial systems.

14. Bank assistance for financial sector reforms to countries in crisis constitute some 50 percent of the lending reviewed here. The circumstances surrounding crisis lending are different from non-crisis lending: the former is prepared under stressful conditions; speed is important; sometimes without prior analysis of or dialogue with the government about issues; as part of large, publicly announced international rescue packages. Because of these exceptional factors, OED examined crisis lending separately, in 14 countries.

15. OED found that the Bank was ill-prepared in Mexico in 1994, and in Thailand, Korea, and Indonesia in 1997 to respond quickly; and better prepared in Argentina, Russia, and Turkey. Even in countries where it recognized signs of vulnerability (Indonesia, Turkey), official Bank documents gave sanguine assessments of risks. Although the stated objectives of the loans were similar in scope and nature to financial sector reforms pursued in non-crisis countries, outcome ratings of the 31 closed operations (US$18 billion) are lower by some 15 percentage points than outcomes of non-crisis lending. This is a somewhat surprising finding given the high relevance of the objectives and the fact that crises often induce or strengthen commitment of governments to addressing the problems. It is likely the result of the need to state overly-ambitious objectives to justify the large loans that are necessary to fulfill the pre-announced assistance package (Chapter 9).

16. Collaboration with the International Monetary Fund (IMF) in countries that experienced a crisis was not always smooth, particularly in Indonesia, Mexico, Russia, and Thailand. Following the Asian experience, the Bank and the IMF reached agreements in principle to improve collaboration, although the boundary between the two institutions is not always clear. In addition, regional development banks often play a role in the rescue, which needs to be coordinated as well. Collaboration among the International Financial Institutions (IFIs) in countries experiencing a crisis remains a challenge. Finally, OED found that prior recommendations for the Bank to prepare guidelines for crisis situations on triggers for actions and clear lines of responsibility have not been implemented and remain valid today.

Recommendations

- The Bank's financial sector anchor should provide much clearer guidance for Bank staff and client countries and the financial sector network should become more pro-active in quality control of financial sector components in multi-sector loans. This involves producing good practice notes on a range of topics, in areas where there is a cohesive internal Bank view on reforms. In areas where debate continues, it needs to provide a review of issues and options for Bank support. Subjects where guidance is needed include restructuring of banks (if, when, and how); asset management companies (if, when, how); privatization of banks; promotion of capital markets (if, when, and how, in conjunction with IFC on this); deposit insurance (what to do if government seeks support; issues to consider) and for topics related to the strengthening the legal, regulatory, and supervisory environment, a particular focus on implementation.

- The Bank needs to focus assistance on: (i) the process of preparing banks for privatization (financial restructuring) and ensuring that banks are sold to fit and proper owners; (ii) implementation of laws and regulations governing the financial sector; (iii) strengthening supervision of financial intermediaries; and (iv) increasing access to credit by improving collateral laws, creditor rights, providing technical assistance and training.

- The Bank should develop monitorable indicators to assess progress on objectives in the area of prudential regulations and supervision for financial intermediaries.

- On support for countries prior to and following crisis:

  - The Bank should develop a rating system, in partnership with other relevant institutions, for vulnerability to crisis, making use of readily available information that can be used to engage countries in crisis prevention measures and issues in crisis response. The Bank should also do a better job than in the past of presenting assessments more candidly in documents.

  - The Bank should make internal arrangements to respond better to crisis by developing guidelines for dealing with crisis, which should include the possibility, if circumstances warrant, of lending liquidity support to countries experiencing a crisis without stipulating ambitious reforms (that may not be realized) as justification for the loan.

  - Coordination with the IMF and other IFIs in crisis assistance needs to be improved, and at the outset of a crisis, the IFIs should reach quick agreement on division of responsibilities.

1. Objectives, Inputs, and Organization of the Review

1.1 *Background.* The importance of the financial sector is widely recognized for the role it can play in the development of a country. Although its impact on poverty alleviation is not as obvious as investments in, say, rural infrastructure, financial sector development is essential for mobilizing resources, channeling them to productive investments, managing risks, and thereby contributing to economic growth. Other key services provided by a well-functioning financial sector include efficient payment and settlement systems, which lower transaction costs, and effective monetary policy. In addition, the forces of globalization and changes in technology have affected the roles as well as the vulnerabilities of financial sectors as never before; the last decade provides many examples of the devastating impact that financial crises can have on countries in terms of lower growth and increased poverty. A well diversified, robust, and stable financial sector can better withstand the forces that induce crises—although it may not be able to prevent them entirely—which negatively affect economies for years afterward.

1.2 For more than fifty years, the Bank has supported financial sectors in client countries, initially through helping to set up and strengthen development finance companies and then, starting in the late 1980s, through supporting sector-wide reforms, particularly in banking, but also in capital market, pension,[1] and insurance reforms.

1.3 The present review examines Bank assistance to financial sector reform over the past decade. Between FY93 and FY03, the Bank made financial sector loans (excluding pension reforms) totaling some US$24.8 billion, representing 11 percent of total Bank commitments. If all loans and credits with financial sector reform components are included, a total of US$56 billion involved some financial sector reforms, representing 24 percent of Bank lending over this period.

1.4 *Objectives of the review.* This review answers a series of questions:

- Are Bank policies on financial sector reforms well-defined and do they follow good practice as defined by the literature?
- What has Bank lending been in the aggregate over time and by Region in Bank assistance for financial sector reforms, including such support in multi-sector loans?
- Has the Bank followed good practice, as defined by the literature and Bank policies?
- Do outcomes of Bank loans show any patterns over time, by type of instrument, by sector classification, by country characteristics?
- Were the objectives of Bank lending met at a country-level, using both quantitative and qualitative indicators of financial sector performance; and is

[1] Pension reform was, until 2002, under the Financial Sector Board.

there any difference between countries that borrowed from the Bank for financial sector reforms and those that did not in terms of these performance indicators?

- What is the assessment of Bank assistance to countries that experienced crises? The period covered by this review, FY93-03, is characterized by severe financial sector crises—in Asia, Latin America, and Europe—that prompted the international community, including the Bank, to mobilize large amounts of assistance. What was the Bank's role in these countries before and after the crises, what have the outcomes been, and what lessons can be drawn for the future from this experience?

1.5 *Caveats on scope of review.* This review is one of a series of recently completed and on-going OED reviews that cover financial sector issues. OED has just completed a review of lines of credit (LOC),[2] which frequently had financial sector objectives. Most of the analysis in this current report therefore does not include analysis of LOC. In addition, OED is currently reviewing the Financial Sector Assessment Program (FSAP), a major joint initiative of the Bank and the International Monetary Fund (IMF), which is the most significant form of Bank non-lending assistance since 1999 (in terms of resources and use of Bank staff) in the financial sector. This present review therefore does not cover the FSAP. Finally, Bank support for pension reform is the subject of a separate on-going OED review and is not discussed here.

1.6 Although the importance of legal and judicial institutions to financial sector development has been recognized in the literature and in the Bank, this review touches on these issues only tangentially in order to limit the assessment to a manageable scope. In addition, Bank support to the financial sector has included corporate restructurings and out-of-court arrangements, which are also not covered here in any detail.

1.7 A final caveat is that the Bank is only one source of support for financial sector reforms and not always the most important one; thus, distinguishing the Bank's contribution in the context of joint efforts by other donors is a challenge. Given OED's mandate to evaluate Bank activities, it was beyond the scope of this review to examine the extent of cooperation within the Bank Group or with other donors, although cooperation or lack of it can be a critical factor in the success of the Bank's efforts. Nevertheless, given the scope of the Bank's lending over the past decade in support of financial sector reforms, it is important to examine results of these efforts.

1.8 *Inputs.* Nine background papers were commissioned for this review; they are listed in the References and will be available on OED's website. These papers, combined with desk reviews of Bank assistance (lending and non-lending) to the financial sectors in 37 countries, form the major inputs for examining patterns of Bank assistance. Data on outcomes at a sector-level come from standard sources such as International Financial Statistics, central banks, and Fund and Bank sector reports.

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[2] OED (2005).

1.9 *Organization of the review.* Chapter 2 summarizes the literature on factors associated with financial sector development, reviews Bank guidelines and strategy for assistance to the financial sector, draws conclusions on benchmarks for assessing the quality of the Bank's interventions, and sets out a framework for the evaluation. The remainder of the review is divided into two parts: Part I analyzes Bank assistance as an input to financial sector reforms: Chapters 3 and 4 review trends and Regional experience, respectively, of financial sector assistance. Quality at entry of Bank assistance is the subject of Chapter 5, and Chapter 6 analyzes Bank assistance in terms of outcome ratings. Part I concludes with Chapter 7, which examines Bank assistance for financial sector reforms in countries experiencing crisis. Part II focuses on results at a country-level: Chapters 8 examines changes in bank ownership and the prudential and regulatory regime of financial sectors; Chapter 9 looks at outcomes of Bank assistance for financial reforms in terms of market structure, measures of contestability and interest rates as indicators of competition, and health of the banking system; and Chapter 10 examines the impact at a country-level in terms of financial sector depth, liquidity preference, access to credit, and stability. Chapter 11 draws conclusions and presents recommendations for the future.

2. What constitutes good practice?

Historical perspective

2.1 Ideas about the basic ingredients of a sound financial system have evolved over time. In the early 1900s free banking was popular, in which banks could be set up and operate without government oversight.[3] Until the late 1980s, most OECD countries had substantial government ownership of banks; more than a few still do today.[4]

2.2 Capital requirements related to risk assets were introduced on an international scale only in 1988 and have recently been modified. Deposit insurance is a relatively new instrument (in the United States, introduced in 1934 following widespread bank failure), and is the subject of debate and research on its impact on financial sector stability (paragraph 2.11); and the emphasis on regulatory requirements and supervision of financial institutions may be shifting toward a greater reliance on the role of "market forces" (paragraph 2.12).

Review of the literature[5]

2.3 There are, however, certain tenets on which theoretical and empirical literature agree. One is that *macro-stability is important for financial sector development.* Both

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[3] In the United States, for example, *privately owned* central banks were established twice in the late 18th and early 19th century, but their existence was controversial and challenged at the Supreme Court, and their charters allowed to lapse; the country had no central bank for most of the 19th century.

[4] In 2003 in Germany, for example, 42 percent of banking sector assets were in state controlled banks; in Greece and Portugal, it was 23 percent; in Switzerland, 14 percent (Clarke, Cull, and Shirley, 2004).

[5] Unless otherwise indicated, the discussion in this section is based on a background paper for this review, Cull (2004), which will be available on OED's website.

theory and empirical evidence support the view that financial depth tends to increase with stability.

2.4 A second tenet for which there is empirical support is that *government-administered financial systems involving fixed interest rates and directed credit lead to financial repression and inefficient allocation of credit*, and that less direct government control over the financial system will over time result in deeper, more stable, and more efficient systems (Caprio, Honohan, Stiglitz, 2001; World Bank, 1989).

2.5 A third generally accepted view is on the importance of a well-functioning and properly supervised payments system that can effect efficient, fair, and safe payments in domestic and cross-border markets (Bossone and Cirasino, 2001).

Financial market structure

2.6 *Research on the best mix of financial institutions, in terms of bank-based systems versus market-based (capital markets) has a striking lack of results.* The debate on the issue started in the early 1960s (Gerschenkron, 1962) and continues to this day.[6] Although theoretical arguments have been advanced for one type over the other, recent empirical research suggests that neither bank-based nor market-based financial systems are associated more with higher growth rates for firms, industries, or the economy over the other (Levine (2002) examines GDP growth rates; Beck and Levine (2002) look at industry growth rates; and Demirguc-Kunt and Maksimovic (2002) focus on firms' sales growth). Rather, it is the overall level of financial sector development, regardless of which structure dominates, that matters for growth. Thus, whether to promote the establishment or expansion of capital markets in a country will depend on the circumstances, including the ability of the country to reduce informational asymmetries.

2.7 For banking systems, the findings from research are ambiguous on whether *market concentration or more competition leads to more efficiency and/or more stability.* Theory suggests that more concentrated market share could lead to greater economies of scale, efficiency, and access to credit (Demsetz, 1973; Peltzman, 1977); or that it could lead to market power and greater inefficiency. Empirical research on cross-country data in developing countries, which is not very extensive, suggests that concentration has a negative effect on access to finance, although the results don't hold for countries with well-developed institutions (Demirguc-Kunt, Laeven, and Levine, 2003, and Beck, Demirguc-Kunt, and Maksimovic, 2002). In addition, research indicates that more concentrated banking systems are less prone to banking crisis, which is likely due to diversification in banks' lending and products rather than reduced competition. Finally, recent empirical research suggests that measures of concentration are less relevant to assessing competitive forces in the banking industry than measures of contestability, including restrictions on banking activity, ease of entry, and foreign bank ownership (Claessens and Laeven, 2004). *Thus there is no compelling argument for reducing banking concentration; the appropriate degree of concentration depends on institutional*

[6] A discussion of that literature can be found in Allen and Gale (2000), Boot and Thakor (1997), Goldsmith (1969), Levine (2002), Rajan and Zingales (2001), and Stultz (2001).

capacity and other objectives. By contrast, there is some evidence that reducing entry requirements and restrictions on activity, and allowing foreign ownership is positively associated with competition.

Ownership of banks

2.8 Although theoretical arguments exist for state control of banks (see, for example, Calomiris and Himmelberg, 1994, Greenwald and Stiglitz, 1986; Stiglitz, 1994, and World Bank, 2001), *empirical research finds that state ownership is associated with poorer financial sector performance than privately dominated systems*: less financial sector development, slower growth, lower productivity, and greater tendency to banking crisis (Barth, Caprio, and Levine, 2001a, b, and LaPorta, Lopez-de-Silanes, and Shliefer, 2002, and Beck, Demirguc-Kunt, and Levine, 2003). At the same time, however, privatization of state banks has not always been successful. Studies show post-privatization efficiency gains in Argentina's provincial banks (Berger et al, 2003); Nigeria's banks (Beck, Cull, and Jerome, 2003), and in a sample of banks from eleven transition countries in Central and Eastern Europe (Bonin et al, 2003) but also include cautionary instances of unsuccessful privatization, most notably in Chile in the 1970s (Brock, 2000) and Mexico in the 1980s (Haber and Kantor, 2003). Chile privatized banks without first cleaning their balance sheets and sold them to their previous owners, while in Mexico, the government sold banks only to domestic buyers and prohibited foreign ownership or any large foreign banks from competing.[7] In both countries, the banking system experienced subsequent crisis: in both countries, the banks were either closed or re-nationalized and privatized a second time with more success.

2.9 *The research on foreign banks in developing countries shows mainly positive impacts*: greater efficiency and better quality portfolios, and lower probability of systemic banking crisis (see Cull, 2004, for a fuller discussion of the literature covering the impact of foreign banks on these aspects).

2.10 *On the question of access to credit*, the limited empirical studies suggest that access is no better in banking systems that are predominantly state-owned than in privately-dominated banking systems. In Argentina and Chile, for example, public banks lend less to small businesses than other banks (Clarke, Crivelli, and Cull, 2003, Clarke, Cull, and Peria, 2001, and Clarke et al, forthcoming). The literature on foreign banks in developing countries suggests a complicated relationship between the foreign banks and access to credit. Work by Clarke et al (forthcoming) finds that large foreign banks lend more to small firms than large domestic banks, although on average foreign banks lend less than domestic banks to small firms. In addition, studies have found that foreign banks may concentrate on certain market segments, so that increasing foreign ownership might result in less access in certain sectors (Barajas, Steiner, and Salazar, 2000, and Cull, 2004). Overall, the research argues for private ownership of banks, and allowing entry of foreign banks; but also that the quality of the purchaser matters for outcomes.

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[7] It has been argued that the Mexico experience was not a failed privatization, but a privatization that did not go far enough. The point is the same: that privatization per se does not lead to good outcomes.

Incentive framework for banking

2.11 This rubric includes regulation and supervision, safety nets such as deposit insurance, legal framework for creditors' rights, and market forces for monitoring. There are theoretical arguments why both regulation and supervision of banking are important. However, the empirical research for developing countries on the effectiveness of regulatory requirements such as minimal capital, loan classification, and liquidity ratios found no association between such requirements and better banking sector performance. The same conclusion applies to banking supervision: neither supervisory powers nor independence is statistically associated with banking development, while private monitoring is strongly associated with more banking development and healthier banks (Barth, Caprio, and Levine, 2001b). Private monitoring includes the requirement to be externally audited; rating of banks by international rating agencies; and the quality of disclosed accounts and other disclosure requirements. In addition, restrictions on bank activities and entry restrictions for domestic and foreign banks are associated with worse performance of banking systems. Furthermore, theory and empirical research concur that private monitoring – incentives such as no explicit deposit insurance and requirements for accounting and auditing, rating of financial institutions by private rating agencies—is strongly linked to banking sector development. *These findings suggest that banking regulations and banking supervision need to be carefully tailored to the conditions of the countries and that, reforms should focus as a priority on creating the incentives and tools (accounting, auditing, disclosure requirements, rating agencies) for market participants to monitor financial institutions.*

2.12 Theory argues both for and against deposit insurance. It can make depositor runs less likely and therefore serve as a stabilizing influence on banking systems. In addition, if governments are already providing an implicit guarantee on all deposits, establishing an explicit system can both protect some depositors while limiting the cost for government by setting caps on the insurance. But it can also introduce moral hazard: depositors have less incentive to monitor banks because they know they are covered in the event of a crisis; and banks have an incentive to take higher risks with depositors' money (Diamond and Dybvig, 1983). Recent evidence suggests that in weak institutional environments, explicit deposit insurance is associated with a higher incidence of banking crisis, higher fiscal cost of resolving a crisis, and slower recovery. There is, however, also evidence that uninsured depositors do monitor the riskiness of banks (Demirguc-Kunt and Detragiache, 2002, Honohan and Klingebiel, 2003, Martinez, Soledad, and Schmukler, 2001), which would argue for a system where at least some depositors are not insured. The policy implications are that *deposit insurance should be designed to exclude coverage of some deposits, and if equity considerations matter, these should be the larger deposits that belong presumably to wealthier clients, and inter-bank deposits; in this way, it will be the generally wealthier clients who are uncovered and who have an incentive to monitor the banks.*

2.13 Although there is some debate over which types of legal systems are more conducive to financial sector development, most empirical work points to the importance of creditor rights and, more broadly, property rights of financiers external to the enterprises, as well as enforcement of contracts, for financial sector development. Legal

systems of different origins tend to offer varying levels of protection to the different categories of stakeholders and as a result may influence the sort of financial development that occurs (debt versus equity markets; external financing versus self-financing), but the literature is unambiguous in finding that protection of the rights of debt and equity holders is associated with more developed financial systems (Levine, 1998, and Levine, 1999).

Causes of Crises

2.14 Finally, this review examines the Bank's role in assisting countries experiencing crisis. Although financial and currency crises have existed for decades, the crises experienced by developing countries in the 1990s were arguably transmitted more widely and rapidly across countries and proved more costly, both economically and politically, than in the past. These crises in turn followed a wave of liberalization in the 1980s and early 1990s, supported by the international financial institutions (IFI), that included, to varying degrees, opening current accounts and capital accounts, freeing exchange rates, freeing interest rates, and lifting restrictions on entry into the financial sector and restrictions on lending by domestic banks, thereby creating the conditions for rapid credit growth, and larger and more volatile global capital flows.

2.15 The impact of liberalization and the ensuing financial integration on growth and volatility in many developing countries is the subject of considerable controversy in the literature (see Claessens, 2005, for discussion of literature on this subject, forthcoming). Many authors examining the causes of crisis agree, however, that liberalization per se has not been the underlying cause of the crises.[8] Mishkin (1999), Feldstein (2002), for example, point to a lending boom characterized by excessive risk taking and poor banking regulation and supervision as the root causes for the crisis of the 1990s. Demirguc-Kunt and Detragiache (2002) found that the certain features of deposit insurance relate to the incidence of crises. Although there is general agreement that the quality of institutions matter for the success of reforms, the speed and scope of domestic deregulation – interest rates, entry, restrictions on activities – as well as the appropriate sequence of reforms aimed at moving toward a more open economy are still the subject of some debate (Claessens, 2005, forthcoming). The question of whether the IFI encouraged liberalization prematurely, that is, in the absence of adequate safeguards and strong institutions is an interesting one, but would involve examining reforms outside of the financial sector, for example, in exchange rate policies and current and capital account policies. Such an assessment is beyond the scope of this review.

Bank guidelines and strategies

2.16 The Bank's 1989 World Development Report (WDR) on Financial Systems and Development was the first public document setting out the Bank's views on the financial

[8] In fact, Hinds (2003) argues, in a background paper for this review that countries had little choice in the late-1980s but to liberalize: retaining fixed exchange rates and closed capital accounts was no longer a policy option for dealing with the transformations occurring in the world economy.

sector. At the time, the importance of the financial sector for developing economies was not widely understood or appreciated, and the first part of the report examined the ways in which the financial sector could contribute to economic growth; it also gave a brief overview of how financial systems had evolved in the Bank's client countries. The last half of the WDR was devoted to outlining the essential ingredients of a healthy financial system; its underlying theme was the importance of an enabling environment with well-governed institutions, where market participants would perform their functions of mobilizing resources, allocating credit, and managing risks in an efficient manner. The ingredients included: a legal framework which ensures creditor rights and a functional court system to enforce them; information flow based on sound accounting and auditing; and strong and independent regulation and supervision of financial institutions. Many of these ingredients have been shown by subsequent research to be associated with more developed financial systems (see paragraphs 2.11-2.13).

2.17 These views were codified in the Bank's 1992 Operational Directive (OD) 8.30 on Financial Sector Operations, although far more attention was given to the macroeconomic environment and financial sector policies on interest rates, directed credit, and credit subsidies than on other aspects. Given the environment in most client countries at the time, this emphasis was mostly appropriate, although the focus on interest rates was arguably premature in systems largely dominated by state-owned banks lending to many state-owned enterprises, whose behavior (both banks and enterprises) was not much influenced by interest rates. OD 8.30 also contained guidance on bank restructuring and resolution of bad debts, but very little on privatization of banks.[9] In addition, Development Economics (DEC) issued three Notes in 1995, on directed credit, lending rates, and restructuring banks, and although the Notes never had the formal standing of directives, they were intended to provide guidance to staff on these issues. Given the surge in Bank support for privatization in the 1990s (see Chapter 3 and Annex 1), the Bank should have provided more guidance on this important reform.

2.18 In 1998, OD 8.30 was replaced by Operational Policy (OP) 8.30, which dealt primarily with lines of credit, leaving a vacuum in Bank policy on financial sector reforms.[10] In 2001, the Bank issued a financial sector strategy, containing the pre-requisites for a well-developed financial system. The emphasis of the strategy is interesting for its contrast to the 1992 OD 8.30, reflecting the shift in the political environment that had occurred in the intervening decade. Where the OD had focused on the macro environment and policies on interest rates and subsidized credit, the strategy focused on the importance of: (i) a reliable legal and judicial environment; (ii) strong banking systems, including a good incentive, regulatory, and supervisory environment; adequate governance of banks; and a well-functioning payment systems; (iii) promotion of capital markets and other non-bank financial intermediaries: and (iv) finding market-based solutions to expanding access to credit. The strategy does not constitute Bank policy, but it is the closest thing to a statement of priorities and guidance to Bank staff on

[9] OD 8.30 had only this to say about bank privatization, "Opportunities should be explored for attracting new equity investments, including from foreign banks, and for selling government-owned shares to private investors" (paragraph 45).

[10] The 1997 Strategic Compact declared the Bank's intention to work with the IMF on financial sector issues (paragraph 3.3), but this did not constitute an internal Bank guideline.

financial sector reforms that exists at present. The strategy indicated that sound practice notes would be prepared on key topics, but as yet, none has appeared, although the Bank's research department and financial sector network have an active research, policy, and dissemination program which have provided intellectual guidance on a range of topics.[11] Nevertheless, there is currently no written guidance for Bank staff on good practice for support for bank privatization, for example, for resolution of non-performing loans, or under what circumstances prudential regulations should be aligned with those contained in the 1988 Basle Accord or the more recent Basle II, or for the entire gamut of reforms that address constraints to financial sector development.

2.19 The financial sector strategy draws on the literature in arguing for strong banking systems based on good governance of banking institutions and a reliable legal and judicial environment. It is also consistent with research findings on competition, when the strategy points out that increasing competition in the financial sector may be inappropriate for the small financial systems that characterize many of the Bank borrowers. It is arguably less consistent with the literature in promoting capital market development, to the extent that the literature is ambiguous on this point.

Past OED recommendations and management response

2.20 A previous OED review of Bank support for financial sector reforms (OED, 1998) recommended that: (i) the Bank follow OD 8.30 (OP 8.30 had not yet replaced the OD); (ii) economic and sector work (ESW) precede lending, as outcomes at a country level were better when this was the case; (iii) financial sector staff have a greater role in quality control; (iv) more resources be used for systematic monitoring of financial sector outcomes; (v) technical assistance loans be used more judiciously than in the past (only where there is clear government commitment to reform and the Bank puts in the necessary resources for designing and supervising the operations); and (vi) the Bank collaborate more actively with both the IMF and the IFC. Management agreed to these recommendations, and gave them prominence in the financial sector strategy that followed in 2001.

A framework for evaluation

2.21 This evaluation of Bank assistance to the financial sector follows the framework set out in Figure 2.1 below. The inputs examined in this review are Bank lending and non-lending assistance although it is recognized, as noted in Chapter 1, that inputs such as other donor assistance and, in particular, the government's own reform programs, are also highly relevant to the picture.

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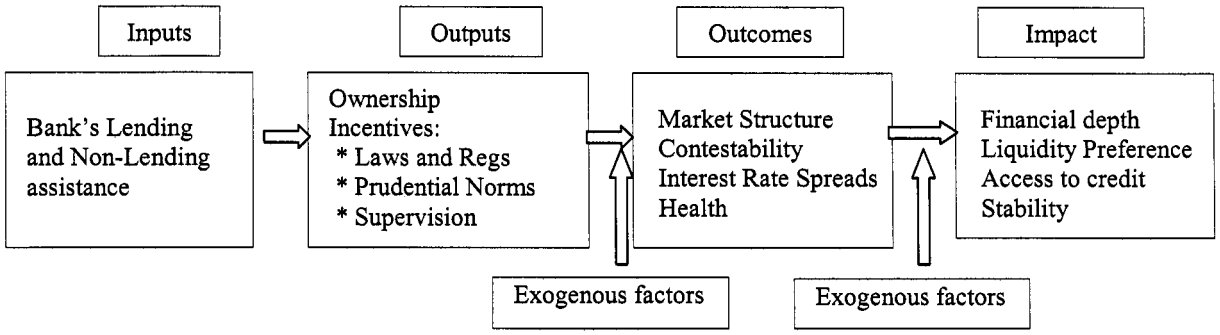
[11] These include seminars and conferences on topical issues, as well as papers and web-notes on selected issues, including interest rate deregulation, asset management companies, and deposit insurance. The Bank's pro-active dissemination of its research on financial sector issues to both Bank staff and clients may well have affected the thinking, diagnostic approaches, loan designs, policies, and reforms for both Bank staff and clients, but OED did not carry out specific tracer studies to assess this. It could be an interesting area for self evaluation for DEC.

Figure 2.1: Evaluation framework



2.22 Part I of this report that begins in the next chapter, analyzes inputs. Apart from trends and Regional patterns of lending, inputs are assessed in two ways: quality at entry of Bank assistance (Chapter 5) and the outcomes of Bank loans (Chapter 6). For quality at entry, OED presents findings of the background papers for this review and desk reviews of 37 case study countries carried out by OED, supplemented by findings from the Quality Assurance Group (QAG). OED examined the relevance of the objectives and designs of the loans in light of good practice, derived from the literature and the Bank's internal guidelines, to the extent that they existed during the period under review. The main elements of good practice consist of promoting incentives to sound risk management in financial intermediation through a combination of strong prudential environment, consistent with international norms; supervision consistent with international principles; decreased government control of banks and non-bank financial institutions; and putting in place the tools and the incentives for monitoring financial intermediaries by market participants. For lending outcomes (Chapter 6), OED analyzed financial sector loans as well as outcomes of components supporting financial sector reforms in multi-sector loans.

2.23 Part II (Chapters 8–10) analyzes the rest of the results chain in Figure 2.1, at a country-level. Outputs are intermediate achievements that may be necessary, although by themselves are not sufficient, for realizing the ultimate objectives for the financial sector. Based on the discussion above on good practice, Chapter 8 examines changes in private ownership of banks and changes in the legal and regulatory environment of countries that borrowed from the Bank for financial sector reforms and, with appropriate caveats, compares these outputs to those in countries that did not borrow from the Bank for financial sector reforms during the period under review.

2.24 Chapter 9 reviews outcomes at a country level: market structure, contestability (competition), efficiency, and health of the financial system, particularly the banking system where most of the reforms were aimed.[12] Although market structure is an

[12] It could also be argued that one of the objectives of a financial system is to intermediate *efficiently*, and that therefore financial sector efficiency and profitability should be considered impacts. This review follows recent literature, however, that uses financial sector depth and stability as measures of financial sector performance (see, for example, Barth, Caprio, and Levine, 2001a and 2001b, and Cull, Senbet, and Sorge, forthcoming), and thus, as the definition of "impact".

imperfect (and, some economists argue, outdated) measure of competition, it is included here because more than a dozen borrowing countries had, at the beginning of the period, concentration rates (percent of banking assets held by the top three banks) of 100 percent, and one of the objectives of Bank assistance, sometimes implicit, sometimes explicit, was to reduce the concentration of market power these situations reflected. Contestability is also examined as a measure of banking competition, that is, the extent to which entry restrictions and restrictions on banks' activities were changed over the period under review. Finally, interest rate spreads are examined, although they too are imperfect measures of either competition or efficiency, as they can be heavily influenced by other factors, including the inflation rate, fiscal deficits, reserve requirements, and tax rates on financial institutions. Some of these factors are taken into account in the analysis. Measures of health are also examined, to the extent the data permit, in terms of capital adequacy, non-performing loans, and profitability.

2.25 Finally, Chapter 10 examines the extent to which the ultimate objectives for financial sector development have been achieved at a country level: how well it serves as an intermediary between savers, mobilizing relatively large amounts of resources, and efficient investors, lending the resources to the private sector, and the extent to which it has remained stable and avoided costly crises. The measures used are: (i) progress toward greater banking depth (M2, which consists of cash, demand deposits, and time deposits, as a proportion of GDP); for capital market reforms, size and turnover of the market; (ii) increasing confidence in the banking system, measured by the inverse of the preference for liquidity (cash as a proportion of M2); (iii) credit to the private sector, as a percent of GDP; and (iv) stability of the financial system in terms of the absence of a major systemic banking crisis.

PART I ASSESSING INPUTS: BANK ASSISTANCE

3. Trends in lending and non-lending

Overview

3.1 Beginning in the late 1980s, in recognition of the important role the financial sector could play in growth,[13] the Bank shifted its focus from support of individual financial institutions, which in any case had had disappointing results, to supporting sector wide improvements in the financial sectors of client countries. In the first half of the 1990s, the Bank dramatically increased analysis of financial sectors as it sought to understand the constraints to better financial sector performance and to provide an underpinning for its adjustment lending for financial sector reforms.

3.2 By the time of the Strategic Compact in early 1997 (prior to the Asian crisis) the Bank expressed its intention to work with the IMF to build capacity in client countries to regulate and supervise their financial systems, with particular focus on banking, and to

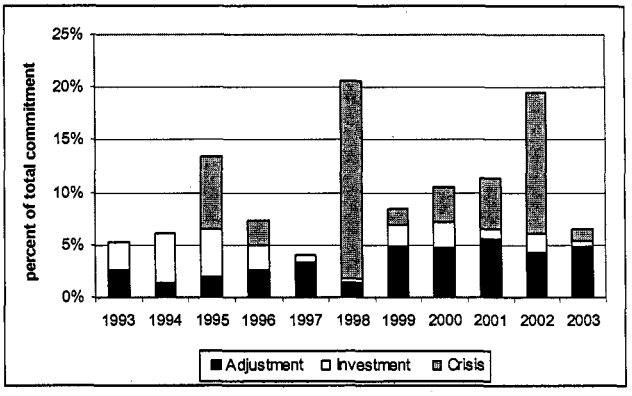
[13] See the 1989 World Development Report, devoted to the financial sector.

develop a set of core monitoring indicators to identify vulnerability to crisis. The Asian crisis in the second half of 1997 gave urgency to supporting financial sector reforms as well as for obtaining more timely information on financial stability. The Bank responded by providing exceptionally large amounts of lending for financial sector reforms to the Asian countries in crisis; it also began a joint diagnostic process with the IMF, the Financial Sector Assessment Program (FSAP), to be examined separately by OED (forthcoming). Thus, although driven mainly by the Asian crisis and subsequent macroeconomic and financial sector crises in other countries, the increased focus on the financial sector expressed in the 1997 Strategic Compact was realized in both lending and diagnostic work in the second half of the period under review.

3.3 Whether in response to the Strategic Compact or to the Asian crisis and its aftermath, financial sector issues also received greater focus in country assistance strategies (CASs). According to the CAS retrospective of 2003, more than 80 percent of the FY00-01 CAS had some discussion of recent progress in the financial sectors, and there had been a significant improvement in both quantity and quality of coverage of financial sector issues over the earlier periods.

Bank lending for financial sector reforms: trends

Figure 3.1: Bank loans classified as finance, by amount, as percent of total Bank commitments, FY93-03



3.4 *Lending classified as finance.* The data on lending classified under the financial sector board over the FY93-03 period reflect these trends. First, Bank support to financial sectors in countries with crises is so large that it causes wide year to year fluctuations in lending (Figure 3.1). Out of a total of US$24.8 billion loans classified as finance, about half, or US$12.1 billion, was for countries experiencing crises. In FY95, for example, counting only loans classified as finance, US$1.0 billion was lent to Mexico and US$800 million to Argentina in response to the Tequila crisis; in FY98, US$5.0 billion was lent to Korea and US$350 million to Thailand in response to the Asian crisis; and in FY02, US$2.5 billion went to Turkey following its crisis.

3.5 Aside from crisis lending, discussed in Chapter 7, there has been a slight upward trend over the period FY93-03 in the proportion of annual Bank commitments classified as finance, driven by an increase in adjustment lending, which began in the late 1980s, and which has offset the drop in lending for lines of credit (LOC).[14] The non-crisis adjustment lending, which total some US$9.2 billion in commitments over the entire period, has roughly doubled between the first and second half of the period.

[14] For a detailed discussion of lines of credit, their trends, designs, outcomes, and issues, see OED (2005).

3.6 *Lending with financial sector components.* The picture changes, however, when loans in other sectors are included that contain financial sector components (see Box 3.1 on how these loans were identified): US$56.1 billion, or 24 percent of total Bank lending, included some support for the financial sector over the period. Of this total, some US$43 billion was in adjustment (169 operations), and US$13 billion was in investment lending (216 operations), including LOC with financial sector objectives. Excluding LOC, investment lending was only US$3 billion. A total of 96 countries borrowed from the Bank for financial sector reforms, if LOC are included (87 countries, if LOC are excluded).

Box 3.1: Identifying Bank assistance for financial sector

Most Bank lending for financial reforms has been through multi-sector adjustment or technical assistance loans and credits. OED read through over 2,000 Bank loan documents to identify support for reforms or investments in the financial sector, finding some 385 operations (excluding pensions, which account for an additional 130 or so), that contained conditionality or funding related to the financial sector.

Of the total number of Bank operations containing financial sector components, only 36 percent of them were classified as finance; another 23 percent were under economic policy; private sector development accounted for about 14 percent; and the remainder were other sectors (see Annex 1, Figure 6 for breakdown).

Because it is not possible to allocate lending amounts in multi-sector adjustment loans to specific sectors and it was difficult to distinguish multi-sector adjustment loans that focused primarily on the financial sector from those where it was a minor aspect, the data give a general, rather than precise, picture of how lending assistance for the financial sector has evolved in the past decade.

Table 3.1: Lending for financial sector reforms, FY93-03

Sectoral Loan Classification	Adjustment		Investment		Totals		As percent of Bank	
	No	Amount US$ m	No	Amount US$ m	No	Amount US$ m	No	Amount
Financial Sector	54	19,683	83	5,122	137	24,805	5	11
Other sectors	115	23,356*	133	7,912*	248	31,268*	9	13*
Total	169	43,039*	216	13,034*	385	56,073*	14	24*

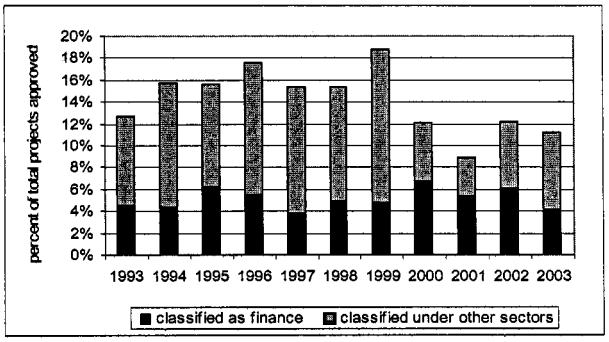
* These figures show the total amount of lending that that include some focus on financial reforms; they overstate the amount dedicated only to financial reforms. Annex 1 has more details on Bank-wide and Regional trends.

3.7 As shown in Figure 3.2, financial reforms in multi-sector operations classified under other sectors outnumbered loans classified as finance in most years (for breakdown by sector, see Annex 1, Figure 3). In addition, there has been a notable downward trend in the last decade in the proportion of loans containing financial sector reforms, although this is due mostly to a dramatic drop in the number of LOC approved. Without LOC, the downward trend, although still evident, is less strong. Because LOC are discussed in a separate OED report (OED, 2005), they are not included in the remainder of this review unless otherwise indicated.

Focus of financial sector reforms

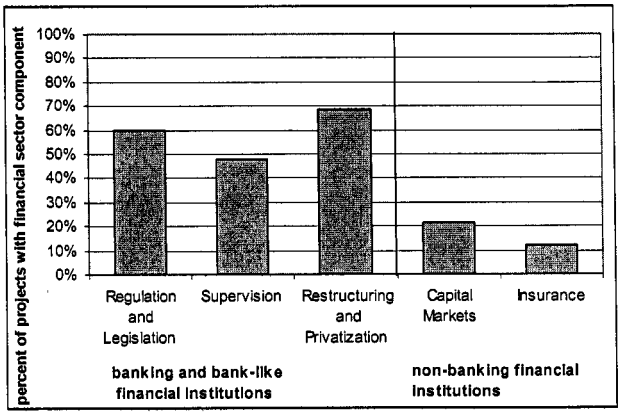
3.8 Banking reforms[15] dominate the agenda in most Bank loans, compared to non-banking reforms such as those covering capital markets, insurance, and pensions. This reflects the fact that for most Bank clients, banks and bank-like institutions are far more important than other forms of intermediation.

Figure 3.2: Number of Bank loans with financial sector reforms, as percent of total loans, FY93-03



3.9 Within banking, restructuring and privatization dominated the agenda. Whether borrowing countries were centrally planned, socialist states or more market-driven, the vast majority of Bank clients had, at the beginning of the 1990s, banking systems heavily dominated by government-owned banks, many of which were characterized by an accumulation of non-performing loans (NPL), inadequate capital, and low profitability. As a result, most countries undertook, at a minimum, to restructure their banks, and many also moved toward more fundamental solutions, including consolidation, liquidation, and privatization. Bank lending reflects these trends. Figure 3.3 shows that out of 280 Bank operations (excluding LOC), almost 70 percent contained reforms aimed at bank restructuring and/or privatization (and often both within the same operation).[16] There is no trend over time, that is, the proportion of Bank loans supporting bank restructuring and privatization was fairly steady throughout the period (see Annex 1, Figure 5).

Figure 3.3: Focus of reforms as percent of all Bank projects with financial sector components



3.10 By contrast, lending for capital market was some 22 percent of loans and insurance reforms comprised only 10 percent of loans over the period,[17] and tended to be concentrated in middle income countries, mostly in Europe and Central Asia (ECA), Latin America and Caribbean (LCR), and Middle East and North Africa (MNA) regions (see Chapter 4). Support of capital markets declined over the period; by FY01-03, fewer than 10 percent of loans contained capital market reforms (Annex 1, Figure 5). The shift away from capital

Table 3.2: Investment lending with financial sector components, by category,* FY93-03

Category	Number	Amount $'000
TA	69	1,112
Guarantees	7	631*
Specific Investment	35	1,359
Total	111	3,102

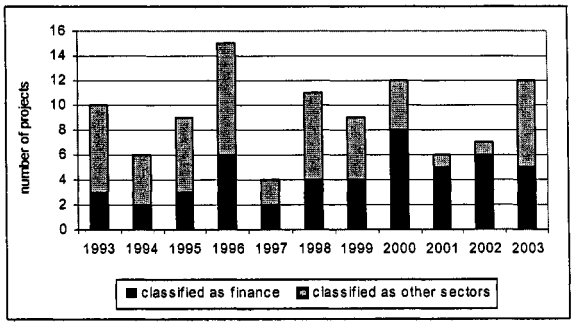
* Excludes LOC; categories are somewhat arbitrary; most specific investment loans were TA. See para. 3.12.

[15] The definition of "banks" varies by country. Development finance companies; savings and loan associations; and even specialized banks are often considered non-bank financial institutions. For the analysis in this report, reforms aimed at bank-like institutions are categorized under banking reforms.
[16] Many loans are under more than one category of reforms.
[17] In addition, pension reform would account for about 38 percent of total loans if they were included.

markets may have been in part the result of IFC's greater role in this area, but it may also have been in recognition of the small part played by the capital markets relative to banking, and the large unfinished agenda in banking.

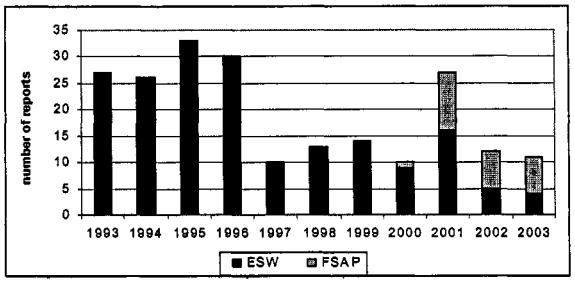
3.11 Although adjustment lending comprised the bulk of Bank support, investment projects also played a role in supporting financial sector reforms, mainly through technical assistance (TA) loans, which were usually approved in tandem with adjustment loans.[18] Out of 111 investment projects (excluding LOC) with financial sector objectives approved during the period, 69 were categorized as TA loans. With the exception of three large investment projects discussed in paragraph 3.12, the other specific investments are mostly identical in content with those categorized as TA and include support to improve the payment systems (e.g., Algeria and Sri Lanka) or settlement systems or other equipment in capital markets (e.g., in Croatia and Uzbekistan). The TA provided funding for consultants to carry out studies, draft laws and regulations, carry out diagnosis or audits of banks or other financial institutions, prepare them for privatization, or, in general, to provide technical support to the reforms supported through adjustment lending. Slightly less than half of these operations (50 of the 111) were in lower income countries, and most of those approved in middle income countries were either in transition economies or in countries experiencing crisis.

Figure 3.4: Investment loans supporting financial sector reforms, by year



3.12 Among the specific investments, three large projects accounting for over half of the total commitment are really adjustment loans disbursed as time slices connected with privatization. In Pakistan, the Banking Sector Restructuring and Privatization Project for US$300 million financed severance payments in bank downsizing prior to privatization; and in two Brazil loans, Rio de Janeiro and Minas Gerais State Privatization projects for US$250 and US$170 million, respectively, funds were disbursed as time slices, but not for severance payments related directly to banking reforms. The third category of investment lending is guarantees: six were approved over the period, for US$630 million, of which one was a loan to Argentina for US$500 million.

Figure 3.5: Number of ESW reports containing financial sector analysis, FY93-03*



*Includes only formal sector reports

[18] There are very few TA loans that were approved in the absence of an adjustment loan and it was usually because the planned adjustment loan did not materialize (Togo, Uzbekistan). China is the exception to this (Box 4.2).

Bank non-lending assistance for financial sector reforms: trends

3.13 As noted in paragraph 3.1, the shift in focus in the late 1980s to sector-wide reforms was accompanied by the need for a better understanding of the constraints and issues in the sector. This is reflected in the surge in formal economic and sector (ESW) reports containing financial sector analysis from single digits per year in the 1980s to 25 – 30 reports per year in the first half of the 1990s. In the first five years of the period under review, FY93-97, some 126 formal ESW reports were produced. In the last half of the period, by contrast, some 74 ESW reports were produced, or 48 apart from the highly specialized FSAP reports (Figure 3.5 for number of reports and Box 3.2 for description of FSAP).

3.14 The drop in formal reports is likely due to several factors. In the late 1990s, there was a shift to informal sector work, such as policy notes (Box 4.2 on China as an example), which do not show up in these numbers. In addition, the resources for the FSAP and for the more recent anti-money laundering and combating terrorist financing (AML/CFT) activities[19] may have replaced (or displaced, depending on one's point of view) other financial sector work in a given country or within a Bank unit covering several countries.

Box 3.2: The Financial Sector Assessment Program (FSAP)

The FSAP is a major initiative undertaken jointly by the World Bank and the IMF in response to the financial crises of the late 1990s. It was initiated in May 1999, initially as a 12-country pilot exercise, to be expanded to other volunteering countries, to facilitate early detection of financial sector vulnerabilities and identification of financial sector development needs, as well as to support the dialogue among the national authorities, the Bank, and the IMF.

As of July 2004, assessments have been completed or initiated in over 80 countries and of those reassessments have been completed or initiated in eight countries; the program has involved a significant use of Bank resources. Reassessments were initially planned to take place every four to five years, but later the frequency was set at seven to ten years because of resource constraints and their implications for the pace of the program.

The FSAP is being assessed by OED and the IMF's Independent Evaluation Office, scheduled for FY06.

[19] Since FY02, AML/CFT activities have taken on increasing prominence in the Bank's non-lending financial assistance and have been incorporated as components in lending assistance in several Regions.

4. Regional patterns of Bank assistance

4.1 Countries came to the process of financial sector reforms in the last decade at different times, with different initial conditions, capacity, and most particularly, degrees of commitment, and there are Regional patterns to these differences; Bank lending reflects these patterns, which this Chapter briefly describes.

Table 4.1: Lending categorized as finance, percent of total, FY93-03

Region	Lending Amount US$m	Percent of Region/Bank Lending	Lending Amount Excluding Crisis Lending, US$m	Percent of Region/Bank Lending
AFR	630.6	2	630.6	2
EAP	6,357.0	11	524.0	1
ECA	5,257.2	11	2,029.4	4
LCR	7,499.8	13	4,491.8	8
MNA	845.5	7	845.5	7
SAR	659.8	2	659.8	2
Total	21,249.9	9	9,181.1	4

4.2 *For lending categorized as finance* (excluding LOC), three Regions, Latin America and Caribbean (LCR), East Asia and Pacific (EAP), and Europe and Central Asia (ECA), account for 90 percent of commitments (Table 4.1 and Annex 1, Figures 1 and 2), although the large sums are due mainly to the crisis lending (as defined here) which is concentrated in these three regions. Excluding the crisis lending, EAP has had almost no lending under the financial sector board. Africa (AFR) and South Asia (SAR) regions also had little, in absolute terms or as a percentage of the Region's own lending. In SAR, Pakistan is the only country that had financial sector adjustment loans, although financial sector reforms have been introduced recently in TA projects in Bangladesh and Nepal. By contrast, even aside from the crisis lending, ECA and LCR have had financial sector adjustment loans in most years and in a fairly large number of countries, reflecting the generally strong trends toward reform in those Regions, while in Middle East and North Africa (MNA) region, financial sector adjustment lending has been concentrated in a few years to a few countries (Jordan, Morocco, and Tunisia).

ECA dominates

4.3 *When the lending is expanded to include all lending with any financial sector components* (again, excluding LOC), ECA far outnumbers the other Regions in terms of both number (99 projects) and proportion of its loans (16 percent) that dealt with financial reforms over the FY93-03 period (Table 4.2 and Annex 1, Figure 4).

Table 4.2: Lending with financial sector components, FY93-03

Region	Number of Projects	Percent of Regional/Bank Projects	Total amount of lending* $m	Percent of Regional/Bank lending*
AFR	69	10	3,926	13
EAP	29	7	11,558	21
ECA	99	16	14,018	31
LCR	59	10	12,845	22
MNA	14	7	2,221	18
SAR	10	4	1,575	5
Total	280	10	46,141	20

* See note on Table 3.1

At its peak in FY95-96, as many as 25 percent of ECA's loans contained financial sector components, and out of 28 borrowers in the Region, only one (Estonia) had no loans with

financial sector reforms included[20] (see Box 4.1 on lending in ECA). This clearly reflects the focus of the countries' commitment to transition from state-controlled mono-banking to an entirely different banking structure and governance; financial reforms were often accompanied by other reforms to establish private ownership and market mechanisms. The incentive of accession to the European Union provided further impetus to reforms. Lending for financial reforms in ECA has decreased in recent years compared to the early part of the period (Annex 1, Figure 4).

Africa and LCR: early reformers

4.4 Some of the earliest borrowers for bank privatization were in AFR and LCR. Ghana, for example, had an adjustment credit in FY88; Cameroon, FY89; Senegal, FY90. In LCR, Bolivia, Chile, Mexico, and Venezuela borrowed in the 1980s for financial sector reforms.

4.5 In Africa, about 10 percent of lending operations have contained financial sector components over the period FY93-03, with the majority of projects in sectors other than finance, which may reflect the need in smaller countries to package reforms across sectors into one operation. Out of about 40 active borrowers at any given time in the Africa Region, 24 have borrowed for financial reforms, with a heavy emphasis on bank restructuring and privatization (Table 4.3 and Figure 4.1). Regulation and supervision were less of a focus, and were included in fewer than half of the operations, possibly because the banks in West African countries are supervised by Regional central banks. Somewhat surprisingly, given the modest size of the economies in Africa, about one fifth of the operations in Africa that touched on the financial sector included support for capital market reforms.[21]

4.6 In LCR, a significant portion of lending for financial sector reforms is connected to crisis support; out of a total of 59 loans with financial sector components, about one-third of them are crisis-related. The non-crisis loans form a heterogeneous group, tailored to the conditions and commitment of the borrowing country. In addition to the focus on banking – restructuring and privatization (Table 4.3 and Figure 4.1); regulatory and legislative changes, such as aligning prudential regulations with Basle standards; and introducing deposit insurance schemes or reforming existing schemes, there was a more intense focus on capital market reforms than in most other regions (see Annex 1, Table 2) – Argentina, for example, had a US$500 million adjustment loan devoted to capital market development. In Brazil, lending for financial sector reforms started relatively late, in FY97, and took an unusual form, with large TA loans for privatization of state banks. Most of the other non-crisis lending to LCR countries that supported financial sector reforms consisted of only one adjustment loan and one TA loan per country over the period under review.

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[20] Estonia had a Rehabilitation Loan with financial sector coverage; and a line of credit that played a catalytic role in commercial bank restructuring, although most of the funds under the project were not used.
[21] See background paper by Mozes (2003) on Bank lending for financial sector reforms in Africa.

Table 4.3: Regional concentration of reforms

	Total	*AFR*	*EAP*	*ECA*	*LCR*	*MNA*	*SAR*
Number of loans with financial sector components	280	69	29	99	59	14	10
		percent of loans that focused on reforms					
Regulation and Legislation		43	76	71	53	64	50
Supervision		33	62	54	49	50	30
Restructuring and Privatization		71	72	72	61	36	90
Capital Markets		14	28	18	29	50	0
Insurance		22	0	8	8	36	10
Payment system		14	14	21	5	21	20

Box 4.1: Financial sector reforms in the ECA Region: Bank strategy, analysis, and lending

Strategies. In most countries, financial sector reform was a priority in the assistance strategies throughout the decade, reflecting not only its importance but also the gradual nature of the progress being made. In some country programs, the priority on financial sector development was reduced in later CASs, either because the job was perceived to have been largely completed (e.g., Hungary, Poland, and Kyrgyz Republic – in this latter case, a judgment that turned out to be wrong), or because progress was so slow (e.g., Romania, Russia, Uzbekistan). In other countries, after significant progress was achieved (Macedonia, Lithuania), the Bank shifted its focus to diagnosis (e.g., FSAP) and policy dialogue, with further reforms financed by other agencies, including the IFC.

Analysis. A considerable body of financial sector analytic work was embedded in economic reports or produced as informal pieces of work, with formal financial sector reports emerging in the latter half of the decade. For some ECA countries, it is surprising how late in the decade the first pieces of formal financial sector work appeared – e.g., Armenia (2000), Georgia (1999), Kyrgyz Republic (1999) where substantial Bank lending in the financial sector had already been undertaken. No dedicated formal financial sector work at all was found for Albania despite 14 loans (four adjustment; four TA; six LOC) aimed at least partially at financial sector objectives or Bosnia Herzegovina, with 16 loans with financial sector components (three adjustment; one TA, 12 LOC).

Lending. In many ECA countries financial sector components were included in a series of structural adjustment operations that took a gradual, but steady, approach to reforms. In Armenia, for example, an Institution Building Project (FY93) and a Rehabilitation Credit (FY95) addressed banking supervision, and between FY96 and 03, five SACs and two accompanying TA credits supported restructuring and then privatizing banks, promoting a capital market, and introducing deposit insurance. Georgia's Rehabilitation Credit (FY95) supported strengthening of prudential regulations, a diagnostic review of five state-owned banks, and development of restructuring or privatization plans, followed by two SACs and two TA credits (in FY96, 98) with conditions on privatizing the majority of shares of former state banks, and after their sale, meeting agreed performance targets. SAC II also had measures to support capital market infrastructure. Latvia, Lithuania, Kazakhstan, Moldova, Tajikistan, and Ukraine each had several multi-sector adjustment loans addressing banking reform, although in some the financial sector components were relatively minor.

By contrast, Poland had one adjustment loan, the EFSAL (FY93, preceded by a FY91 loan focusing on financial institutional reforms) that included recapitalizing state owned banks and empowering them to reduce their non-performing loans by restructuring enterprises, and then privatizing the banks. Similarly, Hungary, Croatia, Slovenia, and Slovak Republic each had one adjustment operation addressing mainly banking reforms. In Hungary, the FY97 EFSAL took several years to prepare and negotiate, but was a wide-ranging operation that addressed most issues identified in prior sector work.

Source: Fred Levy (2003), and OED data base.

EAP: mostly crisis-driven

4.7 In EAP Region, with the exception of the Philippines, the larger countries had few loans dealing with reforms of the financial sector until after the Asian crisis. In the Philippines, a financial crisis at the Central Bank drew Bank support in FY93 to help it restructure; this was followed by an adjustment loan to provide continued support for banking regulation and supervision and for privatization of one large state bank. In Vietnam, an FY95 Structural Adjustment Credit (SAC) included a condition for auditing two state banks, and a tax reform on banks' net income; and no further financial sector reforms until FY01. In China, the Bank made only one loan for TA (Box 4.2). Mongolia and Lao PDR, by contrast, have each had two adjustment credits and accompanying TA operations (in Lao, it was an Institutional Development Fund grant) for banking reforms.

Box 4.2: Bank assistance to China

In the past ten years, although several loans were prepared, the only Bank loan approved and disbursed to China for financial reforms was an FY93 Financial Sector TA Project for US$60 million. It aimed to make improvements in accounting and auditing of banks, supervision by the central bank, and building a modern payments system, but its underlying purpose was to begin a substantive dialogue on reforming the banking system. The scope of the task was huge, given that the central bank itself had over 2,400 branches and 180,000 employees, supervising a banking system with more than US$1 trillion in assets. The preparation and supervision of the project enabled the Bank to engage government officials in policy issues, leading to a reorganization of the central bank and a diagnostic audit of several branches of a state bank, revealing worrisome operational procedures, but the larger purpose was not accomplished. The project's outcome was considered satisfactory, but the Bank, for a variety of reasons related both to reluctance on the side of the Chinese authorities and disagreement within the Bank on the approach, has made no other loans in the financial sector in decade since the TA loan was approved and for about five years, between 1995 and 2000, had no effective dialogue. Starting in 2000, the Bank ramped up its non-lending activities, producing four (informal) policy notes (on interest rate liberalization; deposit insurance; bank supervision; and reforms of state banks).

Source: S. Ramachandran (2003).

MNA and SAR: conservative approach to reforms

4.8 MNA and SAR trail the other Regions in the proportion of each Region's loans that contain financial sector reforms (Table 4.2), and in the proportion of countries that have borrowed from the Bank for banking privatization (Figure 4.1), a reflection of the relatively conservative approach of the countries in these two Regions to financial reforms. In MNA, several countries have pursued stronger prudential regulations and modest restructuring and privatization (Morocco and Tunisia), while other borrowers (Algeria, Egypt) have not borrowed from the Bank to pursue significant banking reforms.

4.9 In SAR, only Pakistan has borrowed frequently during the period for financial sector reforms (Box 4.3), although the Bank has recently resumed lending to address financial issues in both Nepal and Bangladesh. The Bank carried out analytic work during this period in both Bangladesh and Nepal, however, even in the absence of lending. In Nepal, the FY03 TA operation was the first Bank credit approved in almost fifteen years (since FY89) to address financial sector reforms.

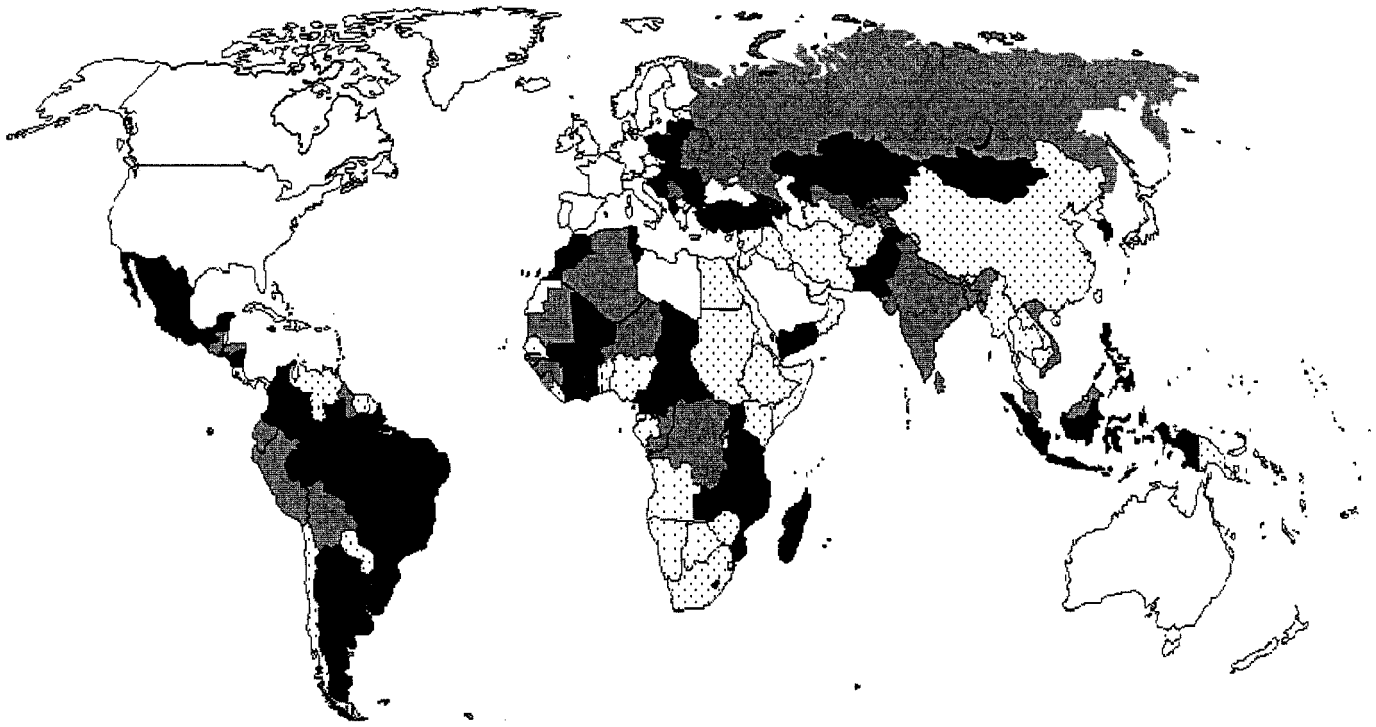
Box 4.3: Pakistan and Bangladesh: government commitment explains differences in patterns of Bank lending

Pakistan began to reform its financial sector in the late 1980s, supported by a FY89 adjustment loan and a FY95 LOC with substantial policy content (which followed a series of earlier LOC in the 1980s with mostly unsatisfactory outcomes). Although some measures were taken (partial privatization of two state banks; liberalization of interest rates, stronger prudential regulations), they failed to make significant improvements and in 1996 Pakistan experienced a banking crisis. After this, the government began to tackle the more serious issues facing the sector, including poor governance, rampant default by large, well-connected borrowers, over-staffing, and undue interference by labor unions in bank operations. The Bank supported the reforms with a series of policy loans (three financial sectors for US$766 million, including funding of severance payments, and three multi-sectors) and one TA loan. The pace of reforms has been uneven, but significant progress has been made in downsizing and restructuring the large state banks; the asset share in government owned banks has dropped from 92 percent in 1990 to 45 percent in 2002. Central bank supervision has improved, and is considered to meet 22 of the 25 core principles of good supervision; and prudential regulations have been strengthened. Weaknesses remain, particularly in state dominated non-bank financial intermediaries, and the legal and judicial process for enforcing legal contracts.

Bangladesh also borrowed from the Bank in the early 1990s for financial sector reforms (through both LOC and adjustment), but the poor results discouraged the Bank from pursuing further reforms for about a decade. The Bank considered the government insufficiently committed to addressing the corruption and governance plaguing the sector, which by any standards are quite serious. In the late 1990s, the Bank estimated that 50 percent of loans were non-performing; there were several hundred thousand defaulters and a pervasive "culture of default"; the large state-owned banks were essentially dysfunctional (insider lending, fraud, negligence) and enforcement of prudential regulations by the central bank was lax. Bank lending to Bangladesh for finance between 1992 and 2002 concentrated on supporting micro-finance, which was intermediated by specialized institutions outside of the banking sector, and not plagued by the same ills. The Bank nevertheless carried out analytic work (with a 1996 report on rural finance and a 1998 report on the financial sector), and lending for financial reforms resumed in 2003, with a multi-sector credit addressing prudential regulations and bank restructuring with a view to eventual privatization and a TA credit. Although stronger prudential regulations have been passed, political opposition to bank privatization has been stronger than expected and the process of preparing banks slower than planned.

Source: Long (2003b).

Figure 4.1: Bank support for bank restructuring and privatization, by country



Among Bank clients

- didn't borrow for bank restructuring or privatization
- borrowed for restructuring only–no privatization
- borrowed for restructuring and/or privatization
- not Bank clients (high income)

5. Quality at entry of Bank assistance

Overview

5.1 This chapter reviews quality at entry in lending and quality of non-lending assistance. In addition to reviewing assessments of individual products (loans and sector reports), OED relied on background papers and desk reviews of 37 country case studies[22] to address, first, the consistency of Bank assistance within a country, between diagnosis and lending and across lending operations and second, the question of whether Bank assistance across countries reflects a coherent strategy for the sector, after taking into

[22] The country case studies were selected to capture the bulk of the (non-crisis) lending and to represent all Regions (see Annex 4 for list of countries and amount of lending reviewed).

account specific conditions in borrowing countries. This chapter also reviews whether past OED recommendations for the financial sector are reflected in Bank assistance.

Quality at entry in lending

5.2 Since 1998, QAG has carried out six quality at entry assessments (QEAs) of loans and credits, using a random sample of operations approved shortly before the assessment, and examining eight dimensions of quality. Operations receive an overall score, from 1 to 4, corresponding to highly satisfactory, satisfactory, marginal, and unsatisfactory. Across all six QEAs, 32 financial sector operations were assessed, representing about 25 percent of total financial sector lending covered by this OED review. The loans received an average overall score of 2.0, corresponding to a satisfactory rating, which is exactly the same as the average rating for loans from all other sectors over the six years (Table 5.1 on page 30). QAG's assessment is consistent with OED's own review in background papers and case countries (paragraphs 5.6-5.9), with several important caveats.

5.3 The first caveat is that the quality at entry of LOC, only some of which were in the financial sector but most of which had financial sector objectives, were found in a separate OED review to be poor and to deviate frequently and in significant ways from the Bank's guidelines on LOC (see OED, 2005 for details).

5.4 The second caveat is that most of the support for financial sector reforms, both in numbers of operations and in amounts lent, has occurred over the last decade in components of multi-sector loans (see Chapter 3 on trends in lending), so it is not possible to get the full picture of the quality of Bank support for financial reforms by reviewing only financial sector operations. The next chapter reviews *outcomes* of both financial sector loans and components of multi-sector loans.

5.5 The OED review of country case studies found that the *objectives* of reforms supported by the Bank have been consistent with the literature in areas where there is widespread agreement in the literature and within the Bank: reducing government ownership of banks and other financial intermediaries; improving prudential regulations consistent with international standards; and strengthening bank supervision, to be consistent with international principles.[23] Examples of good practice exist in every Region, even where outcomes were unsatisfactory (Box 5.1).

5.6 Even where the *objective* of the reforms was consistent with good practice, however, the specific conditionality or design of the loan was not always appropriate for achieving the objective. For example, the Bank sometimes aimed to strengthen the health of the financial sector without addressing the underlying reasons for the poor situation of the banks. Thus, the Bank supported recapitalization of state banks in the absence of any

[23] The 1998 OED review of Bank assistance had recommended that the Bank pursue reforms as advised in OD 8.30, but for most of the period under review, the OD was becoming outdated: it emphasized directed credit and administered interest rates, while Bank lending was become more focused on reducing government's direct role in controlling banks and other financial intermediaries and on bringing the prudential and supervisory framework in line with international norms. The OD was relatively sketchy in these areas (see paragraph 2.16 for discussion of OD).

government commitment to change their governance, particularly through privatization, in Algeria, Lao PDR and Vietnam. Although the Bank is constrained by what the government is willing to do, there is ample evidence that new investment in banks which in practice have political mandates is not a sustainable solution to improving the health of the banking system and generally results in a re-accumulation of bad debts (this issue is discussed further in Chapter 9).

Box 5.1: Examples of high relevance of objectives of financial sector reforms

In Burkina Faso, the Bank took a broad view of the troubled banking system by focusing on consolidation, financial rehabilitation, privatization and, if necessary, liquidation.

In Pakistan, the efforts included improving prudential regulations to align them with international norms, undertaking an ambitious program of downsizing and restructuring public banks to prepare them for privatization, and improving the quality of banking supervision.

In Lithuania, the Bank addressed a wide-ranging reform agenda in the financial sector, including collateral law, accounting standards, and concurrent enterprise privatization.

5.7 In addition, there are cases where Bank lending, in pursuit of reducing the role of government as owner of banks, has been overly focused on privatization as an end in itself, and too little focused on the ultimate objective of having well-managed banks whose owners have incentives to both manage risks and realize returns. Thus, in Mozambique and Georgia, for example, the Bank did not discourage privatization of a bank or banks to inappropriate owners, which in Mozambique, led to considerable expense for the government and in Georgia, led to concern about the quality of the banking assets. In Uganda, the Bank encouraged privatization of banks to inappropriate owners, which led to a re-nationalization and re-privatization, also at considerable expense to the government.[24]

5.8 One type of assistance that will never show up in QEA but which deserves positive recognition consists of situations where the Bank reduced the amount of a loan, or delayed lending, or did not lend at all, because the government was not committed to reforms. These include the preparation of Economic Competitive Adjustment Loan (ECAL I) in Tunisia, where the financial sector component was removed from the loan and the amount cut in half during preparation because the government was not ready to make reforms sufficient to justify lending for them. The Bank returned two years later with ECAL II focused only on financial sector reforms. In the Slovak Republic, the Bank postponed Enterprise and Financial Sector Adjustment Loan (EFSAL) for six years, from a planned operation in FY95 until FY01, when the government was ready to reform. In Bangladesh and Nepal, the Bank had no adjustment operations for over ten years, yet the

[24] Assessment of designs of Bank operations, particularly adjustment loans, is difficult because of large differences between what the program document stated was expected during implementation and legal conditions for disbursement. Thus it was difficult to know the specific reforms agreed in the context of the loan. Examples of these differences were found in Algeria, Cameroon, Chad, Cote d'Ivoire, Kazakhstan, Madagascar, Pakistan, and Poland, to name a few.

dialogue continued in both countries until FY03, when a TA credit addressing financial sector reforms was approved in each country.

Quality of non-lending services

5.9 QAG has also carried out assessments of ESW over five years (FY98–02), using a random sample of ESW completed prior to each assessment, and examining five dimensions of quality. As with lending operations, ESW reports receive an overall score, from 1 to 4, corresponding to highly satisfactory, satisfactory, marginal, and unsatisfactory. Combining all five QEAs, twenty-two financial sector reports, including FSAP reports, received an average overall score of 1.7, which is between a satisfactory and a highly satisfactory rating. By contrast, the average score for all other ESW reports is 2.1 (Table 5.1), significantly lower than the financial sector work.[25]

Table 5.1: Quality of ESW, QAG assessment, FY97-FY03

	Financial sector network		Other networks		
	Number	Average score*	Number	Average score*	Difference
Lending Operations	32	2.0	483	2.0	-
ESW, including FSAP	22	1.7	322	2.1	0.4**
ESW, excluding FSAP	18	1.8	322	2.1	0.4

* Lower score is higher quality
**Statistically significant at 5 percent

5.10 Several background papers for this review also noted the strong quality of financial analysis. In SAR, for example, an extensive ESW program supported lending in Bangladesh, including rural finance reviews that supported lending for micro-finance, as well as in India and Pakistan. The Country Assistance Evaluation for India (OED, 2001a) gave particularly high marks to the financial sector ESW. In these countries plus Nepal, the ESW provided the basis for continued policy dialogue, and helped to define the issues and the policy alternatives, even in the absence of lending. In ECA, "policy papers and ESW reports... were of very high quality, and the issues and options involved in financial sector development were well understood and set out" and the priorities, coverage, and content of the recommendations were consistent with good practice and international standards (Levy, 2003, page 42). Nevertheless, different views on major issues sometimes emerged in ESW within a country, which sent mixed signals to the borrower (paragraph 5.14).

[25] One could argue that FSAP reports should not be included, because the underlying analysis is a joint effort with the IMF, with a standardized approach and scope, so that their quality is not attributable solely to Bank effort. On the other hand, the report produced by the Bank is part of the Bank's diagnostic work. The results with and without FSAP are therefore presented. In addition, procurement and financial management assessments (CFAA and CPAR) are also somewhat standardized ESW products, so OED analyzed the results both with and without these products and found the same results in both cases.

5.11 In addition, OED had recommended in its 1998 review that ESW precede lending and in most countries and for most loans this was the case. Of the 37 country case studies, recent ESW – defined as dated within four years preceding or one year after the year of loan approval – was available in 31 of them. Although the designs of the loans were typically not able to take on board all the recommendations in the ESW, the reforms addressed in the loans had usually been identified as important in the diagnosis.

5.12 Exceptions to this pattern occur particularly in countries that experienced a crisis during the analyzed period (Colombia, Jamaica, Korea, Thailand, and Uruguay), where loans were put in place rapidly without benefit of recent ESW. Similarly in post-conflict countries (Bosnia and Herzegovina, Democratic Republic of Congo, and Sierra Leone), the Bank provided assistance relatively quickly without benefit of prior diagnosis. Other situations included countries where the Bank had a number of loans addressing financial sector reforms, with an on-going dialogue through implementation and supervision (Algeria and Tunisia). As noted in Box 4.1, the Bank supported major financial sector reforms in ECA countries (Albania, Armenia, Georgia, Kyrgyz Republic, and Poland) without the benefit of formal financial sector reports; OED's 2000 Country Assistance Evaluation for Albania (OED, 2000) called the absence of a sector strategy early on a mistake, and suggested that one of the reasons for the failure of the early attempts at sector reform was lack of adequate diagnosis, focus, or prioritization.

Consistency of approach within countries

5.13 Synergies among ESW, adjustment lending, and TA loans (and, on occasion, LOC) in a given country have been good, with mutually reinforcing messages such as the importance of well-governed financial institutions, stronger prudential norms, better legal framework, creditor rights, and external audits. Examples of this are in Box 5.2.

Box 5.2: Examples of strong consistency between Bank products within countries

In Yemen, the financial sector note was prepared specifically as a way of identifying main areas for financial sector reform and as a result, the design of the Financial Sector Adjustment Credit (FSAC) followed closely from the recommendations of the ESW.

In Brazil, in addition to identifying the large and problematic role of state banks, several sector reviews in FY00 also identified the need to improve collateral rights and sharing of credit information and this analysis fed directly into the design of the programmatic Financial Sector Adjustment Loans (FSALs) that followed.

In Hungary, the FY97 EFSAL included virtually all the main issues that had been identified in the sector work that preceded it by two years.

5.14 But in some countries the Bank has sent mixed signals across different but closely timed strategy and diagnostic work, between ESW and lending, or within lending. In Russia, for example, an early banking sector study focused on the need to restructure the large state banks, while the country assistance strategy that followed soon thereafter mentioned only that government should assign high priority to privatizing state banks and consolidating private ones, while focusing Bank lending on providing LOC to private

banks (and leaving the larger issues untouched). In a number of countries, the Bank advocated closing or privatizing state banks while at the same time supporting expansion of government ownership of banks: in Albania, for example, the Bank supported within the same credit closure of a state-owned rural bank and establishment of a new one, which then closed down four years later after accumulating a poor portfolio of loans. In Mongolia, the Bank supported liquidation and privatization of public banks while concurrently helping the government to establish a new state owned commercial bank and a savings bank. In both Morocco and Cameroon, the Bank supported developing the post office as a lending agency at the same time it was encouraging privatization of commercial banks.

5.15 On deposit insurance, the Bank has also sent mixed signals within a country: a sector report for Ukraine in FY95 recommended that creation of a deposit insurance scheme should be an objective only for the long term, to be established only after other reforms were in place and the banks were strong enough to give such a scheme credibility, yet the introduction of deposit insurance was a condition of the FY99 FSAL. These inconsistencies may reflect disagreements within the Bank (which in turn reflect international disagreement) on good practice or on the appropriate approach in a given country, but they suggest the absence of a coherent approach to financial sector development in a specific country.

5.16 In addition, the Bank supported the establishment of stricter prudential regulations, which were followed by Bank funded LOC; although some of the LOC involved non-bank financial intermediaries, there were no requirements for these intermediaries to meet any prudential regulations. In Kyrgyz Republic, for example, a special rural credit agency had no prudential requirements for participating in the Bank LOC, and in Russia, an enterprise restructuring project involved credit guarantees from commercial banks, with no eligibility requirements. The Bank could have used the LOC to reinforce the relevance and importance of prudential norms, even if the intermediary was not formally considered a bank; by failing to make use of them in its own lending, the Bank undermined its message that prudential regulations matter.

Coherence of Bank approach to financial sector reforms across countries

5.17 Bank support has followed international norms and principles in support of prudential regulations and banking supervision and, to a lesser extent, with respect to government control of financial intermediaries (see Figure 3.3 for breakdown of Bank lending by objective). These elements were central to most loans and other features such as improving the accounting and auditing frameworks, introducing or improving bankruptcy law, and ensuring the independence of the supervisory authority were also frequently included in Bank loans addressing financial sector reforms. In addition, financial sector ESW across countries is characterized by a focus on similar issues.

5.18 There were, however, significant differences in the process of reforms (how); sequencing (when), and the selection of specific reforms, which cannot be explained by

initial conditions in the borrowing country, reform momentum, willingness and ability of the government to address constraints, or the coverage by other donors.[26]

5.19 *Bank privatization.* In ECA, although the Bank was consistent in recommending that if privatization was to be pursued, ownership should be concentrated in the hands of strategic investors, and preferably reputable foreign banks, Bank lending in ECA, as elsewhere, did not always support this approach (for example, in Georgia, Uganda, Mozambique). Second, there were inconsistent approaches on whether to privatize or liquidate large state-owned banks, as well as on how quickly to proceed, even within ECA, where there was acknowledged urgency to reforming both the banking and enterprise sectors in the context of transitioning to a market economy. In Azerbaijan, for example, the Bank recommended that any state bank not privatized within 18 months should be liquidated (except for the savings bank), while in Kazakhstan and Albania, the Bank called for a gradual approach to privatization, to be pursued only after sound regulations and strong banking supervision were in place.[27]

5.20 *Payment systems.* There is wide agreement that an efficient, reliable payment systems, is an important building block for financial sector development (paragraph 2.5). Over the ten year period under review, however, the Bank addressed issues of payment systems in only 28 countries and 2 regional systems, with a total of 43 lending operations (31 investment; 12 adjustment) and a relatively heavy concentration in ECA (14 countries, 21 operations). This limited involvement, particularly outside of ECA, cannot be explained by the adequacy of the systems in most of these countries or by support from other donors, which would indicate little need for Bank assistance (see next paragraph).

5.21 Instead, support for improving payment systems came late in the cycle of Bank assistance in a number of countries. Improvements to Pakistan's payment systems, for example, were addressed for the first time in FY03, although the Bank has been supporting financial sector reforms in the country since 1989. In Uganda, the Bank first addressed payments system upgrade in FY99, although it has been involved in financial sector reforms since the early part of the decade; in Albania and Mongolia, the pattern is similar, where the Bank supported reforms in FY93 (Albania) and FY97 (Mongolia) but did not finance investments in payment systems in either country until some six years later. In a number of countries, payment systems improvement appears to be (appropriately) the focus of reform efforts when there is little or limited agreement on other, more politically charged reforms: the Bank made such loans in Algeria, Angola, China, Sri Lanka, Tajikistan, Ukraine, Uzbekistan, and Vietnam, where Bank support for

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[26] Clearly a one-size fits all approach is inappropriate; at the same time, however, the specific reforms supported should be the result of a combination of analysis of country conditions, what other donors are doing, and a consistent view of the critical elements needed for an efficient, effective financial system.

[27] The Bank's FY95 economic report on Albania stated, "As the banks become healthier and more experienced in commercial banking practices, plans for the restructuring and eventual privatization of the state banks should be developed" (see page 59). This recommendation may have been based on perceptions of limited country commitment to privatization at the time, although it is unclear why gradual privatization was appropriate for Albania and Kazakhstan but not for Azerbaijan.

bank privatization (in systems dominated by state banks), for example, was not on the agenda.

Table 5.2: Bank loans supporting deposit insurance, by FY

FY	93	94	95	96	97	98	99	00	01	02	03
No. of loans	1	1	2	5	3	10	12	7	7	8	4

5.22 *Deposit insurance schemes*. By contrast with payment system strengthening where there is widespread agreement on its importance, deposit insurance is a more controversial area (paragraph 2.12). Yet the Bank has supported deposit insurance schemes in 35 countries and 60 operations (mostly adjustment), considerably more than for improving payment systems (Table 5.2). Most of these loans aimed to improve other components of a financial safety net: [28] support for the supervisory agency and the prudential framework, and restructuring and/or privatization of banks.

5.23 Eighty percent of the operations involving deposit insurance schemes were approved in FY98 or later. The timing of the support coincided with either crisis (all of the EAP countries, six in LCR, and four in ECA) or with future prospect of accession to the European Union, where deposit insurance systems have been mandatory since 1994. Although the timing of setting up deposit insurance has not been optimal,[29] governments have apparently been more interested in establishing them in times of systemic banking crisis, with its attendant political and social costs. Nevertheless, given the on-going debate within the Bank on the impact on a financial system of deposit insurance schemes, the extent of Bank support for such schemes is somewhat surprising.

5.24 *Capital market development*. Finally, the Bank has had an ad hoc approach to the priority that capital market development should be given in financial sector reforms, and under what country conditions it is appropriate to support capital markets. This is perhaps reflective of the differing views within the Bank on this issue and the priority given to it by governments. Some 48 Bank operations (21 adjustments; 27 investments) in 30 countries have supported capital market development, half of which were approved over a four year period (FY95-99), and concentrated in ECA and LCR. Of the 30 countries where the Bank supported capital markets, most (19) are middle income countries, but a number of the countries have very small economies and financial systems (e.g., Bolivia, Georgia, Guyana, Kyrgyz Republic, Lesotho, Mali, and Mongolia), with little clear potential even in the medium term for capital market development. It is in this area in particular that the absence of guidelines or good practice on the relevance and priority of capital market development, and under which country conditions, is most evident.

5.25 In conclusion, the Bank has followed good practice where there is widespread agreement on the importance and the nature of reforms, with some exceptions. In addition, within many countries, support for specific reforms has been consistent, although there are exceptions to this as well. Across countries there is a much wider

[28] A country's financial safety net consists of a lender of last resort, insolvency regulations, a framework of prudential regulations and supervision, and a deposit insurance scheme.

[29] Garcia (2001) says that a deposit insurance scheme should be installed only in a country with a sound banking system and other components of a safety net that are functioning well.

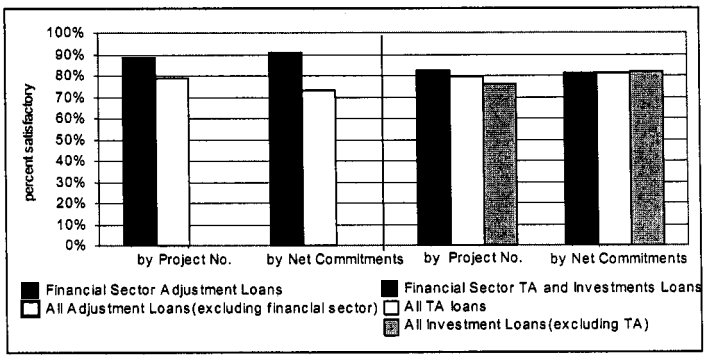
variation of approach, particularly in support for payment systems, deposit insurance schemes, and capital market reform. The combination of on-going debates within the Bank (e.g., whether and how to support deposit insurance schemes), absence of "good policy" notes (paragraph 2.19), and the decentralized nature of Bank operations have all contributed to a situation in which the Bank speaks with many voices on important matters of financial sector policy.[30]

6. Bank assistance: outcomes of loans and credits

Overview

6.1 This chapter reviews outcomes of Bank loans and credits for financial sector reforms. As of end-March 2004, out of a total of 280 loans and credits approved over the FY93-03 period, 159 operations (142 adjustment and 17 TA), or over 60 percent of the operations by number, had closed and been rated by OED. By value, US$35 billion out of a total of US$46 billion had been rated.[31]

Figure 6.1: Outcomes of adjustment and TA loans, financial sector and other, FY93-03, by number and net commitments



6.2 For financial sector adjustment operations, outcome ratings are better than overall adjustment ratings, both by number and by commitment amount. For financial sector TA operations, outcomes are similar to outcomes of other TA lending, slightly better than outcomes of other investment lending by number and about the same by commitment level (Figure 6.1). Although experience and evidence have repeatedly pointed to the importance of government ownership for success of reforms, it is nevertheless interesting to explore whether other factors can be associated with satisfactory outcomes.

6.3 Because closed multi-sector loans addressing financial reforms outnumber those categorized as finance (130 closed and rated multi-sector versus 60 closed and rated financial sector adjustment loans), OED rated the financial sector components of multi-sector loans.[32] This provided a more complete database of ratings of financial sector

[30] The Bank's research department has been active in exploring a number of subjects and producing articles on experience with different elements of a financial system, or of reforms (for example, deposit insurance; asset management companies), but research findings do not emanate from the same authorizing environment nor bear the same weight as would good practice notes from the network anchor.

[31] This chapter excludes outcomes of LOC, which are analyzed in OED, 2005. It also excludes loans focused solely on pension reform, which are the subject of an on-going OED review.

[32] Of the 99 component ratings, 12 came from implementation completion reports, validated by an internal OED review; 27 came from OED's assessment reports. Of the remaining 60 rated by an OED desk review, outcomes of 9 components were rated better than the overall project outcome rating and 11 were rated

components and allowed more robust testing of trends over time and characteristics that might be associated with success, as discussed in the next section.

Financial sector loans versus components of multi-sector loans

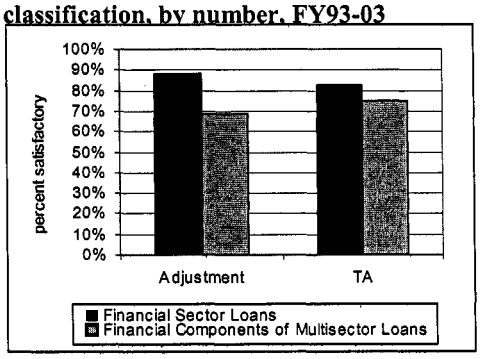
6.4 When financial sector loans and financial sector components are combined, the rate of satisfactory outcomes drops below outcomes of all other Bank lending (Table 6.1), driven mainly by the poor outcomes of the components. Outcomes of the financial components in multi-sector adjustment loans have only a 69 percent satisfactory rating (by number), which is some twenty percentage points lower, than outcomes of adjustment loans under the financial sector board. Among TA loans, outcomes for components of multi-sector loans are slightly lower than for financial sector loans (Figure 6.2 and Annex 2, Table 2).

Table 6.1: Outcome ratings of financial sector lending and components, FY93-03

		Percent satisfactory
Financial sector + components		75
All Bank lending		79
Adjustment:	financial + components	75
	all other adjustment	79
TA:	financial + components	78
	all other TA	80

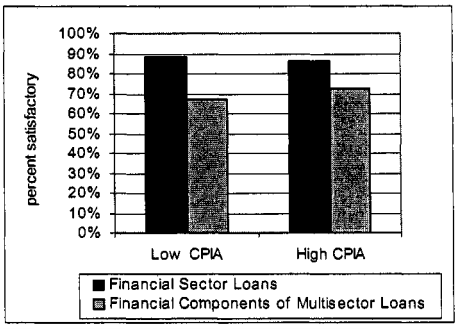
For further details, see Annex 2, Table 2.

Figure 6.2: Outcome ratings and sector classification, by number, FY93-03



6.5 These results cannot be explained by differences in the reforms or conditionality, as they were similar in financial sector and multi-sector loans; nor do the financial sector loans tend to be made in non-crisis situations, while multi-sector loans are for the crisis situations – there is a mixture of both types of loans in crisis and non-crisis lending. But the poorer outcomes for multi-sector lending may be the result of other country characteristics – if multi-sector loans are clustered in smaller countries with poorer institutional and policy capacities and lower incomes, this could explain the poorer results. To test this, OED examined outcomes in countries with different ratings on Country Policy and Institutional Assessment (CPIA) and different per capita income levels.[33] The results in Figure 6.3 show that even among countries with similar low CPIA ratings, outcomes of financial sector components in multi-sector loans are much lower (by about 20 percentage points) than outcomes of financial sector loans and among higher CPIA countries, the difference is 13 percentage points (for details, see Annex 2, Tables 2-4). These differences persist between countries categorized

Figure 6.3: Outcome ratings by sector and by CPIA rating, by number, FY93-03



worse. For all 99 component ratings, the net "downgrade" relative to overall project outcome ratings was 3 percent. The component ratings by source are in Annex 2, Table 1.

[33] The CPIA (Country Policy and Institutional Assessment) is a composite indicator that measures the capacity of a country to manage its resources efficiently and carry out policy reforms, comprised of an unweighted average of 20 indicators, of which only 2 are related to the financial sector. The degree of circularity in this analysis is therefore quite modest.

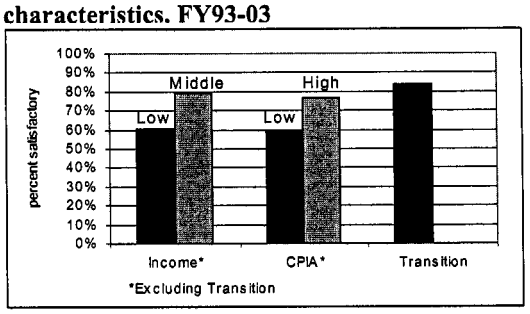
by income level as well, with the largest difference in outcome ratings among middle income countries, where component outcomes were 23 percentage points lower than those of financial sector adjustment loans. Most of these results are statistically significant.

6.6 These findings suggest that financial sector reforms under the control of financial sector staff in the Financial Sector Network have better outcomes than such reforms under other Networks. This may be the result of having specialized Bank staff prepare the loans; the review process within the Network prior to loan approval; or the quality of the Bank's supervision, all of which may focus more resources and more effort on pursuing reforms. Better outcomes may derive from factors on the Borrower's side, such as having specialist counterparts from Central Banks or Ministries of Finance, who may also focus more intently on financial sector issues than in situations where reforms cover many sectors and ministries. These findings could be a proxy for stronger ownership: when reforms are concentrated in a sector, the extent of government commitment to reforms in that sector may be more apparent than when reforms are dispersed across a number of sectors and ministries. Whatever the reason behind the differences in outcomes, these findings suggest that if financial sector reforms are considered a priority by client country officials, and are to be supported by Bank lending, the financial sector board should be closely involved in quality control at the preparation stage; counterparts from finance in the client country (from the ministry or the central supervisory authority) should be closely involved; and financial sector specialists should be assigned to supervise the component.

Country characteristics

6.7 Not surprisingly, country characteristics mattered for outcomes, particularly when measured by 2002 or 2003 characteristics (Figure 6.4 and Annex 2, Table 3). In addition, outcomes of Bank lending for financial reforms in transition countries were higher than in other countries; and when the transition countries are examined separately, the differences in outcomes between the remaining low and middle income countries are significantly larger.

Figure 6.4: Outcome ratings and country characteristics. FY93-03



6.8 For CPIA ratings (available for most countries in the sample only as far back as 1996), the pattern is similar. The difference in outcome ratings between low and high CPIA countries is 16 percentage points (Figure 6.4). The relatively good outcomes in transition countries are probably due to the strong reform movements in many of them. For almost half of the transition countries (the Baltic and Central European countries), the incentive of accession or association to the European Union may have driven both the direction and speed of reforms, and the financial sector reforms were part of a larger program of reforms aimed at enterprises as well, which may have contributed to better outcomes.

Trends and sequence of adjustment lending

6.9 The Bank has been lending for policy reforms for almost 20 years and many lessons have emerged, e.g., on the importance of government commitment; on keeping the design of the adjustment loans relatively simple, on setting realistic timeframes for conditionality. In addition, over the period under review, many countries had more than one adjustment loan, so it could therefore be expected that outcomes of adjustment lending for financial sector reforms would show improvement over time.

6.10 Outcomes of loans approved in the second half of the period, however, are not much higher than in the first half. By contrast, adjustment loans that built on a prior loan for financial reforms had better outcomes than the first loan (Table 6.2).[34] This finding may be the result of perseverance by the Bank, or as likely, a crisis or near-crisis in the banking sector. Governments that were initially reluctant reformers became more convinced of the need (or were forced out of office) once they faced either crisis: near-crisis, or widespread banking insolvencies, which happened at different times in different countries over the period under review. Following the (near) crises, the Bank was often able to engage in more active dialogue on the financial sector. There are countries, however, where crisis or near crisis had little impact on Government's views toward governance reforms (Box 6.1), and a third group of countries, such as Latvia and Lithuania, where the government undertook reforms, particularly bank privatization, in the absence of or prior to a (near) crisis.

Table 6.2: Outcomes ratings and timing, sequence of adjustment loans

Timing, Sequence	Number of loans	Number of satisfactory loans	Percent satisfactory
Year of approval			
FY93-FY97	74	53	72
FY98-FY03	68	53	78
Loan sequence			
First loan addressing financial reforms	51	35	67*
Not first loan addressing financial	91	71	78*

* Significant at the 10 percent level

Does the provision of technical assistance help outcomes?

6.11 Conditionality in adjustment loans aimed at the financial sector often involves highly technical issues, such as passage of banking laws, stricter prudential regulations, and privatization of banks. If a country doesn't have the relevant in-house experience or expertise to carry out the reforms, it is reasonable to expect that the provision of technical assistance (TA) may be the difference between timely and successful implementation and failure. The analysis that follows compares outcomes of Bank loans for financial sector reforms that were accompanied by Bank-financed TA loans with outcomes where no Bank funding for TA was provided. An important caveat of this analysis is that TA may have been provided by other donors, and thus the results here may obscure the importance of timely assistance from other sources.

[34] OED examined the period prior to FY93 for adjustment loans addressing financial sector reforms; investment lending with reforms were not captured in this analysis.

Box 6.1: What a difference a (near) crisis (sometimes) makes

Financial crisis, near crisis, or widespread insolvency was often followed by a change in government or, at least a change in government's willingness to undertake reforms in its financial sector. In Albania, for example, the Bank had supported reforms through two adjustments and one TA credit which did not address underlying governance issues. It was only after the widespread pyramid crisis in FY97 followed by civil unrest that the new government was ready to engage in real reforms. The Bank supported them with three adjustment and two credits which aimed to resolve the pyramid scheme fallout; liquidate or privatize banks, and establish an asset management company to handle bad debts. By mid-2004, all banks had been privatized and the banking system was fairly healthy. In the Slovak Republic, two adjustment loans similarly made little progress; and an EFSAL planned for 1995 was postponed because of lack of Government interest. After a near financial crisis in 1999, the new government was ready to address fundamental problems in the sector, supported by an FY01 loan. Other examples of this were found in Brazil, Burkina Faso, Cameroon, Croatia, and Romania.

Many countries that had full-blown crises (Chapter 7) were also reluctant to reform their financial sectors prior to crisis. Thailand, for example, had no Bank lending and no dialogue with the Bank on financial sector issues prior to its crisis, and in Korea and Indonesia, Bank lending was limited to lines of credit. Argentina agreed to privatize provincial banks with Bank support only after the banks became a serious drain on the provincial governments' budgets in the early 1990s; there has been notably less interest on the part of the authorities in Argentina in privatizing national banks. Only after its 1999 crisis did Colombia begin to consolidate the weak cooperative system and to address privatizing its national banks. In Mexico, the Bank had supported early and only moderately successful banking reforms prior to the Tequila crisis of 1994, but thereafter Mexico re-nationalized (with Bank support) and re-privatized its banks, allowing foreign banks to participate. Similarly, in Turkey, outcomes of Bank's adjustment lending in the financial sector were unsatisfactory until the crisis in 2000.

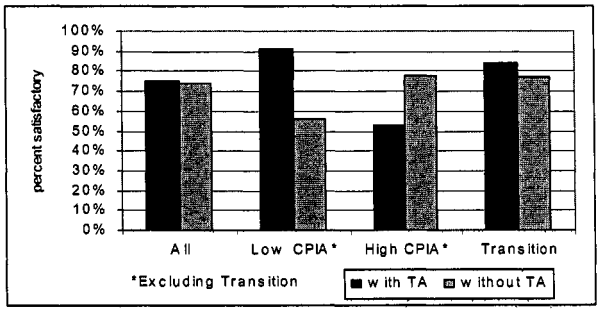
...but not always

Mongolia began its transition to a market based economy in 1991, and had banking crises in 1992, 1994, 1996, and 1998. The FY97 FSAC and TA credit supported liquidation of two banks and establishment of two new public banks, debt recovery mechanisms, and the establishment of a credit information bureau, but no change in governance. Only in the FY00 FSAC and TA credit did the government agree to divest one state bank and to put in place a clear exit policy for troubled banks. In Lao PDR, the FY96 SAC III, aiming to strengthen the prudential framework and accounting of banks and carry out audits of state owned banks, was considered unsatisfactory on all components, and even after state banks reached total insolvency at the end of the 1990s, the government was willing only to restructure the banks, supported by an FY02 FSAC and TA credit, with no change in governance. In Algeria, the state banks served for years as channels for Treasury support to unprofitable state enterprises and, according to detailed diagnosis in the early 1990s, had reached a level of insolvency that implied negative capital. Two adjustment loans were approved (FY95, FY96) that included restructuring state banks and introducing private capital. The reforms were attempted at a very difficult political juncture in Algeria and little progress was made. No further adjustment lending for financial sector reforms has been made to Algeria since FY96.

6.12 The results of the analysis show no difference in outcomes overall between adjustment loans that had associated TA loans and those that did not. It might be expected that TA would make more of a difference for lower income countries than in middle income countries, but outcomes on adjustment lending are similar here as well, whether or not transition countries are examined separately (Figure 6.5). In low CPIA countries, however, outcomes are better in low CPIA countries when a TA loan accompanies the adjustment loan (details are in Annex 2, Table 4). To the extent that the CPIA rating is a good proxy for institutional capacity, this finding makes sense: where capacity is limited, the provision of TA has a measurable value added for the outcomes of adjustment lending.

6.13 By contrast, for the higher CPIA countries, with better institutional capacity and policies, the difference in outcomes is the opposite of what would be expected, that is, *outcomes are better when there is no TA loan in the picture.* This finding hold whether 1996 or 2003 CPIA measures are used, whether or not transition countries are included, and whether "high" CPIA is defined as over 3.0 or 3.5 (although in none of these is the difference statistically significant). This suggests that the provision of TA by the Bank has little positive impact on outcomes of adjustment lending for financial reforms and may even be a signal that the adjustment loan is quite risky, although these findings may simply reflect the failure to measure the TA provided by other donors. Or it may be that in countries with better institutional capacity, the provision of a TA loan by the Bank is an attempt to address some other, non-technical constraint, such as lack of widespread ownership or presence of political obstacles, in the hope that the presence of outside technical specialists may be able to overcome these obstacles. Whatever the explanation, these results suggest that in high capacity countries, the provision of technical assistance in conjunction with an adjustment loan does not appear to carry much value added for the achievement of the objectives of the adjustment loan, although it may add value for other reasons (such as establishing or improving a payment system).

Figure 6.5: Outcomes of adjustment loans with and without technical assistance



7. Bank support to countries experiencing a crisis[35]

Overview

7.1 Much has been written on the financial crises that have occurred in the developing world in the last decade – their causes, their costs, their consequences, and their aftermaths. The causes have been complex and varied across countries. The costs have been high, in terms of both the increased fiscal burden (as high as 55 percent of GDP in Indonesia to recapitalize the banks) and the drop in output, not only in the year of the crisis but in subsequent years. The consequences in terms of corporate bankruptcies, unemployment, increased poverty, access to international capital markets, and political and social upheaval have been serious; and recovery from the crisis has taken many years. The financial sectors in some of these countries, such as Ecuador, Indonesia, Russia, and Thailand, have arguably not yet fully recovered.

7.2 There is no agreed definition of what constitutes a country in crisis. The one used here is a country that experienced both a banking crisis and a macroeconomic crisis, either simultaneously or in quick succession.[36] The run on banks resulted in illiquidity

[35] This chapter is based on the background paper by Millard Long (2003b) and OED's project assessments.
[36] Many countries had one sort of crisis but not the other. Brazil, for example, had a macroeconomic crisis that did not result in a banking crisis. Caprio and Klingebiel (2003) list 83 countries that had technically

and required government action, and the macroeconomic crisis led to a large devaluation; the combination of events created problems for the corporate sector, which could no longer service its loans, creating further pressure on the banks and affecting outputs and investments. Growth dropped and poverty increased.

7.3 Using this definition, fifteen countries in three Regions experienced crises over the FY93-03 period. The 1994 Tequila crisis in Mexico spread to Argentina; and the 1997 crisis that started in Thailand quickly spread to Korea and Indonesia and then to Russia and Bulgaria; Bolivia and Ecuador had crises in 1998 and 1999, and in 2000-02, Argentina, Colombia, Guatemala, Jamaica, Turkey, and Uruguay had crises.[37]

7.4 The rationale for assessing Bank lending to these countries separately from other financial sector support is twofold: one is the importance of this lending. Financial sector loans to countries experiencing or following a crisis represents over 50 percent of total financial sector lending over the period (US$12 billion out of US$21 billion); all loans, including multi-sector, to these countries that include financial sector reforms also account for almost 50 percent of total loan amounts approved by the Bank that had any financial sector components (US$21 billion out of US$46 billion).[38] Thus crisis lending looms large in the Bank's portfolio of financial sector support.[39]

7.5 The second reason for considering crisis lending separately is that such lending is usually prepared and approved quickly, under emergency situations, in the context of large financial aid packages put together by international financial institutions (IFI). It may not benefit from prior diagnostic work on the sector or from a close dialogue with government on reforms. On the other hand, governments that were reluctant reformers prior to crisis may become more willing adherents. All of these factors may affect, in different directions, the nature and quality of the reforms undertaken, and the outcomes in ways that do not apply, or apply to a much lower degree, under less urgent conditions.

7.6 The next section reviews the Bank's record on predicting crisis and assessing vulnerability; the following section reviews the Bank's response to the crises, and how its assistance fit into the larger international rescue efforts. The chapter then discusses the objectives and outcomes of loans that focused on financial sector reforms. Finally, the chapter examines cooperation with the IMF during crisis, whether a centralized approach within the Bank worked well and is sustainable for responding to crisis, and whether the Bank's organization is adequately structured to handle crises. The chapter concludes with lessons drawn from the experience of the past decade on dealing with crises.

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insolvent financial systems between 1990 and 2002, and thus were labeled as a systemic or borderline banking crisis country. Unless these countries also experienced a macroeconomic crisis, they are not discussed in this chapter.

[37] Venezuela had a crisis, but no Bank lending, and is not discussed here.

[38] These figures exclude LOC.

[39] Other adjustment loans made to countries experiencing crisis that did not involve the financial sector are not discussed here. In addition, loans reviewed here were approved within two years of the crisis.

Did the Bank anticipate the crisis?

7.7 All of the countries that had financial crises over this period had systemically weak financial systems, but not all countries with weak financial systems have had crises. Two other elements have been involved in most of these countries examined in this review. One was an economic or political shock (deterioration in terms of trade; contagion from other crises; assassination of a presidential candidate) that led to an initial run on the banks. The second was a government response that the markets deemed inadequate, which in turn led to a larger run and crisis. While it was feasible for the Bank to analyze the weaknesses of financial systems in most countries, it was and is not possible to predict shocks, nor in most cases, government's response or the reaction of market participants. Thus, it would be unrealistic to expect the Bank, or any other institution, no matter how well-informed, to predict timing of crises.[40] It is reasonable, however, to expect the Bank to assess the vulnerability of its clients to crisis and therefore to be prepared to respond quickly once a crisis hits.

7.8 In a number of the countries under review here, however, the Bank was not well-informed, in part because it had not been active in the financial sector in the years leading up the crisis. In Mexico, after supporting financial liberalization in 1989-90, the Bank considered the reforms successful, and the Bank's dialogue lapsed. As a result, the Bank had little recent work to draw upon prior to the crisis. An internal high-level review of the Bank's handling of its post-crisis assistance to Mexico concluded that given the warning signs of potential trouble in the banking system – a lending boom, a rapid increase in non-performing loans (NPLs), a weak legal and regulatory framework for banks – the Bank should have been better prepared to respond to a crisis. The OED Country Assistance Evaluation on Mexico (OED, 2001b) also noted, "The inadequate high-level attention to the financial system during 1992-93 was by far the most serious omission in the Bank's agenda in Mexico during the period under review."

7.9 In Thailand, the Bank's 1990 sector report on the financial sector was the most recent analysis prior to the 1997 crisis, although there were several economic reports produced between 1994 and 1997 which did not mention the financial sector. In addition, the Bank had not made any financial sector loans in many years prior to the crisis. In Korea, the Bank had produced a report on the financial sector in 1993, at the request of the government, but had not had a dialogue since then, except for supervision of an FY94 line of credit. In spite of warning signs of increasing vulnerability in these two countries, the Bank had little current financial sector analysis relevant to the crises that hit both of them. In Indonesia, the Bank had an active line of credit and had produced a financial sector review in 1996 that identified weaknesses in the financial sector, but the government was not interested in adjustment lending to address them prior to the crisis. By contrast, the Bank had been heavily involved in adjustment and/or investment lending in Argentina, Russia, and Uruguay and was both aware of and trying to address weaknesses in the financial systems.

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[40] A 2003 analysis by the U.S. General Accounting Office concluded much the same about IMF's ability to anticipate crises.

7.10 The degree to which the Bank's assessments found their way into internal papers, formal sector work, and lending documents varied in candor, according to the primary audience for the analysis.[41] In Indonesia, for example, a financial sector report that was discussed within the Bank but not formally with government raised concerns about the health and vulnerability of the financial system and the need to introduce reforms (these issues were discussed, however, at meetings between the Bank and the Central Bank of Indonesia). At the 1995, 1996, and 1997 meetings of the Consultative Group for Indonesia prior to the crisis, the Bank pointed out the risks to the macro-economy of the financial sector's vulnerability to shocks. Yet the assistance strategy for Indonesia discussed at the Bank's Board in the summer of 1997 was sanguine about Indonesia's risks. In Turkey, although the Bank was well aware of the fragile situation of the banks in Turkey and the pressures on them, the formal country economic report of September 2000 and the country strategy presented an optimistic scenario for the reforms and likelihood of success.[42]

7.11 Two reasons cited by proponents of providing a sanguine treatment in public documents of the vulnerability of a country's financial system to crisis are:
(i) publicizing high vulnerability in the financial sector of a client country could precipitate a crisis that might not occur otherwise; and (ii) if client countries know that the Bank will make its assessments public, it would be unwilling to provide the confidential information required to make the assessments. OED disagrees with both of these arguments.

7.12 First, assessing vulnerability to crisis is not the same as predicting a crisis. The Bank has identified high NPLs, weak supervision, poor governance, concentrated risks, rapid credit growth, poor accounting, and other factors associated with vulnerability in many countries that have not had crises. It is possible to use available information to assign risk categories to financial systems without precipitating a run on the banks. Second, governments have allowed information on these factors to be available in Bank documents as well as to other market participants (like rating agencies) for years; pulling this information together into an assessment of risk would be no more revealing than what is currently available in the public domain. On the other hand, drawing conclusions from publicly available information on risks could help both the Bank and the client government focus on contingency planning.

7.13 Since the 1997 Asian crisis, the Bank and IMF have started a joint program of financial sector assessments (FSAP) that is intended to identify more systematically the resilience of the financial systems to risk and the adequacy of the supervisory and prudential framework. As of July 2004 more than 80 assessments are completed or on-going. The details of the assessment are confidential, but both institutions produce summary assessments to their Boards. On the basis of these summary assessments, the Bank could develop risk categories for financial systems, which would signal to the Bank, other donors, and stakeholders as well as the government (if it hadn't gotten the

[41] Internal documents the most frank, documents to the Board the least, and sector work somewhere in between (the degree of candor may depend on whether the documents are disclosed to the public).
[42] The President's report of the FSAL had an underlined section that noted the risk of a banking crisis if weaknesses were not addressed.

message from the FSAP itself) the priority that should be given to financial sector reforms and resources devoted to contingency planning (what the best course of action would be if a crisis were to occur). It would also provide a more candid basis for assessing whether proposed assistance programs are focusing on the most relevant issues.

Bank response to crisis

7.14 The Bank made post-crisis loans to all but two of the fifteen crisis countries. In Russia, the Bank approved a large Structural Adjustment Loans (SALs) for US$1.5 billion as part of a US$23 billion rescue package in the month *before* the crisis, to try to avert one. The Bank did not lend to Venezuela. In the other countries, the Bank was part of a larger rescue effort by the international financial institutions (IFI) and G-7 countries (Table 7.1), and the amounts pledged and lent by the Bank were relatively small compared to the IMF. In Mexico, for example, following the 1994 Tequila crisis, the Bank committed roughly 4 percent of the US$49 billion pledged by the international community; the IMF committed 35 percent. In Thailand, the Bank lent a total of US$2.1 billion out of an IFI package of US$17 billion; the IMF, US$4 billion. In Korea, although Bank lending reached a record high of US$7 billion lent over six months to one country, it was a modest portion of the US$58 billion emergency package put together by the IFI (although the full amount never materialized – see note to Table 7.1); the IMF's share was US$21 billion. In Argentina, in the third round of crisis support, the Bank's lending was under 5 percent of the total package, compared to the IMF's share of over 50 percent.

Table 7.1: Response to crisis: international rescue efforts and Bank response

	Rescue package US$ billion*	As percent of country's GDP**	IMF Standby or EFF US$ billion	Bank actual commitments US$ billion
Argentina, 1995-96	3.7	1	1.9	1.66
Argentina, 1999	8.3	3	2.8	3.03
Argentina, 2001	40.0	15	22.7	1.85
Ecuador 1999-2000	2.0	12	0.3	0.43
Indonesia, 1997-99	38.0	18	10.0	2.45
Jamaica 1996-1997	2.0	33	0.0	0.23
Korea, 1997-98	58.0	12	21.0	7.05
Mexico, 1995	48.8	17	17.8	1.95
Russia, 1998	22.5	8	12.5	1.50
Thailand, 1997-99	17.2	11	4.0	2.08
Turkey, 2001-2003	22.2	15	19.0	3.23
Uruguay, 2002	3.3	27	2.2	0.40

* Announced; full amount includes bilateral pledges, which were not typically committed; for example, the US$58 billion for Korea included US$20 billion "second line of defense" from bilaterals that was never used.
**GDP in first year of crisis; a more appropriate measure might be rescue package as percent of capital outflow, but this information was not readily available for most countries.

7.15 The Bank often pledged lending amounts prior to any dialogue with the government concerned. Thus the Bank's intentions on both timing and amount of funding were publicly announced, without benefit of discussion on the scope of the reforms or negotiations with the governments. The first adjustment loan approved immediately after the crisis was often made under emergency and difficult conditions, where speed was essential and the need for comprehensive understanding of the issues or

government's capacity to address them, secondary. These factors provide perspective on the ensuing discussion of the outcomes of Bank lending in crisis.

7.16 On the other hand, many of the governments in these 15 countries had been unwilling to undertake reforms of their financial sectors. Nine of the countries had had no Bank adjustment lending, or none within the previous 10 years prior to the crisis in support of financial sector reforms. The crises changed either the governments themselves or their attitudes about reform, or both, thus underlining again the oft-repeated finding that government ownership is critical to successful pursuit of reforms. Thirteen of the countries agreed to address financial sector problems following the crisis (and Russia just before the crisis), and of these, seven countries also accepted TA loans accompanying the adjustment loans to help implement the reforms. The countries and loans containing financial sector reforms are listed in Table 7.2.

Objectives and design of the loans

7.17 Although all the loans were timed and sized to address liquidity problems, to try to contain the currency runs, and to restore market confidence, the loans also addressed underlying structural problems, particularly in the banking and corporate sectors. The loans included analysis of banks' financial condition, establishment of asset management companies and/or deposit insurance institutions to take over troubled financial institutions, restructure them, and re-privatize them and dispose of loans and other assets, and establishment or support to corporate bankruptcy and restructuring. Other reforms addressed fundamental legal and regulatory issues, banking supervision, and accounting (Box 7.1). In other words, the reforms supported under these crisis adjustment loans were very similar in nature and scope to the financial sector reforms discussed previously in this review, but many of them were prepared under emergency conditions, and some without benefit of recent diagnostic work or extensive dialogue with the government.

7.18 The TA loans were often also prepared quickly; in Bolivia, Indonesia, and Thailand, they preceded the adjustment loans. In the absence of detailed knowledge about priorities and local capacity to implement quickly needed reforms, these TA loans were appropriately flexibly designed, to adjust to the circumstances as they developed. At the same time, several of them suffered during the early years of implementation from inadequate attention to "mundane" issues such as Bank guidelines on procurement and on hiring consultants, and experienced delays which were all the more frustrating in a situation where speed was critical to stem the bankruptcies and further deterioration in the economy.

Table 7.2: List of Crisis Loans with Financial sector components

Country	Loan Name	Loan Type	Commitment Amount (US$ m)	Approval FY	Outcome
Argentina	Provincial Bank Privatization	SAL	500.0	1995	Satisfactory
Argentina	Bank Reform	SAL	500.0	1996	Satisfactory
Argentina	Special Structural Adjustment Loan	SSAL	2525.3	1999	Unsatisfactory
Argentina	Special Repurchase Support Facility	SSAL	505.1	1999	Highly Unsatisfactory
Bolivia	Regulatory Reform Sector Adjustment Credit	SAL	40.0	1999	Satisfactory
Bolivia	Regulatory Reform and Privatization	TA	20.0	1998	Active
Bulgaria	Rehabilitation	SAL	30.0	1997	Unsatisfactory*
Bulgaria	Financial and Enterprise Sector Adjustment Loan	FESAL	100.0	1998	Satisfactory*
Bulgaria	Critical Imports Rehabilitation	SAL	40.0	1997	Satisfactory*
Colombia	Financial Sector Adjustment Loan	FSAL	505.6	2000	Moderately Sat
Colombia	Programmatic Financial Sector Adjustment Loan	PSAL	150.0	2003	Satisfactory
Ecuador	Financial Sector Technical Assistance	TA	10.0	2000	Unsatisfactory
Ecuador	Structural Adjustment Loan	SAL	151.5	2000	Unsatisfactory
Guatemala	Financial Sector Adjustment Loan	SAL	150.0	2002	Active
Guatemala	GT Financial Sector TA Loan	TA	5.0	2002	Active
Indonesia	Banking Reform Assistance	TA	20.0	1998	Unsatisfactory*
Indonesia	Policy Reform Support (PRSL I)	SAL	1000.0	1999	Moderately Unsat*
Indonesia	Second Policy Reform Support (PRSL II)	SAL	500.0	1999	Moderately Unsat*
Jamaica	Bank Restructuring & Debt Management	PSAL	75.0	2001	Satisfactory
Jamaica	Bank Restructuring & Debt Management II	PSAL	75.0	2003	Moderately Sat
Jamaica	Jamaica Emergency Recovery Loan	SAL	75.0	2002	Moderately Sat
Korea, Rep	Structural Adjustment	SAL	2000.0	1998	Satisfactory
Korea, Rep	Structural Adjustment II	SAL	2000.0	1999	Satisfactory
Korea, Rep	Financial and Corporate Restructuring Assistance	TA	48.0	1999	Satisfactory
Korea, Rep	Economic Reconstruction	SAL	3000.0	1998	Satisfactory
Mexico	Financial Sector Restructuring	FSAL	1000.0	1995	Unsatisfactory
Mexico	Financial Sector Technical Assistance	TA	37.4	1995	Satisfactory
Russian Fed.	Structural Adjustment Loan III	SAL	1500.0	1999	Unsatisfactory
Thailand	Finance Companies Restructuring	SAL	350.0	1998	Satisfactory**
Thailand	Financial Sector Implementation Assistance	TA	15.0	1998	Satisfactory
Thailand	Economic And Financial Adjustment Loan	EFAL	400.0	1999	Satisfactory**
Thailand	Economic and Financial Adjustment Loan II	EFAL	600.0	1999	Moderately Sat**
Turkey	Financial Sector Adjustment Loan	FSAL	777.8	2001	Moderately Sat
Turkey	Programmatic Financial and Public Sector Adjustment (PFPSAL I)	PSAL / SSAL	1100.0	2002	Satisfactory
Turkey	Second Programmatic Financial and Public Sector Adjustment (PFPSAL II)	PSAL / SSAL	1350.0	2002	Moderately Satisfactory
Uruguay	Structural Adjustment Loan	SSAL	151.5	2003	Active
Uruguay	Special Structural Adjustment Loan	SAL	101.0	2003	Active
Total	**37 operations**		**21408.2**		

Ratings as of July 16, 2004.
* based on an OED assessment review.
** PPAR pending, ratings are not final.

Box 7.1: Objectives of crisis lending: mostly ambitious reforms

In Colombia, prior to the 1999 crisis, the only Bank lending over the period for financial sector reforms was a TA loan that was not proceeding well. After the crisis, two adjustment loans (FY00 and FY03) addressed a large program of bank restructuring, downsizing, liquidation, and/or privatization of state banks, and closing or restructuring financial cooperatives, as well as strengthening banking regulation and supervision (including anti-money laundering), deposit insurance, housing finance, insurance regulation, regulation and supervision of capital markets, and Government debt and money markets.

In Korea, there had been no adjustment lending for financial sector reforms prior to the crisis; the first adjustment loan after the 1997 crisis explicitly stated that the primary objectives of the US$3 billion loan (the largest ever approved by the Bank) were the provision of emergency liquidity to restore confidence in the economy and the development of a framework for medium-term structural reform, which was to be pursued under subsequent adjustment lending. The two subsequent adjustment loans, for US$2 billion each, and the accompanying TA loan (US$48 million approved, US$26 million disbursed) had extensive and detailed objectives, focused on the financial sector, the corporate sector, the labor market and the social safety net, including improved transparency of Government support to all financial institutions and corporations; capital market reform covering government auctions of debt instruments; and improved competition policies.

In Turkey, early Bank support in the 1980s for financial sector reforms were not successful; but by the late 1990s, the Bank and Government had agreed on a four pillar strategy for reforming the sector: creation of a strong regulatory and supervisory agency for banks; aligning prudential regulations with international norms; strengthening the bank failure resolution agency (deposit insurance entity); and restructuring and privatizing state owned banks. The FY01 FSAL was approved prior to the crisis incorporating these pillars, but once the crisis hit, the FSAL was restructured to allow for a series of programmatic loans addressing these objectives. Two programmatic FSALs were approved in subsequent years (FY02 and FY03), embracing these four reform areas and adding public sector reforms as well.

Relevance of objectives

7.19 OED assessments of these loans did not question their relevance or design. As they addressed fundamental problems in the banking and corporate sectors, as well as legal and regulatory issues that were at the core of the crisis, they were considered by OED to be highly relevant for the return to economic growth and stability. Nevertheless, many critics have questioned whether the Bank and other IFI should be providing large rescue packages and liquidity during crisis,[43] thereby creating perverse incentives. For lenders and investors, particularly from the foreign private sector, the rescue packages have not required them to "take a haircut", that is, to forgive debt or negotiate write-downs, and thus, they have not borne the costs of the risks of committing funds to developing countries. For wealthy and well-connected domestic investors, particularly in the case of Indonesia and Russia, the liquidity provided to banks enabled them to get their money out of the country. And finally, for governments, because rescue packages were announced based on the promise of reform rather than after reforms have been undertaken, the large financial flows have been no guarantee that the reforms would be undertaken and may in fact have served as a disincentive to undertake them.[44]

[43] See, for example, Kenen (2002).

[44] The IMF examined the possibility of "bailing-in" the private sector, to make investors share losses in the case of crisis. A pilot case was used in Ecuador, with mixed results, and the IFIs have since moved away

Achievement of objectives: below average

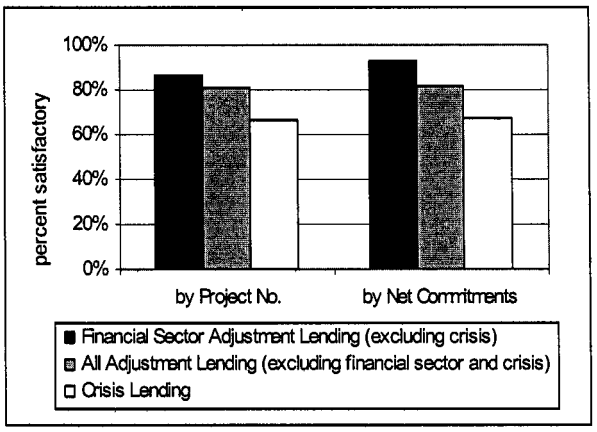
7.20 Given the high relevance of the objectives of the crisis loans, their outcomes were mainly a function of whether those objectives were achieved. As shown in Table 7.3, of the 30 adjustment operations included in this review, 27 have closed and been rated, for a volume of US$21 billion in gross commitments. Sixty-seven percent by number and 68 percent by net commitment amount had satisfactory outcomes, averages that are below all other adjustment lending and below financial sector lending, by number and by commitment amounts (Figure 7.1). Of the seven TA loans that were put in place, four have closed and been rated; of these, three were rated satisfactory.[45]

Table 7.3: Post-crisis adjustment operations with financial sector components

	Adjustment		Technical Assistance		Total	
	Number of loans	Net Commitment	Number of loans	Net Commitment	Number of loans	Net Commitment
Total, of which:	30	21,253	7	155	37	21,408
Closed and rated, of which:	27	17,931	5	77	32	18,008
Satisfactory	18	12,109	3	64	21	12,173
Percent satisfactory	67	68	60	83	66	68

7.21 These outcomes are somewhat surprising, given the later finding (Chapter 8) that banking distress or near crises often focused attention on the need for reforms that authorities had been unwilling to tackle prior to the banking crisis. In a substantial number of case study countries, outcomes of Bank loans that came after the onset of systemic banking problems had better results than Bank loans that preceded them. But these two sets of findings are not mutually exclusive: in an emergency situation, when both significant resources and speed are essential to stem the crisis, the ambitious objectives set out in Bank documents can often not be realized in the short timeframe of a single adjustment operation. Korea is a good example of a series of adjustment loans under crisis conditions that started out with a first adjustment loan that sought only to supply liquidity and establish the framework for future reforms; subsequent operations then relied on that framework to specify the reforms.

Figure 7.1: Outcome of adjustment lending, crisis lending with financial sector components versus non-crisis



7.22 Most of the initial adjustment loans that had unsatisfactory outcomes had ambitious and, in the end, unrealistic objectives (Box 7.2). This may be due to two

from further consideration of this approach. International pressures on the Bank will be strong to continue to participate in emergency rescue operations, and it is highly likely the Bank will continue to play a role.

[45] Out of the twenty-nine closed and rated operations (including TA loans), nine have had assessment reports; three in Thailand are on-going and the ratings for these operations are not yet final.

factors: (i) an over-estimation of government's commitment to reform; and (ii) a perceived need to assure the Bank's Board that the measures being undertaken are sufficiently deep and broad to justify such a large loan.

Box 7.2: Mixed outcomes

In **Argentina**, the first round of financial reforms after the 1994 crisis focused on privatization of provincial government-owned bank, which were a considerable fiscal drain on the provinces. **The outcomes of the loans involved were considered satisfactory**, and the process was used in the Bank as example of good practice. These reforms strengthened the banking sector, which may have helped Argentina withstand the 1998 shocks and, along with the IFI lending, avert a crisis at that time (see and Kiguel and Dujovne, 2003). The 1999 crisis was followed by two adjustment loans; one aimed to strengthen banking supervision, reduce public involvement in banks by privatizing the mortgage bank, and improve regulation of the capital market; and the second loan was to provide liquidity to stem a banking run. Both of these had unsatisfactory outcomes, mostly because the reforms implemented were necessary but ultimately insufficient to redress the cumulative impact of the series of shocks that confronted Argentina in 1999 and 2000. Once the 2001/2002 crisis ensued it quickly undermined the improvements in banking supervision and other reforms carried out under the projects. The impact of the crisis was magnified by the Government's decision to concentrate crisis-related losses in the bank's balance sheets through asymmetric pesification.

In **Indonesia,** the series of loans following the 1997 crisis addressed resolution of the banking crisis and corporate restructuring. One TA loan and two adjustment loans were approved in support of these objectives. The outcomes of all three loans were considered by an OED assessment to be unsatisfactory. In the years immediately following the crisis, the government was not fully committed to resolving the problems in the banking and corporate sectors, and the agency established to deal with the resolution and re-privatization of the banks and disposal of assets made little progress. By 2003, the pace of reforms had improved, but government still controlled over 60 percent of the banking system, disposal of assets moved slowly, and the banking sector remained vulnerable to further shocks.

7.23 Within the Bank, the case of Bank support to post-crisis Thailand was one of the most contentious: the three adjustment loans to Thailand that contained financial sector reforms had been rated satisfactory by both the Region's self-evaluations and OED's desk reviews carried out shortly after the loans closed. But in the course of this current OED assessment, it became clear that many knowledgeable staff in the Bank (and outside observers) thought that the Bank's assistance had been misguided and unsatisfactory, particularly with respect to its role in closing virtually all of Thailand's finance companies. As a result, OED undertook an assessment on three adjustment loans, the Finance Companies Restructuring (FY98), and the two Economic and Financial Adjustment Loans that followed (both, FY99); their report is forthcoming.[46] The experience in Thailand raises difficult questions about coordination and cooperation with the IMF, the subject of the next section.

Collaboration with the IMF

7.24 The division of responsibility between the Bank and IMF on financial sector work is not clear. Pre-crisis diagnostics, monitoring, post-crisis lending, and TA all lie within the mandates of both organizations. On substance, macroeconomic policies, fiscal, and

[46] For this assessment, OED hired two finance professors who had not been involved in the Asia crisis bailout, but were familiar with the issues.

financial areas are all covered, albeit to different degrees, by both organizations and are also the areas that, if weaknesses exist, can lead to crisis. The absence of a clear division of responsibilities has in some cases led to duplication of efforts, confusion, and disagreements between the Bank and the Fund in post-crisis assistance efforts, in some cases in a public forum (Box 7.3), which only added to the uncertainties of the crisis.

7.25 Since 1999, the Bank and IMF have been collaborating on the Financial Sector Assessment Program, assessing the vulnerability of financial systems (this is the subject of a separate OED review). In addition, the IMF has primary responsibility for on-going surveillance and for containing a crisis when one occurs; the Bank's lending in a crisis is contingent on the IMF's having a program in place. Following the experience in the Asian crisis, the Bank and the IMF reached agreements in principle to improve collaboration.[47] The latter is to focus on the immediate aftermath of a crisis, on shorter-term actions to stem the crisis, such as devaluation of the currency, government guarantees of financial liabilities, and government intervention in specific institutions. The Bank is to tackle the longer term reconstruction of the financial system, including bank restructuring and re-privatization, disposal of banking assets, corporate restructuring, and improving the legal, regulatory, and accounting structures for both banking and corporations.

7.26 In practice, however, the boundary between these roles is still not clear. The way in which the IMF oversees government's actions to guarantee financial liabilities and intervene troubled financial institutions will have repercussions on subsequent restructuring efforts supported by the Bank. In addition, the roles of regional development banks need to be coordinated. The most practical way of approaching these issues may well be on a case-by-case basis, but from the outset of a crisis, there needs to be agreement on basic approaches and the respective roles of each institution to avoid the sorts of problems that have complicated crisis management in the past.

Box 7.3: Coordination between Bank and IMF in crisis: needs improvement

In Mexico and Russia, the Bank and IMF disagreed on the extent to which the currencies were over-valued. As a result, the Bank carried out its own macro-economic analysis. In Thailand and Indonesia, there was confusion over the division of responsibilities in the early stages of the crises among the Asian Development Bank, the World Bank, and the IMF. In Thailand, even after an agreement was reached that the IMF would focus on banks and the Bank on finance companies, the agreement was not kept. In Indonesia, Bank staff did not have access to data concerning the financial sector obtained by the IMF, because the IMF was concerned about maintaining the confidentiality of the information. And the public criticism by the Bank's Chief Economist of IMF's approach in Indonesia drew wide press coverage, adding to the confusion in the midst of an already difficult situation. An IMF evaluation of its role in crisis (IMF, 2003) noted that the degree of cooperation depended mostly on the personalities of the mission leaders.

Source: Long (2003b).

[47] IMF 2001, IMF 2002a, and IMF 2002b.

Is a centralized unit in the Bank specializing on crises effective and sustainable?

7.27 "Crisis tests government officials as few other events in their career will...few will have the prior experience to be well prepared to face it. The role of multilateral institutions such as the Bank and the IMF in helping the authorities overcome a crisis, bringing to bear their extensive experience in other countries...can be pivotal in influencing the outcome."[48] As the Asian crisis unfolded, the Bank created a specialized central unit in January 1998, Special Financial Operations (SFO), to oversee the Bank's assistance to the Asian crisis countries. The SFO was generously funded, from a special budget allocation from the Bank, from a trust fund from industrialized countries, and from regular Bank budget connected with the Region's TA loans.

7.28 Because its budget was substantial, the SFO was able to provide services to Thailand, Korea, and Indonesia that the Regional units were not in a position to finance. The SFO had full time staff based in the field over several years focused on a single country, assuring both close contact with developments and continuity of staff. The SFO was also able to hire people with specialized skills to support the different tasks involved in resolving financial crises. In Korea, the SFO hired a senior former government official who had good access to political decision makers, which was considered a key factor in the Bank's ability to work at the political as well as the technical level.

7.29 On the negative side, the newly hired staff of the SFO lacked experience with Bank procedures, which was a handicap for speedy implementation of projects involving procurement and hiring consultants; this handicap was overcome in time. In addition, and more fundamentally, the centralized unit with responsibility for managing the Bank's lending for the crisis was the source of friction with the Regions, who had been handling all lending work since the late 1980s. The work of the SFO was not well integrated with the rest of the Bank's program in the country; and the existence of the SFO was contentious. Its generous budget a source of frustration for the Regions, which wanted to handle the assistance to their countries even in crisis; and there were disagreements between the SFO and other central Bank staff on substantive issues, such as procedures involving bad loans and emphasis on banking supervision.

7.30 No other Region agreed to use the SFO's services for the subsequent crises in Russia, Argentina, or Uruguay and the SFO structure was not sustainable in the Bank's organizational structure. The SFO was disbanded in 2001, its budget and staff allocated to the Regions, mostly to EAP. Although there is a small central unit responsible for Banking and Financial Restructuring whose mandate includes contributing to future crisis work, the Bank no longer has a team specialized in crisis response.

7.31 Deep crisis of the sort discussed in this review is too rare to justify a dedicated group. It does make sense, however, to identify experienced staff within the Bank who could be mobilized on short notice, as a sort of "virtual" crisis response team; if that proved insufficient to deal with a multi-country crisis – as occurred in Asia – the Bank

[48] Scott (1999).

could again put together the resources and external staff to work with the virtual, experienced Bank staff.

Bank management, dealing with crisis

7.32 Because the Bank deals with almost all sectors and themes touching economic development, its top Regional managers are seldom specialized in financial sector issues, and normally lack the background to deal with financial crises. Dealing with top IMF, bilateral, or government officials over policy issues or agreeing on division of responsibilities in crisis situations has proved problematic. Bank staff working on these countries reported that their positions on issues were not adequately represented or defended by management. The Bank needs to articulate a clear line of responsibility for representing the Bank in the event of crises, to work with Regional managers in dealing with governments, the IMF, other IFIs, and bilaterals, and in ensuring internal Bank-wide coordination of efforts.

7.33 The 1996 internal review of the Bank's response to the 1995 Mexico crisis concluded that the Bank was ill-prepared and its response ad hoc to the crisis. It recommended preparing guidelines with triggers for action, clear lines of responsibility, and procedures for concentrating resources, putting in place a core team, and providing a framework for debating and agreeing expeditiously on recommended actions. These recommendations were not acted upon; as a result, the Bank remained unprepared for the next round of crises. The recommendations are still valid today.

Recommendations

7.34 Although the Bank cannot predict crisis, it can do a more systematic job of assessing vulnerability to crisis, particularly now that the Financial Sector Assessment Program is on-going. In addition, the Bank should change its approach to presenting risks in its documents, to provide a more candid assessment of low, medium, and high risk countries based, in part, on its assessment of the financial sector vulnerability to crisis. OED does not think this will affect the Bank's access to information in the client countries nor the behavior of the markets.

7.35 It is likely that international pressure on the Bank to lend in crisis situations will continue and that the Bank will be called on to play its role in any international rescue package. The Bank should be more candid in the objective of its lending; it should be clear that in the first instance it is primarily to provide liquidity and restore market confidence. Second, it should frame its objectives based on a realistic assessment of what the government is willing and capable of doing in a short time period, regardless of the size of the loan. The timing and size of subsequent adjustment loans, after the initial frenetic, "emergency" phase, should be based on progress to date on reforms and likelihood of continued progress. If TA loans are part of the package, special arrangements should be made at the time of approval to expedite procurement and selection of consultants.

7.36 Coordination with the IMF and other IFIs needs improvement. At the outset of a crisis, the Bank, the IMF, and any other IFI involved should reach an agreement on the basic approach and respective role of each institution. The Bank should also better prepare itself to handle crises, appointing a top manager to be responsible for coordinating the Bank's response and dealing with governments and external agencies. Just as the Bank now has guidelines for post-conflict assistance, the Bank should develop similar guidelines for dealing with crises.

PART II ANALYZING OUTPUTS, OUTCOMES, AND IMPACT AT A COUNTRY LEVEL

8. Outputs at a country level: ownership and incentives

Overview

8.1 Three main pillars of Bank lending for financial sector reforms were privatization of banks, establishing or improving prudential regulation, and strengthening supervision of banks (see Figure 3.3 and discussion in Chapter 3). This chapter reviews changes in measures at a country-level of these reforms supported by the Bank, as well as lessons emerging from the quality of the reform processes.

The shift to private ownership

8.2 Although the empirical literature is fairly unambiguous in its findings on the benefits of private ownership compared to state ownership of banks in the Bank's client countries, the Bank sometimes focused on privatization as an end in itself rather than on improving the governance of banks that was the underlying objective of the process (this issue is discussed further below). Nevertheless, privatization was an objective or the means to achieving a deeper objective in Bank lending in some 40 countries. This chapter thus examines progress in privatization, measured by the change in assets in government-owned banks[49] as a percent of total banking assets (Annex 3, Table 5, has the list of countries where information was available for this analysis). Although this definition has serious drawbacks as a measure of government ownership (see Box 8.2), it was the only one that provided a consistent data series across countries and over time.

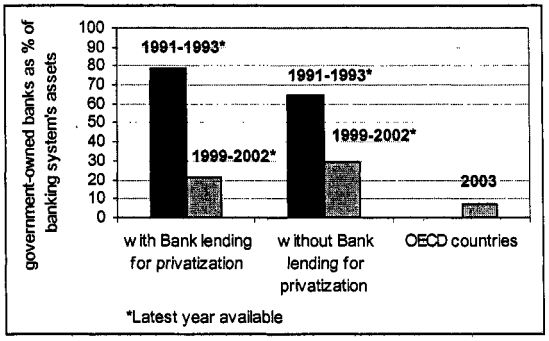
8.3 The chapter also draws on background papers and case study countries to gain insights into data limitations, factors associated with success (or failure), and experience with different approaches to bank restructuring and privatization, including support for asset management companies.

[49] Defined as banks in which the government owns at least 50 percent of the capital.

Considerable progress...

8.4 At the beginning of the period under review, assets in government-owned banks comprised an average 79 percent of total banking assets in the 40 countries that subsequently borrowed from the Bank for bank privatization (where information was available). By the end of the period, assets in government owned banks had dropped to about 21 percent of total banking assets. By this measure, Bank support for privatization can be considered, on the whole, successful (Figure 8.1).

Figure 8.1: Changes in government ownership of banks, with and without Bank lending for privatization



8.5 In addition, the average change in government ownership is higher in countries that borrowed from the Bank in support of bank privatization, than in countries that did not borrow for this purpose (Figure 8.1 – the average for OECD countries is also shown for information and not as a the standard against which Bank client countries should be assessed; the list of OECD countries is in Annex 3, Table 6).[50] There may clearly be some bias in the sample of countries that did borrow from the Bank, as they may have been more willing to privatize than countries that did not borrow. Although OED made an effort to avoid this (Box 8.1), it is likely that some bias still exists which explains part of the difference. Another explanation for the difference, however, could be that the process of negotiating loans with the Bank and the subsequent requirement to adhere to loan conditionality within a certain time frame may exert pressure to show results that is missing in countries with no Bank lending.

Box 8.1: Problems comparing results in countries with and without Bank borrowing

In an effort to avoid obvious problems in comparing the two groups of countries, those that borrowed for bank privatization with those that didn't, only countries were included that had an active bank privatization program. Thus, countries were *excluded* if they had banking sectors already substantially privatized, such as Botswana, Lebanon, Senegal, and Swaziland, or if they had no active privatization program, such as Algeria, China, Iran, Syria, and Vietnam. This, of course, begs the question of why countries with active programs would not want to borrow from the Bank in support of privatization. The reasons likely include no need for balance of payments support, an unwillingness to negotiate conditionality, general avoidance of adjustment lending, or absence of policy dialogue on financial sector issues. Any of these reasons could introduce a bias in the results. A list of countries in the "with" and "without" groups for this analysis is in Annex 3, Table 5.

8.6 Neither the number of loans nor the inclusion of TA loans affected the results, as shown in Table 8.1.[51] By contrast, country characteristics mattered: Table 8.2 shows that progress in transition countries stands out as particularly successful, where the banks

[50] Because of the possibility of a skewed distribution, median values were also examined; they have a smaller difference, but the same pattern: countries that had Bank support for bank privatization showed a larger drop in government ownership than did countries that had no such support.

[51] Because of the limited number of observations, it was not possible to test whether outcomes for bank privatization in low CPIA countries might have been better with TA than without, as was the case for outcomes of individual loans found in Chapter 6.

changed from virtually totally government-owned (except for Hungary, Poland, and the Slovak Republic) at the beginning of the period to almost totally privately-owned by 2002. For non-transition countries, differences between groups are not as great: low income countries did (somewhat surprisingly) better than middle income countries, excluding transition (45 percentage point change versus 36, respectively), while low CPIA borrowing countries did exactly the same as the higher CPIA borrowers. Countries with larger financial systems compared to smaller systems were also somewhat behind in terms of reducing government's role. This latter result may reflect the greater difficulty in selling very large public banks, which are sometimes preceded by the social and political hurdles involved in downsizing and laying-off large numbers of people.

Table 8.1: Change in government ownership, by number of adjustment loans and with and without TA

	Privatization: government ownership	
	No of countries	Change in percent
One Bank loan	12	-59
More than one Bank loan	27	-58
Significantly different?	--	no
Countries w Bank funded TA	23	-59
Countries w no Bank funded TA	16	-58
Significantly different?	--	no

...But privatization is far from complete in many countries

8.7 Data on commercial bank ownership presented above are only part of the story, because they may understate the extent to which the government has reduced its role as intermediary. First, some governments retain a large minority ownership in banks that are considered legally private, and thus retain effective control. Second, some banks are owned by state-owned enterprises or public utilities and are therefore de facto controlled by government. Third, near-banks, using deposits or other sources of funding to make loans, are not counted as part of the commercial banking system, and are therefore excluded from the statistics on government ownership. These can include specialized banks, like housing or agricultural banks, and development banks, that may account for a substantial portion of total banking assets more broadly defined, and that can introduce distortions by non-market based lending and represent considerable contingent liabilities for the government (Box 8.2).

Table 8.2: Change in bank ownership

	Number	Assets of government owned banks as percent of total banking assets		Change in percent ownership
		1991-93*	1999-2002*	
Countries with no Bank lending	23	64	29	**35**
Countries w Bank lending, of which:	40	79	21	**58**
Transition countries	17	94	15	79
Low income countries, w/out transition	16	70	25	45
Middle income countries, " "	7	62	26	36
Low 2003 CPIA countries, " "	9	71	28	42
High 2003 CPIA countries, " "	14	66	23	43
Larger financial systems, " " **	6	64	31	33
Smaller financial systems, " "	17	69	23	46

*latest year for which data available
**Argentina, Brazil, Colombia, Morocco, Pakistan, and Philippines.

Box 8.2: Data on bank ownership can be misleading

Restructuring and privatization of commercial banks were supported in Cameroon by three adjustment and two TA operations. At the beginning the 1990s, government ownership accounted for 37 percent of the shares of the top banks; by 2002, all commercial banks were considered private. Government, however, has retained ownership of between 25 to 45 percent of the top three banks that account for over two-thirds of the assets of the banking sector and a much higher percentage of retail banking in the country. Government does not appear to be actively involved in the daily management or policies of these banks; nevertheless, in one of them, government agreed to sell one-third of its shares to local businessmen, but has been arguing with the bank's management on an acceptable list of buyers for over two years. In Cape Verde, after privatization of the largest bank BCA, government retained 20 percent equity stake and "Golden" share rights, i.e. privileged voting rights. "Golden Shares" were created in order for the government to maintain control over strategic industries. In Cote d'Ivoire the government retains some 15-25 percent of the capital in the privatized banks.

In Tunisia, the government can retain up to 49 percent of shares in banks that are considered private, and privatization has been mostly through selling equity shares in the market, with the government retaining effective control. In addition, there are a number of public development banks (at least seven as of end-2003) that account for a significant share of term lending and that are not part of the statistics on commercial banks.

8.8 In addition, the averages mask wide variations among countries. In most of the transition countries, state ownership has shrunk to close to zero, starting from 100 percent ownership. In Pakistan, by contrast, it was still over 50 percent in 2002. In Tunisia, Morocco, and Yemen, state ownership has shrunk by an average of (only) 23 percentage points and remained (in 2003) over 30 percent of banking assets, as it did in Argentina and Brazil, due to a combination of ambivalence by government and the difficulty in selling the banks. In the latter two countries, there was a clear pattern of success at the sub-national level, but an inability to privatize the large federal banks. This does not diminish the relevance or the achievement of the privatization objectives in those countries; it does, however, underline that satisfactory outcomes do not imply that the agenda on privatizing banks is finished. In addition, this discussion does not cover countries that did not borrow from the Bank and/or did not have programs to privatize, including Algeria, Belarus, China, Costa Rica, Iran, Nepal, Syria, and Vietnam, where the banking sector is dominated by state owned banks.

8.9 It is unrealistic to expect governments to have no involvement in financial intermediaries (see footnote 2 and Figure 8.1 for OECD average). Bank staff have reported that governments in most Regions express interest in continued Bank support for public banks, so it is clear that much work remains to be done to engage governments in developing internally consistent policies on the role of the public sector in banking sector intermediation.

Quality matters

8.10 Although research shows that private banks and foreign banks often have a positive impact on banking performance in client countries (paragraphs 2.7-2.9), the Bank's experience demonstrates that neither privatization nor foreign entry has been a guarantee of better performance. Even apart from other factors that can affect the subsequent performance of the banks (macroeconomic factors, market structure, investment climate), the quality of the process mattered for the outcome in terms of how

well the banks performed after privatization. The process can include financial restructuring prior to privatization, measures to prevent a re-accumulation of NPLs before the sale of the bank, speed of privatization after restructuring, privatization to a strategic owner versus sale of shares to the public, and whether government retained significant minority shares. The following paragraphs discuss the Bank experience with different types of restructuring prior to privatization. The quality of the investor(s) who bought the banks also made a difference to the performance of the privatized bank (Box 8.3).

Box 8.3: Privatization is no guarantee of good banks – the quality of the buyer matters

In Mozambique, the Bank was closely involved in the mid-1990s, through an adjustment and a TA operation, in helping to privatize two large commercial banks (BCM and BPD). BCM was sold to a foreign businessman with no banking experience and BPD to a small foreign banking group, with government retaining significant ownership in both. BCM continued to accumulate NPLs after privatization and went through several rounds of recapitalization by the government before it was merged with another Mozambique bank (see background paper by Mozes, 2003, for details). In the case of BPD, the combination of government interference and adverse economic conditions in the bankers' home country caused the foreign investors to stop making capital investments, and BPD was taken over by the central bank and re-privatized a second time, having been recapitalized four times by the government.

In Macedonia, through a misunderstanding between the Bank and the government, the first "privatization" of Stopanska Bank, supported by an FSAC in FY95, resulted in its sale to a former state owned enterprise; after at least four years of further portfolio clean up, supported by a second FSAC (FY01), it was sold to a foreign commercial bank, which then recapitalized it.

Financial restructuring prior to privatization: better outcomes

8.11 In the majority of case study countries, the Bank supported financial restructuring prior to privatization. These cases have better outcomes than in the few countries where financial restructuring was not undertaken and where the privatization did not go well: either the banks could not be sold, or at least not at a price acceptable to government, or they were sold to investors who were inappropriate, or at least who did not manage the bank well after taking control (Box 8.4).

Box 8.4: No financial restructuring prior to privatization: didn't work well

In Georgia, under the Bank's FY97 SAC I, banks were operationally restructured (branches closed), but not recapitalized; NPLs were not dealt with: the banks were bought by employees, and remained unsound.

In Morocco, neither of the banks targeted for sale under the Bank's FY96 FSAL were sold – one (CIH) because its portfolio had deteriorated so much it needed financial restructuring and the other (BNDE) because the two attempts to sell brought unacceptably low bids (the reasons for the low bid were not clear – they may have been unrelated to the quality of its assets). A waiver was required on these banks' sales prior to tranche release.

In Togo, the FY98 TA credit financed consultants to prepare restructuring plans, including dealing with high NPLs; this effort was to be followed by an FSAC which never materialized. Government did not follow up on the bank restructuring and only one out of seven of the banks were sold, although this may have been due to lack of government commitment as well as the poor financial situation of the banks.

8.12 The scope and type of Bank support depended on how advanced the process was at the time of the loan. In a number of countries, the Bank provided TA for carrying out

audits or other diagnoses to identify the NPLs (which is not a trivial task if either prudential norms or accounting practices are weak) and for developing a plan to deal with them. The Bank has also supported several methods for removing the banks' NPLs (both in the context of privatization and for restructuring alone; the latter is discussed in paragraph 8.20 and Box 8.8): taking them entirely off the books of the banks and putting them into an asset recovery unit, which essentially shrank the bank, or replacing them with government bonds, which could provide a theoretically risk free asset at government expense.[52] Other solutions to NPLs were pursued in Poland (EFSAL, FY93), where banks were given special legal powers to recover their loans; this met with some success, although a similar effort to create a special workout unit in a large bank in Mongolia, but with no special legal powers, did not lead to results in terms of recoveries. From the limited information available in Bank documents, it appears that special legal powers are key, whether for workout units in banks or independent asset management companies (AMC), discussed in the next paragraph.

8.13 *Asset management companies* (AMC) were supported by Bank lending in a number of the case study countries.[53] Based on limited information, AMC were not successful in terms of rates of loan recoveries when the NPLs were owed by loss-making state owned enterprises or even defunct enterprises that couldn't pay or politically well connected borrowers that wouldn't pay, and, in particular, when the AMC had no special legal powers to collect on loan payments. By contrast, if the AMC was given special judicial powers to recover the loans (meaning it could bypass the normal court system), even in otherwise poor legal and judicial environments, they could meet targets for recovery of NPLs (Box 8.5). Using AMC with special powers to pursue debtors had two other advantages: when AMCs were government-owned, and they usually were, the amounts collected could be used to defray part of the costs of bank restructuring.

Box 8.5: Asset Management Companies (AMC) -- empowerment

In Cameroon, the Bank supported the establishment of an AMC in 1989, which managed to recover only 3 percent of the assets transferred to it; under SAC II (FY96), the AMC was restructured and given more legal powers, and its performance improved slightly, although it still has institutional weaknesses: the Bank is currently providing TA to transform it into a for-profit debt collection agency. In Burkina Faso, the Bank-supported AMC achieved its loan recovery targets because it was exempt from going through the judiciary and because it was able to publish a list of defaulters.

In Albania, the Bank supported the establishment of an AMC in 1997, but in its first three years, it recovered only 3 percent of assets. Renewed World Bank support under a subsequent loan combined with new management and legal powers have improved the AMC's performance somewhat, so that by end 2003, about 7 percent of the initial stock of assets had been recovered, 30 percent had been submitted to the courts for resolution, and another 30 percent sent to the Bailiffs' Office for execution. In the Slovak Republic, a work out scheme was established under an AMC, but was unsuccessful because of attempts by the AMC to use the assets to become a real bank; the Bank intervention was successful in stopping this.

[52] In Cameroon, the "risk" free asset proved to be high risk: the government was unable to service its bonds that had replaced NPLs in restructuring in the late 1980s; under SAC II (FY96) government arrears were guaranteed by the Regional central bank and a second round of restructuring was required.

[53] Countries are Albania, Cameroon, Romania, and Slovak Republic, as well as crisis countries (Indonesia, Korea, and Thailand). The support from adjustment lending was mostly through conditionality that specified transfer of NPLs to the AMC; or recovery targets. TA loans provided more specific assistance.

Second, the process of pursuing defaulters could serve as a signal that the default culture was no longer tolerated. Although some empirical research exists on the experience with AMC performance (Klingebiel, 2000) as well as with decentralized approaches to NPL recovery in banking crises (Dado, Klingebiel, 2000), this is an area where the Bank could do more to provide guidance to staff on trade-offs in approaches (centralized versus decentralized) and on factors associated with effective loan recoveries.

Other forms of bank restructuring

8.14 *Downsizing.* Pakistan is the only case where Bank funds (US$300 million, Bank Sector Restructuring and Privatization Project, FY02) were used explicitly for severance payments in the context of an ambitious program of downsizing large state-owned banks. In Brazil, there were two sub-national investment loans supporting employee retrenchment in the context of bank privatization, although the loans weren't directly tied to this cost. Many other Bank loans supported downsizing prior to privatization, although it remains an open question whether the costs are an efficient use of funds: new owners could have other ideas about the best size and structure of their bank; on other hand, new owners may not want to deal with political problems involved in laying off workers. In any case, there is little systematic evidence on whether downsizing is important prior to privatization; the Bank supported privatization of banks in the absence of downsizing, apparently successfully, although the ability to do this may depend on the scale of overstaffing and the ability of an employer to fire workers and the political sensitivity of doing so.

8.15 *Twinning.* Bank support of twinning, matching foreign banks with weak domestic ones, has had mixed experience. In Poland and Mongolia, twinning helped banks to restructure and reorganize prior to privatization, although in Poland, it was generally successful mainly for banks whose management was committed to the idea. The experience in Kazakhstan, where the Bank supported twinning for a large number of banks, was less than satisfactory, as some of the banks were uninterested while others were not sufficiently well organized to make the necessary arrangements.

Avoiding buildup of NPLs

8.16 *Credit ceilings don't work, or at least not for long.* Bank loans sometimes included conditionality on credit ceilings or suspension of lending in the context of bank restructuring as a precursor to privatization (and in other cases, as a way of limiting the accumulation of NPL in banks the government was determined to retain). In both Albania under FY94 Enterprise and Financial Sector Adjustment Credit (EFSAC), and Romania, under FY95 Financial and Enterprise Adjustment Loan (FESAL), the government imposed credit ceilings on the state banks. In neither case did the ceiling work for long: in both countries, the government undercut the agreement by allowing the state banks to exceed the ceilings. In Yemen, under the FY98 Financial Sector Adjustment Credit (FSAC), the government suspended the state banks' lending to public enterprises as agreed, but the Central Bank took over direct lending to the public enterprises instead. These few cases where information is available suggest that

governments or the banks themselves may not be able to resist the pressures from well-connected enterprises.

Alternative to bank privatization: closure

8.17 The Bank has supported alternatives to privatization in all Regions except SAR, including increasing minimum capital requirements for banks and liquidation. In Armenia, for example, the Bank supported the closure of private banks through a succession of adjustment operations which introduced a gradual increase in minimum licensing requirements, thereby forcing the exit of banks unable to meet them, and substantially reducing the number of banks from 72 in 1991 to 30 in 2001. Under a series of adjustment loans and TA operations, Kazakhstan also closed many banks, reducing the number from 184 in 1991 to only 22 in 2001. In other countries, the process of bank liquidation has proved time-consuming and politically difficult (Box 8.6), but probably preferable to trying to privatize non-viable banks.

Box 8.6: Liquidation has been supported by the Bank in most Regions, but has proved difficult

Albania liquidated an agricultural bank twice; after closing it the first time (under FY93 Agricultural Sector Adjustment Credit) the Bank helped the country to set-up a second rural bank, which was then closed in 1997 with Bank support when it too proved unviable. Under an adjustment operation (FY99 Enterprise and Bank Privatization Credit) in Bosnia, the Federation agreed in principle to liquidate all insolvent banks, which the Bank had identified through diagnostic work, but Bosnia's own diagnosis found all banks to be solvent. In Ukraine, two Bank adjustment loans have addressed the closure of Bank Ukraina, which is taking some time.

In Cote d'Ivoire, the Bank supported the liquidation of five development banks, and the transfer of assets to an AMC; Guinea liquidated one public bank under FY95 FSAC, while the liquidation of a bank in Burkina Faso (FY91 SAC) took over five years to accomplish.

Privatization took longer than expected ...

8.18 The process of bank privatization often took much longer than the two or three years envisaged at the outset, and in some countries, it remains incomplete after more than a decade. Partly this was due to ambivalence on the part of governments in the early years, but in other cases, such as Burkina Faso, it was difficult to find buyers initially. Slow privatization, for whatever reasons, increased the costs, because of the problem of a re-accumulation of NPLs. In Tanzania, for example, differences between the Bank and the IMF on how to split up the largest state owned bank took several years to sort out, and in the meantime, NPLs continued to accumulate. The delay due to this debate arguably ended up costing the government considerably more to resolve the NPLs than if the differences had been resolved expeditiously.

....and sometimes led to unanticipated problems

8.19 In Mozambique, the privatization of the banks led to an unexpected concentration of market shares. One of the partners in a large Mozambique bank was a small foreign bank, which merged with a larger bank in the same country, which was also the partner of a second large bank in Mozambique. After much discussion, the two large banks in

Mozambique, which now had the same foreign owner, were allowed to merge in Mozambique, creating one bank that held over two-thirds of the assets of the banking system. In retrospect, bank privatization should have been accompanied by safeguards against high level of concentration.

Restructuring banks without privatization: seldom successful

8.20 Contrary to Bank guidance on restructuring banks in the absence of a plan to privatize (DEC note 1995), the Bank has explicitly supported government recapitalization of state-owned banks, with no government plan or commitment to privatize them. The most common outcome of these efforts has been deterioration in the financial situation of the recapitalized bank and the need to repeat the exercise some years later, sometimes again with Bank support. In other cases, the government planned to privatize, but either the process was too slow or the attempt failed (no acceptable bidders) and new NPLs accumulated (Box 8.7).

Box 8.7: Restructuring banks with no commitment to change ownership: examples of Bank support

Albania: The first round of restructuring, supported by an FY95 Bank credit, involved credit ceilings; clearance of inter-bank loans; action plans to strengthen the banks. Two years later, a second round of restructuring was necessary, supported by the Bank, involving the transfer of NPLs, technical assistance, a change in management, and the re-imposition of credit ceilings. The banks have since been privatized.

Lao PDR restructured its state banks in the mid-1990s with ADB support and indirect Bank support through a parallel SAC III; a second round is again being supported through a Bank credit (FY02), but not in the context of privatization

Guinea: Under an FSAC in FY94, four private banks were recapitalized without changing their ownership or governance; four years later one bank was liquidated at considerable cost to government and three banks were recapitalized again with interest free loans from the government; information is not available on the current health of these banks.

Ghana: restructured in the early 1990s with Bank support and intended to privatize, but privatization didn't happen fast enough; needed to restructure again under FY99 Economic Recovery Support Operation II.

Vietnam: FY03 Poverty Reduction Support Credit II continues to support restructuring of four biggest state banks even though the government has no intention to privatize banks in the near future.

Recommendations on restructuring and privatizing banks

8.21 The recommendations that emerge from this review is that the Bank needs to be involved in countries where capacity is limited in helping in the process of privatization to ensure that: (i) financial restructuring precede or accompany the privatization; in the absence of financial clean up, the privatization process is unlikely to attract good investors; (ii) recapitalization of banks is in the context of a government plan to privatize; (iii) for debt recovery mechanisms, AMCs, if they are created, be given special judicial powers; (iv) government sells all of its shares in the banks to be privatized; continued ownership by the government may both discourage good investors as well as create

problems post-privatization; (v) any strategic investor involved be "fit and proper";[54] the Bank may need to provide support for due diligence on potential owners; and (vi) appropriate competition policies are in place to avoid unanticipated mergers and creation of exceptional market concentration.

Getting incentives in place: legal and regulatory reforms, strengthening supervision

Overview

8.22 The Bank has supported a wide range of establishment of and changes in laws and regulations affecting banks and bank-like institutions as well as capital markets. In banking, the basic thrust of reforms supported in over 160 operations (representing some 60 percent of all loans with financial sector reforms) in 74 countries has been to allow market forces to determine deposit and lending interest rates and allocation of credit, and to bring client countries closer to Basle (international) norms for prudential regulations and principles for bank supervision.[55] In capital market reforms, the majority (about 80 percent) of the 48 operations in 30 countries supported the passage of laws, establishment of a regulatory framework, and standards for securities markets, although the Bank was also active in providing assistance to strengthen the institutional capacity of regulatory agencies and stock exchanges.

Improvements in the regulatory regime: mixed picture on the details

8.23 To measure improvements in the regulatory regime for banks, OED compared data on changes in prudential requirements for banks between 1998 and 2003 for countries that borrowed from the Bank between FY98 and FY02 with changes in countries that did not borrow from the Bank for regulatory changes during this period (see paragraph 8.5 and Box 9.1 for caveats to this comparison).[56] Four variables were examined: capital adequacy, quality of capital (requirements for items to be deducted from the definition of capital), loan classification, and provisioning requirements for doubtful loans.

8.24 There are only eleven countries in the sample where the loans during this time period had specific conditionality for upgrading prudential regulations and where there were data points for 1998 and 2003. Overall, the average required capital ratio did not increase by much among the borrowing countries (Thailand increased it and Argentina,

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[54] The expression "fit and proper" means owners who have relevant banking experience, a good reputation, and no conflict of interest through connections to companies that could benefit as bank clients.

[55] The Core Principles for Effective Banking Supervision were issued in September 1997, which is about half way through the period under review; even prior to this, however, Bank loans supported many of these principles.

[56] The source of the data was the Bank's Database on Prudential Regulation and Supervision, at: http://www.worldbank.org/research/interest/prr_stuff/bank_regulation_database.htm. OED included only those countries where the timing of the loan was such that adoption of new regulations should have shown up as differences in the data between 1998 and 2003.

after lowering it temporarily after the crisis, is now gradually increasing it again). However, all eleven countries were already requiring banks to be above the internationally recommended ratio of 8 percent prior to 1998. By contrast, among the nineteen countries that did not borrow at all from the Bank during this period (and for which information is available), the average capital requirement increased from 8.4 percent to 10.2 percent. Thus, by this measure, countries that borrowed from the Bank for prudential strengthening did not strengthen the capital adequacy requirement by as much as non-borrowers (Table 8.3). Furthermore, in terms of the quality of the definition of capital, among the borrowing countries, two (Brazil, Tajikistan) upgraded their definitions, *while three countries (Argentina, Bolivia, and Korea) lowered their standards*. By contrast, among non-borrowers, the standards for measuring capital increased overall, and by a wider margin. *Thus, in terms of improving capital requirements, the borrowing countries did not do as well, overall, as the non-borrowing countries.*

Table 8.3: Capital and loan classification, 1998 and 2003, with and without Bank lending

	Countries that borrowed from the Bank	Countries that did not borrow from the Bank
	----------2003 compared to 1998----------	
Minimum Capital-Risk weighted assets ratio	No change	Higher
Quality of capital (definition)	Weaker	Stronger
Loan classification	Stricter	Less strict

Note: For details, see Annex 3, Tables 1 and 2.

8.25 On loan classification, the picture is different: four of the eleven countries that borrowed during the period strengthened the classification of loans by lowering the number of days required before loans were downgraded and, on average, the requirements were stricter than for non-borrowing countries; among non-borrowing countries, two strengthened and two weakened the standards. *Thus, countries that borrowed during this period have made better progress and now have stricter requirements for loan classification than countries that did not borrow* (Table 8.3). On loan loss provisioning there is no major difference between the two groups of countries.

8.26 Overall, the data present a mixed picture, and one that is confirmed by the analysis of the quality of prudential regulations in the FSAPs. While the FSAPs found that almost half of the twenty-four countries that had borrowed for Bank support for strengthening prudential regulations had strong systems, a little over half still had significant shortcomings, particularly with respect to exposure limits, insider lending, or ownership structures. Most countries had weaknesses in the measure of capital adequacy.

Regulatory framework for banking and capital markets in ECA transition countries

8.27 EBRD indicators exist (only) for ECA transition countries, for the regulatory framework for banks over the period 1998-2002, and for the regulatory framework for the securities market and non-bank financial institutions, over the period 1997-2002.

Assuming that reforms supported by Bank lending in years prior to FY97 would already be reflected in "baseline" indicators, OED compared average progress for countries that borrowed from the Bank for legal and regulatory reforms over the period FY97-01 and for capital market reform over the period FY96-02. Changes in indicators were compared with those for the transition countries that did not borrow from the Bank over the relevant period (see important caveat on selection bias in Box 8.1). The results on banking indicators are in Table 8.4 and show that for the countries that borrowed over the period, there was an overall improvement in banking regulations averaging a little over one grade (0.36), whereas for the countries that didn't borrow during this period, the improvement was more modest, at an average of 0.2 (see Annex 3 for details by country). These results, for a relatively small sample of countries, are consistent with the findings on privatization: borrowing countries have done better than countries that didn't borrow over the relevant period, although a closer look at the details (as in the previous paragraphs) reveals a more nuanced picture.

Table 8.4: Indicators on strength of financial regulations, transition countries

	Banking	*Securities markets and non-bank financial institutions*
	Increase in quality of financial regulations: 1998 - 2003	
With Bank lending for regulatory changes	0.36	0.28
Without Bank lending for regulatory changes	0.20	0.22

Note: The EBRD indicator for each country is a composite measure, scaled from 1 to 4, with pluses and minuses; an increase from 2 minus to 2 was counted as an increase of 0.33; from a 2 to a 2 plus was 0.33, etc. See Annex 3, Tables 3 and 4 for detailed indicators by country.
Source: EBRD Transition Report, various years.

8.28 A similar analysis was carried out for the reforms in capital markets; the results in Table 8.4 show that by contrast with the banking sector, the improvements in both groups of countries (with and without borrowing from the Bank for capital market reforms) were similar (at 0.28 in borrowing countries versus 0.22 in non-borrowing). In four of the seven countries that borrowed from the Bank, there was no change in the regulatory framework for securities markets and non-bank financial institutions, while in over half of the 18 countries that did not borrow there was improvement in the framework.

Implementing the laws and regulations and banking supervision: little information

8.29 An equally important issue on prudential regulations and legislative reforms is their implementation.[57] From the thirty-seven case country studies, although virtually all of them contained Bank support for strengthening the legal and/or regulatory regimes, there was only sporadic information available on the extent to which the changes were being implemented. The story is similar for strengthening supervisory capacity, which is an integral part of implementing prudential regulations: there was little evidence to

[57] Theoretically, one set of measures would be the changes in capital adequacy ratios and non-performing loans, which could be expected to improve (capital adequacy up, NPLs down) over time as a result of stronger prudential regulations if everything else were constant. The obvious problem is that there are far stronger economic as well as political influences at work that affect these ratios.

support whether supervisory agencies had been strengthened. The FSAPs found that out of the twenty-four countries that borrowed for either legal/regulatory reforms or strengthening banking supervision, about half had improved in the quality of the supervisory agency and in on-site and off-site supervision of banks, but in 15 of the 24 countries the FSAPs noted shortcomings in adherence to prudential regulations and lack of enforcement of the prudential framework by the supervisory authority. Thus, again, a mixed picture.

8.30 In the case studies and the FSAPs three constraints in particular are cited as hindering stronger implementation of prudential regulations and better functioning of banking supervision: (i) lack of institutional capacity of the supervisory agency, including an absence of special enforcement power and legal immunity for the supervisors; (ii) a solid legal framework for bankruptcy framework; and (iii) lack of political support for the supervisory agency (see Box 8.8).

Box 8.8: Lack of political support: Algeria

At the end of 2002, public banks accounted for over 90 percent of loans and 84 percent of deposits. The banks still carry a significant volume of nonperforming and poorly provisioned loans to the public sector. Although on-site supervision has been strengthened and off-site supervision is being expanded, both human and financial resource constraints, "*as well as the sometimes unresponsive reaction of the authorities to instances of failure to observe the regulations*, undermine the effectiveness of the prudential system."

Source: World Bank and IMF (2004).

Special topic: legal immunity for supervisors

8.31 One issue that has been pursued in a number of countries by the Bank is establishing legal immunity for banking supervisors, which serves to insulate them from fear of being sued by banks that didn't like their findings. The Bank's attempts to address this have met with mixed results. In Peru, the Bank proposed including it in the FY92 FSAL, but Government didn't agree. In both the Philippines and Brazil, introducing legal immunity for banking supervisors was a condition of a recent adjustment loan, but in neither country was it met. Of the thirty-seven case countries examined, eleven countries have banking supervisors that were not immune from legal prosecution as of 2002 (and information was not available for nine of the countries). The FSAPs also cite this as an unresolved issue in many of the borrowing countries.

Special topic: deposit insurance[58]

8.32 Out of the total of thirty-five countries where the Bank lent for deposit insurance schemes (paragraph 5.21 and Figure 5.6), most (20 countries) involved creation of a scheme, while the rest addressed reforms of existing schemes (12 countries) or quite marginal changes (3 countries). Most of the reforms creating deposit insurance schemes

[58] This section is taken from a background paper by Ilka Funke (2004b).

(involving studies, legal reforms, the establishment of the scheme, and establishment of an agency to handle it) had satisfactory outcomes. Little information is available, however, on the quality, functioning, or impact of the schemes. In three countries (Bosnia and Herzegovina, Bulgaria, and Poland), the Bank's completion reports indicated that the deposit insurance schemes increased public confidence in the banking system, and in Argentina, the Bank reported that there was no evidence that trust had increased.

8.33 By contrast, the efforts to reform existing deposit insurance schemes did not achieve their objectives. Reforms included phasing out unlimited coverage that had been put in initially during a banking crisis, improving the schemes finances through raising premium levels or other means, or improving the functioning of the deposit insurance institution. Out of seven countries that tried to limit the insurance coverage, only Ecuador, Korea, and Mexico succeeded; of those that were unable to limit coverage, the governments claimed that these reforms could not be implemented because of the still low level of confidence in the banking sector or the weak financial health of the banks. Better progress was made in improving the financial health and operational efficiency of the deposit insurance agencies, although even here, implementation has been uneven; eliminating automatic government guarantees for state banks was achieved only in Lithuania, but not in Bulgaria or Romania, where it was also supported; and legal immunity for deposit insurance agency staff was achieved only in Uzbekistan, not in Philippines (no information on Argentina).

Recommendations on improving the incentive framework

8.34 It is important for the Bank to develop indicators to measure progress in the reforms it supports, so that it has a means of monitoring whether the reforms on paper are being implemented in practice.[59] Indicators are necessary to measure progress toward objectives, for example, on the degree to which banking supervision adheres to Basle principles for good supervision, whether prudential regulations are consistent with international principles (Basle I), and, most important, the extent to which banks and other financial institutions are in compliance or moving toward compliance with the regulations. Especially in the context of programmatic lending, which consists currently mostly of support for actions rather than requiring progress on outcomes, it is important to establish measurable, realistic, medium-term indicators which will enable all stakeholders to monitor whether targets are being met.

[59] At present, the analysis of the financial sectors carried out through FSAP provides some information, but the program does not cover all Bank borrowers; and it is not a monitoring tool, in the sense of providing information on a regular basis.

9. Outcomes at a country level: market structure, contestability, efficiency, and health

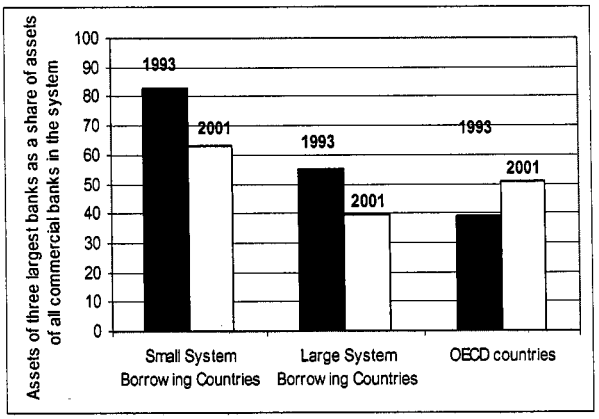
Overview

9.1 This chapter examines whether outcomes at a country-level have been achieved in terms of changing market structure,[60] competition levels through greater contestability, efficiency, and health of the banking system in countries that borrowed from the Bank for these purposes over the period under review. This chapter draws on both quantitative indicators and case studies for insights into the reforms and qualitative results.

Changes in market structure: bank concentration

9.2 The change in market structure is measured by the concentration ratio, which is the share of total banking assets held by the three largest banks. Although the use of this measure as an indicator of competition has been contested in the literature (paragraph 2.7), the Bank has nevertheless sought to decrease concentration in many (particularly smaller) financial systems as a way of decreasing market power and encouraging competition. In most of the fifty-four countries that borrowed from the Bank for financial reforms and where information is available on this measure, the data show a steady decrease in the share of the top three banks over the period under review. The reforms pursued included deliberate downsizing, liquidation, and/or allowing entry of new banks. Because larger systems[61] might be significantly less concentrated than smaller ones, Figure 9.1 shows results separately for each group. By 2001 (latest year available), only Algeria had a concentration ratio over 60 percent among the larger systems, although among the smaller systems, twelve countries still had concentration ratios above 70 percent. By contrast, the larger financial systems had on average lower concentration ratios than OECD countries both at the beginning and at the end of the period.[62]

Figure 9.1: Bank concentration in countries that borrowed from the Bank for financial reforms, 1993-2001



9.3 In order to examine whether the yearly changes in banking concentration could be associated with Bank lending over the period under review, OED and DEC developed a model to compare annual changes in these indicators in countries that borrowed from the

[60] As noted in Chapter 2, the literature does not provide a consensus view on an efficient market structure, but Bank assistance to concentrated financial sectors has nevertheless tried to increase competition; it was an explicit objective in 23 out of 37 case country studies (list is in Annex 4).
[61] Larger systems were identified as the 25 countries that accounted for 84 percent of all banking system deposits in developing countries in 2000; for the list of these countries, see Hanson (2003).
[62] OECD countries are shown for comparison only and not as a target or benchmark.

Bank for financial sector reforms with changes in indicators in non-borrowing countries (see Box 9.1 for a discussion of the challenges of this analysis and how they were addressed). The results presented in Tables 9.1 and 9.3 and in Chapter 10 are for the model that includes macro-economic and institutional controls. Variations on this model include one with policy controls (specifying which policies were covered by the Bank loans) and a model with no controls. Results are qualitatively similar across the different variants of the model presented here.

9.4 Table 9.1 shows that banking concentration decreased at an average rate of 1.1 percent per year in countries that borrowed from the Bank for financial reforms, and by 2.2 percent per year in countries that didn't borrow. Thus, banking sectors in developing countries have tended to become less concentrated over the last decade. The decrease in banking concentration in countries without Bank lending, however, was significantly larger than the decrease in the countries with Bank lending. The models also tested whether the number of adjustment loans or the presence of TA lending had any explanatory power for the results among Bank borrowers; they did not.

Table 9.1: Annual growth rate of changes in bank concentration: with and without Bank lending for financial sector reforms

	Banking sector concentration
With Bank lending	-1.05*
Without Bank lending	-2.16*
Significantly different?	Yes
Number of countries	59
R^2	0.33

* significantly different from zero at 1 percent level

Changes in Contestability

9.5 Recent literature has argued that contestability is more important for competition in a banking system than concentration ratios (paragraph 2.7). Contestability can be measured by the ease of entry and restrictions on banking activities, which measure the potential for competition. Using the Bank's database on prudential regulation and supervision (reference, footnote 53), OED compared data on changes in entry requirements and restrictions on activities for banks between 1998 and 2003 for 24 countries that borrowed from the Bank between FY98 and 02 with changes in 29 countries that did not borrow from the Bank during this period.

Table 9.2: Changes in contestability

	Countries that borrowed	Countries that did not borrow
	2003 compared to 1998	
Entry: number of licenses	same	same
Minimum capital requirement	same	same
Restrictions on banking activities	Less restrictive	More restrictive

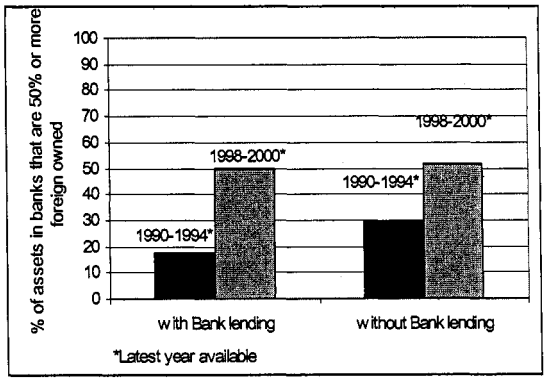
Note: For details, see Annex 5, Tables 1-4.

9.6 *Entry requirements*. Two forms of entry requirements were examined: the number of pieces of information required for a bank to establish itself in a country, and the minimum capital requirement. A decrease in the average amount of information required would indicate an increase in contestability. Most of the borrowing countries and the non-borrowing countries had almost an identical number of requirements at the beginning and end of the period (eight items were required in most countries); there was thus little change within groups or between groups (Table 9.2). For the minimum capital at entry

requirement, Table 9.2 shows again both sets of countries changed very little in terms of minimum capital required for entry into banking, although among countries that borrowed from the Bank for financial sector reforms, a slightly higher proportion increased the capital requirement than among non-borrowers.

9.7 *Restrictions on activities.* By contrast with the results on changes in entry requirements, however, the countries that borrowed from the Bank reduced the extent of restrictions on banking activities, on average, while countries that didn't borrow increased the restrictions on banks' activities, on average (Table 9.2). Thus, in this dimension, contestability increased on average in borrowing countries, while it decreased in non-borrowers.

Figure 9.2: Changes in foreign ownership, with and without borrowing from the Bank



9.8 *Change in foreign ownership.* Rather than examine the data on prudential changes in the de jure ability of foreign banks to establish partnerships or ownership, OED examined the de facto change in foreign ownership of banks, defined as share of assets held in banks that are 50 percent or more foreign-owned, in the borrowing and non-borrowing countries, because it is the actual changes in ownership that indicate greater contestability rather than merely legal changes which could be undermined by other administrative barriers. For twenty-six borrowing countries for which information is available, foreign ownership more than doubled over the period,[63] while it increased by about two-thirds in the twenty-five countries that did not borrow from the Bank (Figure 9.2). The nine transition countries among the borrowers had very large changes, from zero foreign participation in most of them to well over 42 percent; while there were few differences between low and middle income, or between low or high CPIA countries. These results indicate a slightly greater increase in this measure of contestability, among borrowing countries compared to non-borrowers.

9.9 In sum, the picture is mixed on the indicators of contestability, but combining no change in some indicators with a change toward greater contestability in others, borrowing countries seem to have slightly increased competition levels in banking compared to non-borrowers.

[63] Data are available only up to 2000; the situation has evolved further in the direction of more foreign ownership among a number of these countries (with and without Bank borrowing) since then.

Box 9.1: OED/DEC on constructing a "counterfactual"

In economic analysis, it is very difficult to construct theoretically and statistically robust counterfactuals. This evaluation is no exception. As noted in paragraph 8.5, comparisons of Bank borrowers with non-borrowers face the problem that countries that borrowed from the Bank may have had factors influencing the reforms that are not captured by the borrow/not borrow dichotomy. To address this, the OED/DEC models used a country-level fixed effect. *The results of the models should therefore be interpreted as departures from a country's typical value for the variable tested.* Definitions and sources of information for variables used and the models tested in this review are in Annex 6.

Other factors could also drive financial indicators away from a country's typical value. The regressions thus include variables measuring the quality of the macroeconomic and institutional environment: growth rate, inflation rate, fiscal deficit (relative to GDP), and, as a measure of institutional capacity, the CPIA. Variations of the basic model include controls for the country's financial sector reform program, a recognition that some types of reform are more likely to spur short-term improvement on financial indicators than others. All controls are lagged one year relative to the financial indicators to help mitigate problems arising from the dependent and independent variables being simultaneously determined.

Still, it is possible that the borrowing countries were poised to make the most progress in reforms, in particular the transition countries, compared to countries that were not on the same reform path. Other countries might choose not to borrow because they had already reformed. Thus a bias (in terms of observed changes) would be in favor of the borrowers. On the other hand, countries that had been performing poorly and had more deeply entrenched banking weaknesses may have felt the most need to borrow in the hope that Bank assistance would bring about changes, and thus the bias would work against the borrowers. To address this issue, OED/DEC also used treatment effect regressions that explicitly account for self–selection and propensity score matching techniques; the results of using both of these techniques reinforced the main findings.

In terms of initial conditions (in the early 1990s) in borrowing and non-borrowing countries, they are presented in the Table below; on a number of variables, they were not very different in the two groups, although the non-borrowers have somewhat better indicators.

Table: Initial conditions in variables in borrowing and non-borrowing countries, early 1990s

	Indicator	Borrowers	Non-borrowers
Government ownership of banks	Assets in government owned banks as share of total banking assets	79.0	64.5
Concentration ratio	Share of assets held by three largest banks as percent of total assets	74.8	76.8
Foreign ownership	Share of assets in foreign owned banks as percent of total assets	17.4	29.6
Interest rate spread	Difference between lending and borrowing interest rate	16.0	7.7
Financial depth	M2/GDP	29.4	36.9
Liquidity preference	Cash/M2	24.5	18.3
Credit to private sector	Banking credit to private sector/GDP	25.2	29.1

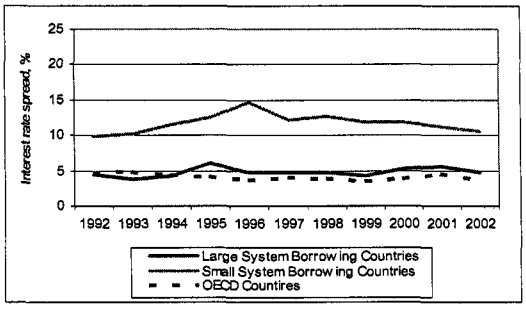
Additional variants of the model reveal *no strong statistical links between the timing of loans and the outcomes*. That is, post-loan growth rates for these indicators were not, for the most part, significantly larger than pre-loan rates, although in several alternative models, post-loan improvements in variables were larger than pre-loan growth rates. *Some indicators, however, declined as the number of adjustment loans increased*, an indication that countries that received multiple loans tended to perform worse than others, or more probably that they needed additional loans because they were having difficulties. Taken together, these results suggest that Bank involvement in the financial sector is a component of successful reform programs, but not necessarily the driving force behind them.

As a final caveat, the definitions of "with" and "without" borrowing are not "pure": in some countries, such as Nepal and Bangladesh, the Bank maintained an active dialogue, but made no loans addressing financial sector reforms (until FY03, so would not be included in the "with" for this analysis). Thus, although these countries are included in "without borrowing", the dialogue may have nevertheless had an impact on the financial sector. In other countries, including Chile and Kenya, the Bank made adjustment loans addressing financial reforms prior to the period under review, whose impact may have emerged only in later years. What this discussion points to is the difficulty of constructing a counterfactual.

Interest Rate Spread

9.10 Although the spread between interest rates on deposits and loans is far from an ideal measure of efficiency for a number of reasons, it is used here as an imperfect proxy to capture changes in efficiency and to serve as one more indicator of the evolution of the banking system in Bank client countries.[64] Median interest rate spreads are in Figure 9.3, with OECD countries shown as a point of comparison. Consistent with the picture of concentration ratios, interest rate spreads in the larger systems are about the same as those in the OECD countries. The medians are used because of the wide differences among countries, particularly at the beginning of the period. Uganda, for example, had large negative spreads in 1992-94, while Peru and Zambia had spreads in triple digits in some years. By the end of the period, spreads had converged, although Brazil still had spreads in excess of 40 percent by 2002 and Georgia, Lao PDR, and Malawi in excess of 20 percent; interest rate spreads in most other countries were in single digits.

Figure 9.3: Median interest rate spreads: in countries that borrowed from the Bank, 1992-2002



9.11 The results of the DEC/OED model on changes in interest rate spreads are shown in Table 9.3. There was a significant decrease in spreads, of 1.7 percent per year in borrowing countries, versus no significant decrease in the countries that did not borrow from the Bank, suggesting that Bank borrowing can be positively associated with the efficiency of banking systems. As in the model on changes in concentration ratios, the models on changes in interest spreads showed no difference in results for the number of adjustment loans or the presence of TA operations.

Table 9.3: Annual growth rate of changes in interest rate spread: with and without Bank lending for financial sector reforms

	Interest Rate Spread
	Annual growth rate
With Bank lending	-1.74*
Without Bank lending	-0.18
Significantly different?	Yes
Number of countries	47
R^2	0.21

* significantly different from zero at 1 percent.

Health of the financial system

9.12 The trend in health indicators of financial systems among borrowing countries, particularly for the last five years, is generally upward. However, the measures of health – NPLs, capital adequacy, and profitability – all proved difficult to measure over the full period under review, for a number of reasons. First, data were hard to find in the early part of the period (1992-93): only ten borrowing countries had information on NPLs, for example, at the beginning of the period, and fewer on capital adequacy. Second, banking reforms can significantly affect the measures of health without necessarily changing the underlying dynamics of banking operations that led to poor health to start with. For

[64] Interest rate spreads are affected by inflation rates, tax rates, reserve requirements, unequal subsidies available to some banks, and the extent of NPLs in the system. In addition, very low spreads may drive banks to insolvency and are thus not necessarily associated with long term efficiency. Finally, the reliability of the information on interest rates in a given country for a given year may not be great.

example, the introduction and implementation of stricter prudential regulations can lead to an increase in the measure of NPLs, provisioning requirements, and shortfalls in provisioning, and to a drop in the measure of capital adequacy, even if nothing in the lending operations of the banks change (see Box 9.2 for an example). By contrast, restructuring banks by taking NPLs off their books and recapitalizing them obviously results in an immediate drop in the measure of NPLs and an increase of capital adequacy of the banking system. The real test of banks' health is what happens to these ratios over time, after these reforms. Thus, the interpretation of changes in NPLs, profitability, and capital adequacy depends on the nature and timing of the reforms rather than on the inherent health of banking system.

Box 9.2: Financial reforms can affect measures of banking health in both directions

In Tunisia, reforms in the early 1990s supported by Bank lending caused most measures of health to worsen and then in the late 1990s, further reforms supported by the Bank caused most measures to precipitously improve. At the beginning of the 1990s, Tunisia introduced stringent prudential regulations, whereby banks had to adopt loan classification, loan loss provisioning, and minimum capital ratios consistent with international good practice (Basle guidelines). For the first time, virtually all the commercial banks in the country, including subsidiaries of foreign banks, showed large NPLs (31 percent of assets) and shortfalls in provisions, and failed to meet the minimum capital requirement. Banks drew up action plans (a condition of a Bank loan) to meet the requirements within three years; most banks made progress, but not enough. In FY99, under ECAL II, the Government agreed to restructure banks by replacing NPLs with zero interest bonds: by this action, the NPLs immediately fell from 23 percent in 1997 to 13 percent in 2000; capital adequacy more than doubled, from 6 to 13 percent of risk assets, and profitability increased modestly. Over this period there has been little change in governance of commercial banks, and more recent data show that NPLs have increased again, to pre-ECAL II levels.

9.13 From the twenty-one case study countries for which some information was available, and based on both qualitative and quantitative assessments of progress in the health of the banking system, at least fourteen of the countries moved in the right direction in terms of decreasing NPLs as a percent of loans, particularly in the last half of the decade. Most of these countries reduced NPLs from well over double digits to well under, although in 2000 (last year available) Yemen still had NPLs of 34 percent of assets (down from 40 percent), and by 2001, Brazil had decreased NPLs from 23 percent (1995) to 11 percent. In most of these countries, the reduction in NPLs came from bank restructuring – Albania being the most dramatic example of reducing bank NPLs that had reached 91 percent following the pyramid scheme collapse in 1997 to 35 percent the following year and, after another round of restructuring, to 7 percent before the banks were sold. Looking only at the last five years, when more information is available for 41 countries that borrowed from the Bank for reforms, slightly more countries improved than deteriorated (17 versus 15), and the improvement in NPLs was greater on average than for countries that did not borrow from the Bank during this period (Table 9.4).

Table 9.4: Measures of banking health in borrowing versus non-borrowing countries

	Number of countries	*1998*	*2003*	*Change*	*Number of countries that changed*
			Ratio of NPLs to assets		
Countries that borrowed from the Bank for financial sector reforms	41	14.4	7.9	- 6.5	17 improved 15 deteriorated 9 no change
Countries that didn't borrow from the Bank	19	7.1	6.3	- 0.8	10 improved 5 deteriorated 4 no change
			Capital to risk adjusted asset ratio		
Countries that borrowed from the Bank for financial sector reforms	41	17.3	19.8	2.5	21 improved 12 deteriorated 8 no change
Countries that didn't borrow from the Bank	19	14.2	14.9	0.7	10 improved 7 deteriorated 2 no change

9.14 In terms of capital adequacy, there was very little information for the whole period; for the few countries that had information, most increased to double digits. Between 1998 and 2003, capital adequacy in 41 borrowing countries increased in more of them and by larger amounts than among countries that did not borrow from the Bank (Table 9.4). There has been no significant trend in profitability of banks in borrowing countries (or in non-borrowing countries) over the period.

10. Impact at a Country Level: Financial sector depth and stability

Overview

10.1 Development of the financial sector is often measured by a set of "bottom line" indicators, which include: (i) depth, the extent to which the financial sector mobilizes resources; (ii) credit to the private sector, the extent to which the financial sector uses its resources to finance productive investments; and (iii) stability, the extent to which financial sectors can resist systemic insolvencies. This chapter examines trends in these indicators and presents the findings of the OED/DEC model, which takes country factors into account and compares results in countries that borrowed from the Bank for financial sector reforms with those that didn't borrow over the period under review. The caveats in the previous chapter related to these comparisons apply to the results in this chapter as well (see Box 9.1).

Financial sector depth: positive findings....

10.2 Two indicators are used to measure progress in financial sector depth: (i) M2/GDP,[65] which is a measure of the money supply relative to the size of the economy;

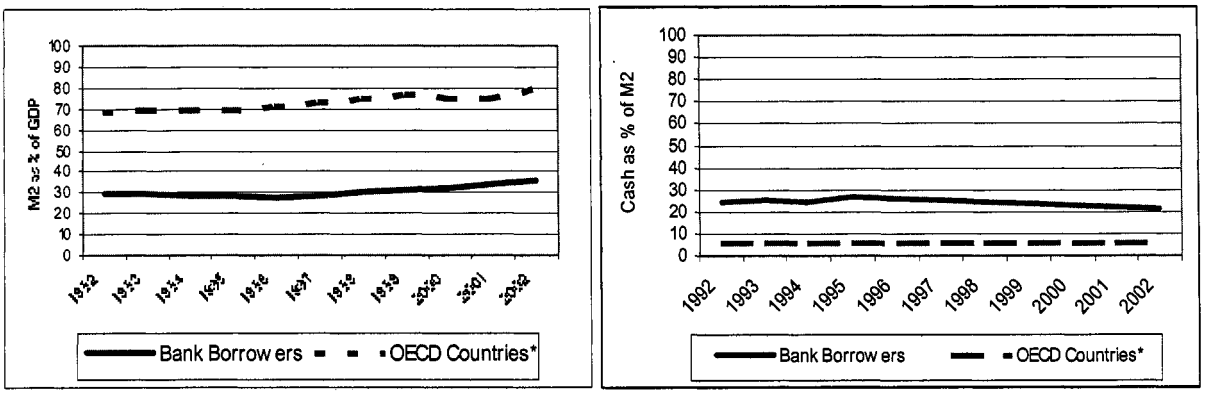
[65] M2 is the combination of cash, demand deposits, and time deposits (International Financial Statistics, lines 34 and 35).

the higher the ratio, the deeper the financial sector depth; and (ii) cash as a percent of M2, which is a measure of liquidity preference that declines when the public is willing to put its funds into the banking system, and thus is inversely related to public confidence in the system. The lower the ratio of cash to M2, the higher the level of confidence.

10.3 Over the period of 1992-2002, financial sector depth in countries that borrowed from the Bank for financial sector reforms grew from an average of 29 percent of GDP to 36 percent, as shown in Figure 10.1. Given the significant financial turmoil and subsequent restructuring that occurred over this period in many borrowing countries (Box 6.1), this increase in average financial sector depth can be viewed as reasonably good progress.

10.4 On the measure of liquidity preference, which should decline as confidence in the banking system increases, Figure 10.1 shows that this measure also moved in the right direction: cash as a proportion of the money supply declined from 25 percent to 22 percent, indicating an increase in confidence.

Figure 10.1: Financial sector depth (M2/GDP) and liquidity preference (cash as a percent of money supply), in countries that borrowed from the Bank for financial reforms, 1992-2002



* Excludes countries in the Euro zone; Source: WDI, 2004.

10.5 The results of the OED/DEC model are in Table 10.1. They show that in both the "with Bank lending" and "without Bank lending" group of countries, financial sector depth as measured by M2/GDP grew by about 1.7 percent per year. There was no significant difference between the two groups.

10.6 Preference for liquidity in the form of cash dropped by about one-half percent per year in both groups, thus indicating a greater willingness to put resources into the banking system and an overall increase in confidence. In this model, there is no significant difference between the two groups of countries, although in several variations of the model (the simple model and the one including policy controls), the non-borrowing group showed a significantly lower increase in confidence.

Table 10.1: Annual growth rates in financial sector depth and confidence in the banking system: with and without Bank lending for financial sector reforms

	M2/GDP	Cash/M2
	Annual growth rates	
With Bank lending	1.73*	-0.48*
Without Bank lending	1.65*	-0.37*
Significantly different?	No	No
Number of countries	69	77
R^2	0.38	0.17

* significantly different from zero at 1 percent level

This could indicate that reforms undertaken with Bank support aiming at reducing government role and increasing competition may have also increased public confidence in the banks. One interesting finding on changes in public confidence is that it was significantly and inversely related to the number of adjustment loans. That is, the higher the number of adjustment loans the lower public confidence was among borrowing countries. A plausible explanation of this finding is that countries in deep financial trouble have more loans from the Bank for financial reforms (see Box 6.1 on this point) than countries that are not experiencing banking problems, and that the public is responding to the banking problems by keeping their money in cash.

.....but financial systems are still very shallow in many Bank clients

10.7 The results presented above do not show the wide variations among clients and the very shallow systems that still characterize many clients. Figure 10.1 shows that M2/GDP is still on average only about one-half of the level of OECD countries. Table 10.2 shows the distribution of changes in the two indicators for the borrowing countries where information was available. Although M2/GDP increased in the majority of countries in the sample, it fell for almost one-third of them (18 out of 62 countries), and remained below 20 percent in 18 out of 62 countries. Public confidence actually fell in over a third of the countries (in 19 out of 57 countries, the ratio increased, indicating a fall in term deposits).

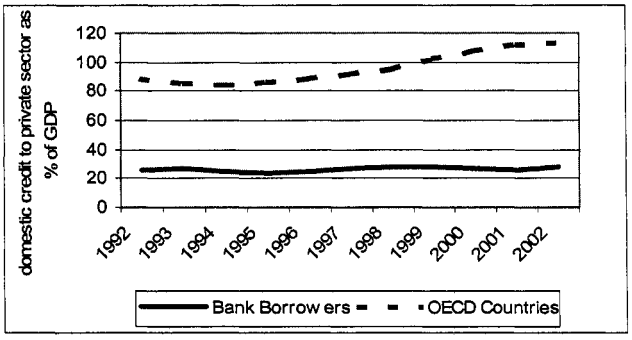
Table 10.2: Distribution in changes in measures of financial sector depth, borrowing countries

	Change in indicator between 1992-94 and 2001-02					
Percentage point change in depth	>20	10-19.99	5-9.99	0-4.99	<0	Total
	Number of countries					
M2/GDP	11	7	15	11	18	62
Percentage point change in cash/M2	>0	0 - (-4.99)	(-5) - (-9.99)	(-10) – (-19.99)	< (-20)	Total
	Number of countries					
Cash/M2	19	17	13	6	2	57

Credit to the private sector

10.8 Credit to the private sector, measured by claims on the private sector by the banking system as a percent of GDP, is considered one of the keys for economic growth. It is the main objective of a banking system's mobilization of resources. Credit to the private sector over the period 1992-2002 in countries that borrowed from the Bank for financial sector reforms is shown in Figure 10.2, and shows a small increase over the period (25.2 to 27.5 percent of GDP).

Figure 10.2: Credit to the private sector as a percent of GDP in countries that borrowed from the Bank for financial reforms, 1992-2002



Source: IFC and WDI, 2004.

10.9 The results of the OED/DEC model show that credit to the private sector as a share of GDP increased in both borrowing and non-borrowing countries (Table 10.3), but here the growth rate is larger in non-borrowing countries: 1.7 percent per year in non-borrowing countries versus 0.4 per cent per year in borrowing countries. One explanation may be that within the group of Bank borrowers, the more rapid bank privatization and establishment of higher standards of prudential norms – requiring stricter loan classification and provisioning, higher capital ratios, and stricter rules on interest rate accrual – may have combined to foster more prudent lending. Thus the slower growth of lending may not be, in the first instance, a bad thing.

Table 10.3: Annual growth rates for credit to the private sector: with and without Bank lending for financial sector reforms

	Private Credit/GDP
	Annual growth rate
With Bank lending	0.37*
Without Bank lending	1.65**
Significantly different?	Yes
Number of countries	71
R^2	0.19

*significantly different from zero at 10 percent
** significantly different from zero at 1 percent

10.10 Nevertheless, credit to the private sector remains at a low level in most Bank borrowing countries; it is still only about one-fourth the level in OECD countries; it fell in about 40 percent of the countries that borrowed from the Bank (24 out of 60 for which information is available) and increased by less than 10 percentage points for another 40 percent (Table 10.4). At end 2002, credit to the private sector remained at a very low 10 percent of GDP in 16 out of 60 countries.[66]

10.11 And again, as in the case of public confidence, private credit as a percent of GDP was inversely related to the number of adjustment loans: the higher the number of adjustment loans the lower the access to credit, which may reflect the degree of distress in the banking systems that called for repeated Bank lending.

Table 10.4: Distribution in changes in access to credit, borrowing countries

	Change in indicator between 1992-94 and 2001-02					
Percentage point change in access to credit	>20	10-19.99	5-9.99	0-4.99	<0	Total
	Number of countries					
Credit to private sector/GDP	4	7	12	13	24	60

10.12 OED also examined in a separate review the experience with more micro-approaches to increasing access to credit by financing lines of credit through financial intermediaries (OED, 2005). Over a decade (FY93-03), much of the financing remained unused (cancellations rates averaged some 40 percent of original commitments) and outcomes of the projects were satisfactory in only about half of the projects. Thus, more direct attempts to expand access to credit have had high success rates.

10.13 Reasons for the low level of financial intermediation include macroeconomic influences (Chapter 2). Private access to credit can be crowded out by government's need for financing, in turn related to fiscal deficits (World Bank, 2004), and institutional and environmental factors such as collateral laws, creditors' rights, strength of judicial

[66] At the high end for M2/GDP are Morocco (87 percent); and Slovak Republic (64 percent); and for access to credit, Tunisia (69 percent); and Morocco (54 percent).

system and the enabling environment for private investment may play critical roles in the willingness of banks to extent credit.

10.14 In addition, however, more work may be required with respect to the banks' capacities to lend and to manage risks. After ownership and market structure has changed, interest rates liberalized, and prudential regulations and banking supervision strengthened, if the banking staff and managers have little experience in banking, then more micro approaches may be needed: technical assistance, training, and demonstrations of successful lending may be required, aimed specifically at lending and risk management techniques. These low levels of financial intermediation point to a need for the Bank to work with client countries to continue to identify and remove constraints to enhancing the role of the financial sector in mobilizing resources, channeling them to productive investments, and managing the related risks.

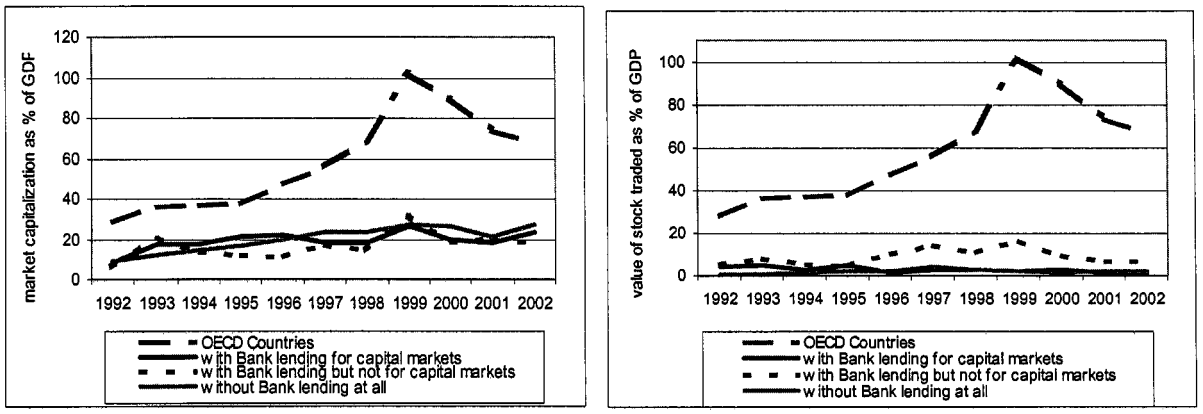
Financial sector depth: capital markets

10.15 This section reviews the evolution of capital markets in the countries that borrowed for capital market improvements, using changes in market capitalization and market turnover (value of stock traded), both as a percent of GDP. Information was available for fifteen countries (although 30 borrowed for capital market reforms), dominated by Latin American countries.[67]

10.16 Figure 10.3 below shows some increase in market capitalization in borrowing countries, but it remained relatively low, on average, and market turnover decreased over the period, as a percent of GDP. In addition, the distribution of the changes in these indicators (Table 10.5) shows that about 40 percent (six out of fifteen for which information is available) experienced a decrease in market capitalization, while more than half of the countries saw a shrinkage in value of stocks traded, as a percent of GDP (the fact that the gap with OECD countries widened over the period may be due more to the extraordinary growth in the OECD countries than to the slow or no growth in the borrowing countries). Thus Bank assistance in this area is not associated with deeper capital markets. A comparison with countries that did not borrow from the Bank at all and with countries that borrowed from the Bank but not for capital market reforms are also presented in Figure 10.3. The results show little difference between borrowing countries and non-borrowing countries.

[67] Of the fifteen for which information was available, seven were from LCR, two from ECA, three from MNA, and two from EAP and one from AFR.

Figure 10.3: Market capitalization and value of stock traded in countries that borrowed for capital market reforms, 1992-2002*



Source: WDI 2004.

Table 10.5: Distribution in changes in capital market measures

	Change in indicator between 1992-94 and 2001-02			
Percentage point increase	>10	0-10	<0	Total
	Number of countries			
Market capitalization as % of GDP	5	4	6	15
Value of stocks traded as % of GDP	2	3	9	14

Source: WDI 2004.

Stability: did Bank borrowing improve the stability of banks?

10.17 As a proxy for measuring stability, OED examined whether borrowing countries had fewer instances of systemic bank insolvency[68] after borrowing than before, or fewer instances than in countries that had not borrowed during the period under review. The analysis was complicated by the fact that the Bank often lent to countries already characterized by systemic bank insolvency or near insolvency: the question for these cases was whether Bank assistance helped countries emerge from their crisis. The analysis was further complicated by the fact that the data on systemic insolvency included only countries that either had insolvencies or were close to having them; it could not be assumed that countries not included in this list had necessarily robust banking systems. Thus the sample of countries is at the lower end of the spectrum in terms of health of the banking system.

10.18 Table 10.6 below summarizes the results; the list of countries in each category is in Annex 6, Table 1. No clear pattern emerges. Out of the fifty-eight countries that borrowed from the Bank for financial sector reforms and for which information was available, eighteen were not characterized by banking insolvency at the time they borrowed, and did not experience it afterwards, while fifteen of them borrowed during insolvency and improved thereafter. An additional twenty-three also borrowed during

[68] Financial instability as defined in Caprio and Klingebiel (2003): banking systems in which much or all of the capital is exhausted, based on official statistics or the estimation of experts familiar with the banking system in that country.

insolvency and did not pull out of it in the years following the loan(s). Among the fifty-eight Bank borrowers, only two borrowed during a period of when there was not systemic insolvency (Jamaica and Ukraine), but then experienced a banking crisis. Among the twenty-two countries that did not borrow from the Bank for financial reforms during this period for which information was available, more than half experienced systemic bank insolvency. From this analysis, *it is not possible to conclude that borrowing from the Bank for financial reforms can be associated with greater stability*; but given that more than half of the fifty-three countries in this sample either did not experience a banking crisis or improved after borrowing, *Bank borrowing is not associated with a decrease in stability either.*

Table 10.6: Number of countries with and without systemic insolvency

	Total number	*Countries without systemic insolvency*	*Countries with systemic insolvency*
Did not borrow from the Bank for financial sector reforms	22	9	13
Borrowed from Bank for financial sector reforms	58	18	40, of which:
			15 borrowed during insolvency and improved 23 borrowed during insolvency but didn't improve 2 borrowed and insolvency followed
Total number	80	27	53

11. Findings and Recommendations

Findings

11.1 After well over a decade of borrowing from the World Bank for financial sector reforms, most of the ninety-six borrowing countries have witnessed improvements in their financial sectors. Nevertheless, in most of the countries, the financial sectors deepened only modestly and remain relatively shallow, and private sector access to credit remains low. Between FY93 and FY03, Bank assistance for financial sector reforms was supported by some US$56 billion dollars in lending, or 24 percent of the Bank's total commitments. The support aimed at bank restructuring and privatization, strengthening prudential regulations and banking supervision, improving the regulatory and institutional framework for capital markets and insurance, and capacity building in specific financial intermediaries.

11.2 Most of the lending for financial sector reforms was embedded in components of multi-sector loans; out of 385 loans containing support for these reforms, only 36 percent (137 loans) were in the financial sector, and the remainder were components of adjustment and technical assistance loans and lines of credit in other sectors. Over the period FY93-03, lending for financial sector reforms has declined, due mainly to the sharp drop in lines of credit (LOC). Apart from LOC, support for financial sector

reforms through adjustment and technical assistance lending has declined only slightly, with a more noticeable drop in (formal) non-lending assistance.

11.3 This OED review finds that the objectives of financial sector lending followed good practice in the areas of reducing government ownership of financial intermediaries, improving prudential regulations to be consistent with international norms, and strengthening banking supervision to adhere more closely to international principles. This review also finds, however, that consistency within a country and most especially coherence of the Bank's approach to financial sector reforms across countries should be improved, particularly with respect to the priority for Bank support for payments systems, deposit insurance schemes, and capital market development. The combination of on-going debates within the Bank (e.g., whether and how to support deposit insurance schemes), absence of "good policy" notes, and the decentralized nature of Bank operations have all contributed to a situation in which the Bank speaks with many voices on important matters of financial sector policy.

11.4 Excluding LOC, which are analyzed in a separate OED review, outcomes of all lending for financial sector reforms (adjustment plus technical assistance (TA) loans) averages 75 percent satisfactory, slightly below the 79 percent average for all (adjustment and TA) lending excluding financial sector. However, the outcomes of loans under the financial sector board were significantly better than outcomes of financial sector components of multi-sector loans, which points to the need for a stronger role in quality assurance of financial sector components by the sector board as well as the need to ensure that the financial sector reforms embedded in multi-sector loans have strong support from financial sector officials in the client country.

11.5 In addition, adjustment loans and components of adjustment loans have better outcomes in countries with modest institutional capacity when they are accompanied by TA loans than when TA loans are absent. In higher capacity countries, however, adjustment loans have worse outcomes when TA loans accompany them than when they don't. One explanation for this is that a TA loan in a higher capacity country may be a signal that the government is not fully committed to carrying out the reforms.

11.6 At a country-level, OED examined whether Bank borrowing could be associated with changes in outputs, outcomes, and impact. Output was defined as a decrease in government ownership of banks and stronger regulatory and supervisory frameworks for banking. Outcomes were defined as: (i) market structure measured by concentration rates; (ii) contestability measured by ease of entry and absence of restrictions on activities – freedom to compete – in banking; (iii) efficiency measured by interest rate spreads; and (iv) health of the banking system measured by capital adequacy and non-performing loans. Finally, impacts were defined as: (i) financial sector depth in banking, measured by the money supply as a proportion of GDP and preference for cash as an indicator of the lack of confidence in the banking system; (ii) size of the capital markets, measured by capitalization and turnover as a proportion of GDP; (iii) credit to the private sector, and (iv) financial sector stability (absence of systemic banking insolvency). Because financial sector developments are so closely linked to other country characteristics, for much of this analysis, an econometric model was used to control for country conditions,

including growth rates, inflation rates, fiscal deficit, and institutional capacity. OED also tested whether the results were different for countries that borrowed from those that did not borrow for financial sector reforms over the period under review. Because countries that borrow from the Bank may be self-selecting, and more likely to be reform-oriented than those that don't borrow, the results of the econometric analysis show association of Bank borrowing with outcomes, rather than causality.

11.7 *Output at the country-level.* Between the early 1990s and 2003, Government ownership decreased dramatically in countries that borrowed for bank privatization, and by more than in Bank client countries that were also privatizing their banking system without borrowing from the Bank. Official data mask the full picture of government control of financial intermediaries, however, because governments often retain significant minority ownership in banks that are considered private and many countries have state owned non-bank financial intermediaries that do substantial lending. Thus, reducing governments' role in financial intermediation remains a challenge. Although the Bank often and appropriately supported financial restructuring prior to privatization of banks, Bank support has not consistently focused on the quality of the new owners, and this has contributed to poor results. In addition, the Bank has supported financial restructuring of banks in the absence of government commitment to change their ownership, and this has led to poor results (re-appearance of poor loan portfolios and insolvency).

11.8 Improvement in laws and regulations governing the financial sector was uneven in borrowing countries. Between 1998 (the earliest year for which systematic information was available) and 2003, capital requirements remained about the same, while rules on loan classification were stricter; the opposite was true for non-borrowing countries (stricter capital requirements, less stringent loan classification). Among transition countries, the regulatory frameworks for banks and capital markets show more improvement since 1998 in borrowing than in non-borrowing countries. On the critical aspect of implementation of the laws and regulations, there was little information, and thus it was not possible to assess the extent to which laws and regulations were in fact observed. Strengthening banking supervision remains a priority. A number of countries that borrowed from the Bank to strengthen banking supervision are still far from complying with Basel core principles.

11.9 *Outcome at the country-level.* Concentration levels decreased significantly since the early 1990s for all countries, although more so in non-borrowers, while contestability since 1998 (earliest year for which data are available) increased in borrowing countries as measured by lower restrictions on banking activities and decreased in non-borrowing countries. Interest rate margins (since the early 1990s) narrowed significantly in borrowing countries and did not change in non-borrowing countries. Finally, data on health are not sufficient for a comparative analysis (of "with" and "without" borrowing), but they do point to an improvement (non-performing loans decreased; capital adequacy increased) in the borrowing countries. Thus, overall, Bank borrowing is associated with good outcomes and, where information permits comparisons, to mostly better outcomes than in non-borrowing countries.

11.10 *Impact at the country-level.* The positive results on outcomes discussed in the previous paragraph do not translate into equally positive findings on impact over the last decade, although developments have been in the right direction. Financial sectors became deeper in countries that borrowed for financial sector reforms over the period, although not significantly more than in non-borrowing countries. In any case, they remain, on average, relatively shallow – M2/GDP, for example, was below 40 percent in the Bank borrowers in 2002 (it is about 80 percent in OECD countries). Liquidity preference (cash as a proportion of the money supply – considered the inverse of public confidence in the banking system) decreased significantly (at roughly the same rate as in non-borrowing countries), which could be the result of the reforms aimed at downsizing, restructuring, and privatizing banks and pro-active efforts by governments to regulate and supervise them.

11.11 Credit to the private sector (as a percent of GDP) grew at an annual rate of 0.4 percent per year in the countries that borrowed from the Bank for financial sector reforms, less than it did in countries that did not borrow from the Bank (where it grew by about 1.7 per cent per year). One explanation of the modest growth in credit is that the process of strengthening both governance and prudential regulations could lead to greater prudence in lending; thus, although the growth is slower than in non-borrowing countries, it may be more prudent lending. But on average, credit to the private sector remains very low, below 30 percent of GDP in the 62 borrowing countries for which information was available (and in 16 countries, it was below 10 percent; in OECD countries, as a point of comparison, it was over 110 percent). Finally, OED found no pattern in terms of improved stability of the financial system in countries that borrowed from the Bank relative to those that didn't.

11.12 The findings on financial sector depth and credit to the private sector suggest that the reforms supported by Bank lending over the past decade are closely associated with improvements in the financial systems, but they have not been sufficient to bring about well-developed financial systems.

11.13 Bank assistance for financial sector reforms to countries in crisis constitute some 50 percent of the lending reviewed here. The circumstances surrounding crisis lending are different from non-crisis lending: the former is prepared under stressful conditions; speed is important; sometimes without prior analysis of or dialogue with the government about issues; as part of large, publicly announced international rescue packages. Because of these exceptional factors, OED examined crisis lending separately, in 14 countries.

11.14 OED found that the Bank was ill-prepared in Mexico in 1994, and in Thailand, Korea, and Indonesia in 1997 to respond quickly; and better prepared in Argentina, Russia, and Turkey. Even in countries where it recognized signs of vulnerability (Indonesia, Turkey), official Bank documents gave sanguine assessments of risks. Although the stated objectives of the loans were similar in scope and nature to financial sector reforms pursued in countries not experiencing a crisis, outcome ratings of the thirty-one closed operations (US$18 billion) are lower by some 15 percentage points than outcomes of non-crisis lending. This is a somewhat surprising finding given the high relevance of the objectives and the fact that crises often induce or strengthen commitment

of governments to addressing the problems. It is likely the result of the need to state overly-ambitious objectives to justify the large loans that are necessary to fulfill the pre-announced assistance package (Chapter 9).

11.15 Collaboration with the IMF in these countries in crisis was not always smooth, particularly in Indonesia, Mexico, Russia, and Thailand. Following the Asian experience, the Bank and the IMF reached agreements in principle to improve collaboration, although the boundary between the two institutions is not always clear. In addition, regional development banks often play a role in the rescue, which needs to be coordinated as well. Collaboration among the IFIs in crisis situations remains a challenge. Finally, OED found that prior recommendations for the Bank to prepare guidelines for crisis situations on triggers for actions and clear lines of responsibility have not been implemented and remain valid today.

Recommendations

- The Bank's financial sector anchor should provide guidance for Bank staff and client countries and the financial sector network should become more pro-active in quality control of financial sector components in multi-sector loans. This involves producing good practice notes on a range of topics, in areas where there is a cohesive internal Bank view on reforms. In areas where debate continues, it needs to provide a review of issues and options for Bank support. Subjects where more guidance is needed include restructuring of banks (if, when, and how); asset management companies (if, when, how); privatization of banks; promotion of capital markets (if, when, and how, in conjunction with IFC on this); and for topics related to strengthening the legal, regulatory, and supervisory environment, a particular focus on implementation.

- The Bank needs to focus assistance on: (i) the process of preparing banks for privatization (financial restructuring) and ensuring that banks are sold to fit and proper owners; (ii) implementation of laws and regulations governing the financial sector; (iii) strengthening supervision of financial intermediaries; and (iv) increasing access to credit by improving collateral laws, creditor rights, providing technical assistance and training.

- The Bank should develop monitorable indicators to assess progress on objectives, especially in the area of prudential regulations and supervision for financial intermediaries.

- On support for countries prior to and following crisis:

  - The Bank should develop a rating system, in partnership with other relevant institutions, for vulnerability to crisis, making use of readily available information that can be used to engage countries in crisis prevention measures

and issues in crisis response. The Bank should also do a better job than in the past of presenting assessments more candidly in documents.

- The Bank should make internal arrangements to respond better to crisis by developing guidelines for dealing with crisis, which should include the possibility, if circumstances warrant, of lending liquidity support to countries experiencing a crisis without stipulating ambitious reforms (that may not be realized) as justification for the loan.

- Coordination with the IMF and other IFIs in crisis assistance needs to be improved, and at the outset of a crisis, the IFIs should reach quick agreement on division of responsibilities.

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Lending classified as finance including LOC

Table 1: Lending by Region, including and excluding LOC, FY93-03

Region	Lending Amount including LOC, $M	Percent of Region Lending	Lending Amount excluding LOC, $M	Percent of Region Lending
AFR	806.6	3	630.6	2
EAP	6,764.0	12	6,357.0	11
ECA	6,386.4	14	5,257.2	11
LCR	8,145.8	14	7,499.8	13
MNA	990.5	8	845.5	7
SAR	1,711.7	5	659.8	2
Total	24,805.1	11	21,249.9	9

Figure 1: Lending classified as finance, including LOC, as percent of lending, by Region

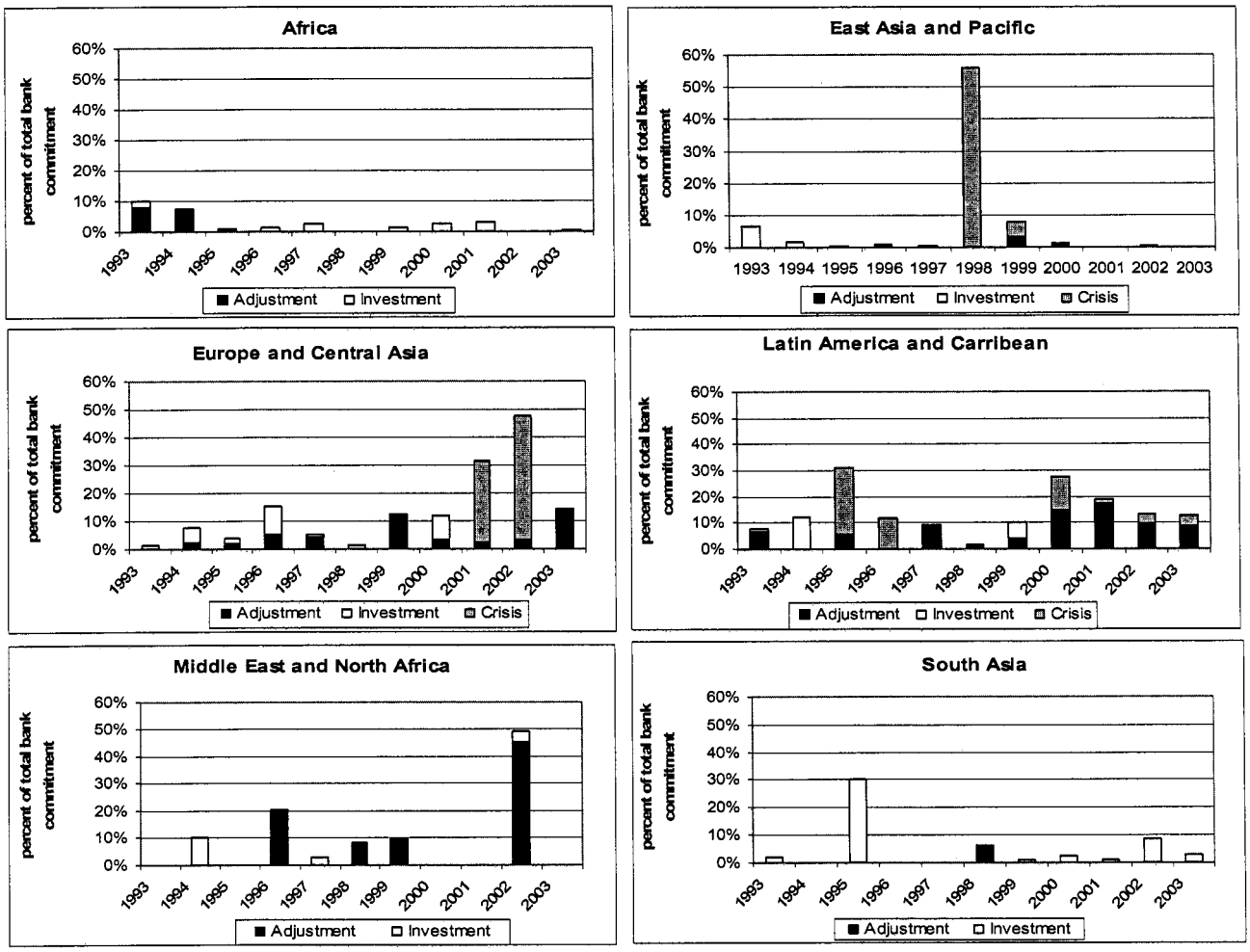


Figure 2: Lending classified as finance excluding LOC as percent of total lending, by Region

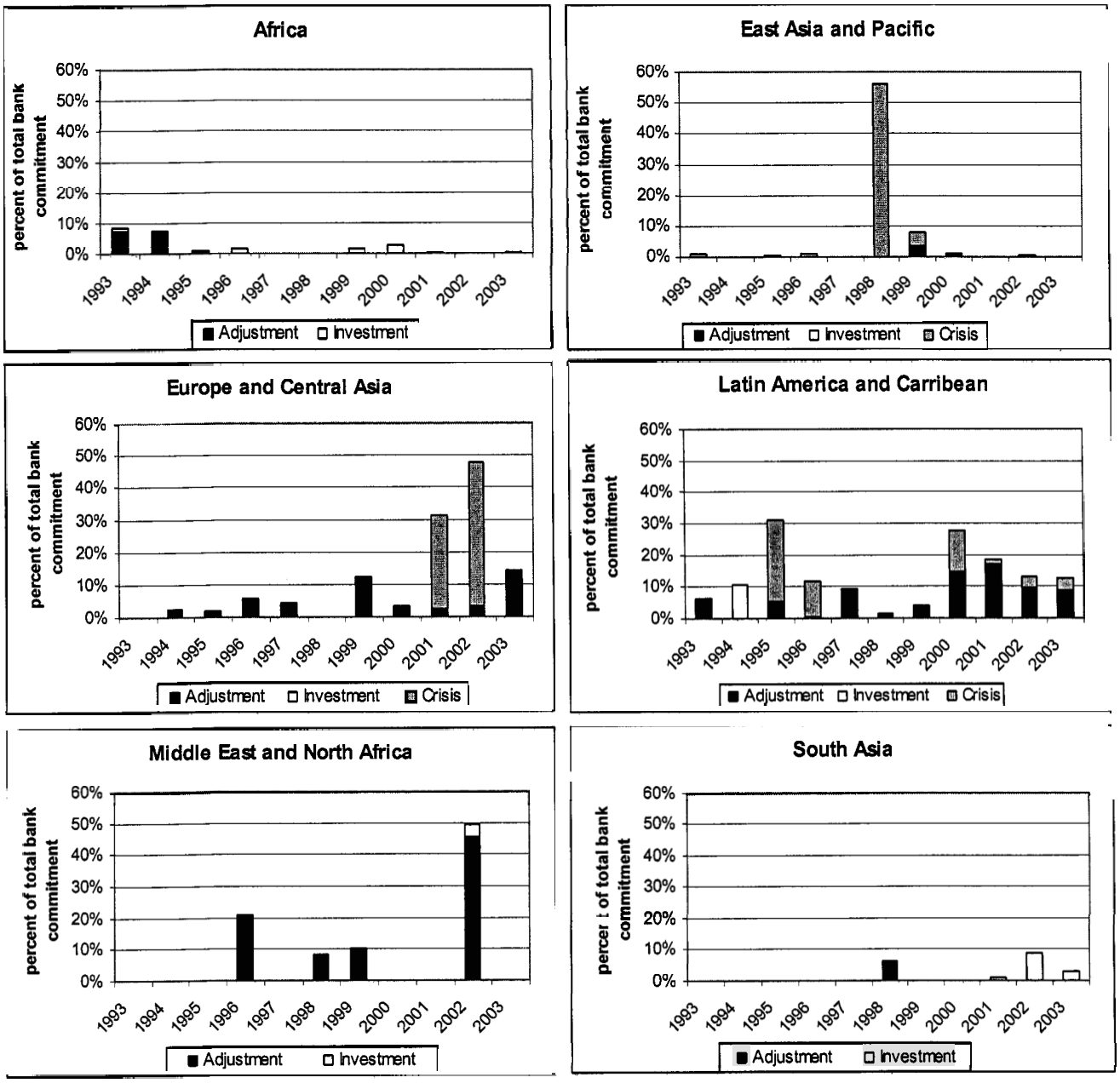


Figure 3: Breakdown of operations with financial sector components by sector board (including lines of credit)

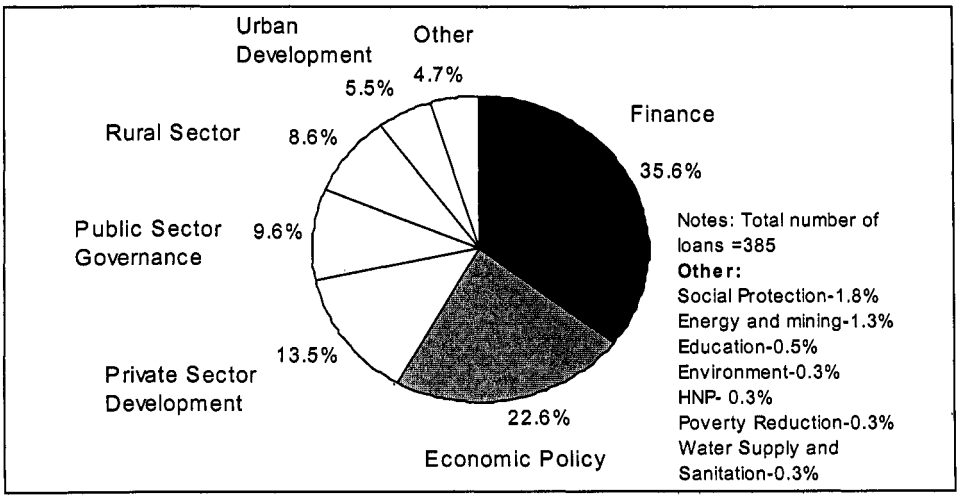


Figure 4: Number of loans, including multi-sector loans and lines of credit, by Region, as percent of Region's loans

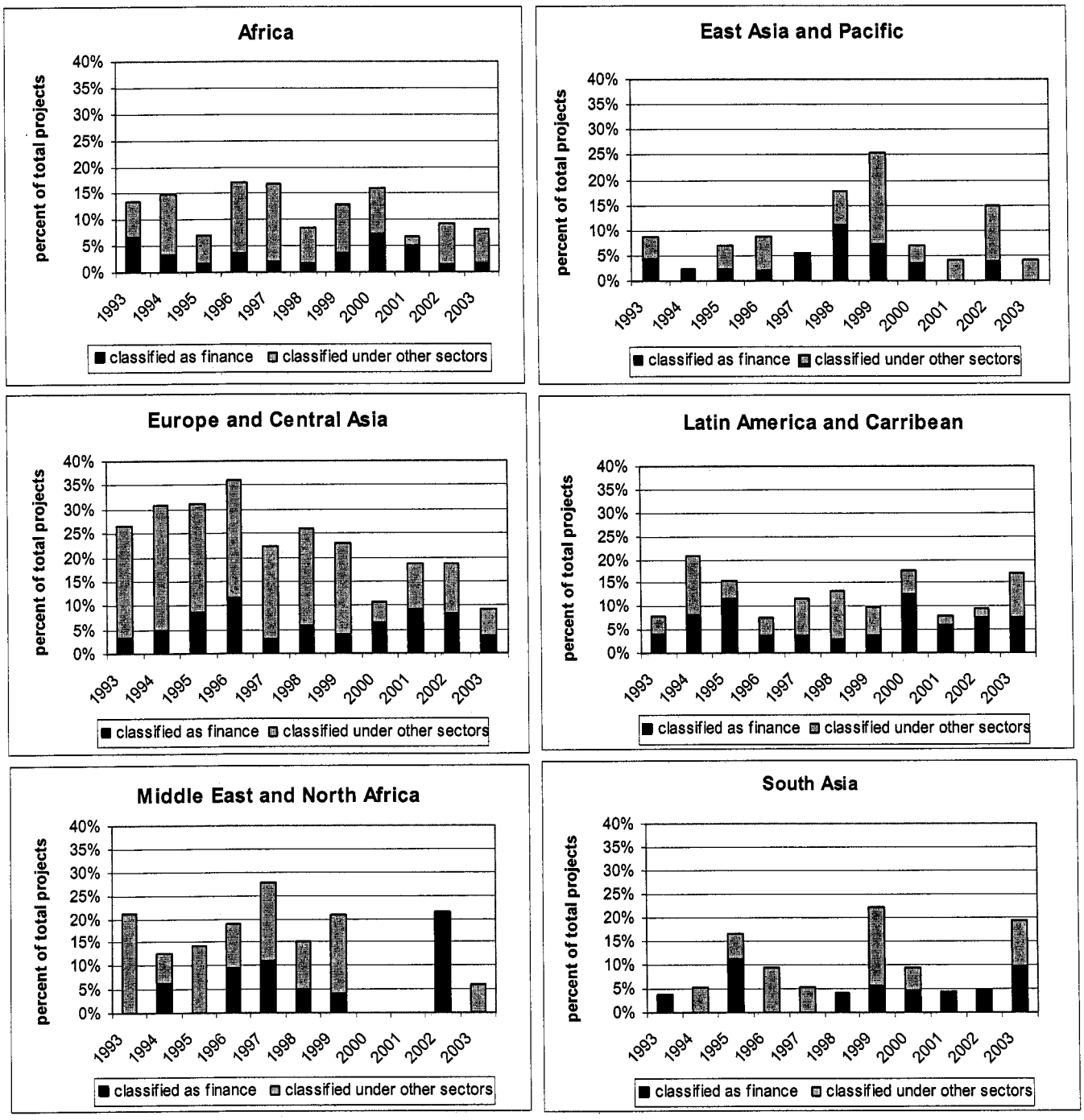
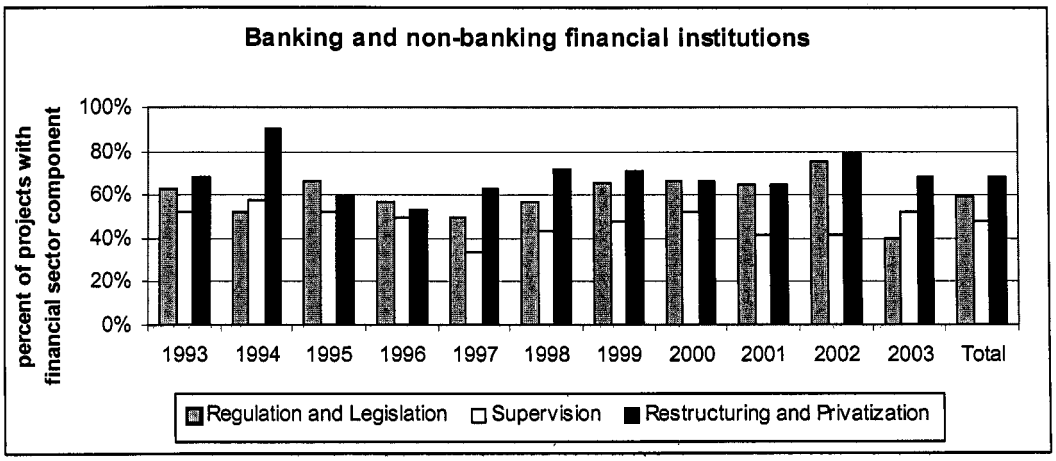


Figure 5: Trends in lending in support of specific financial sector reforms as percent of all projects with financial sector reforms in that year



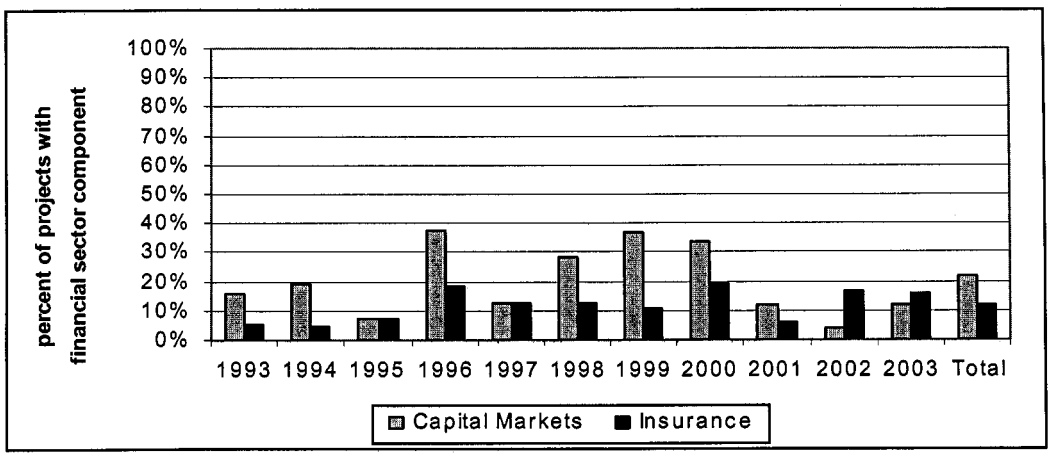
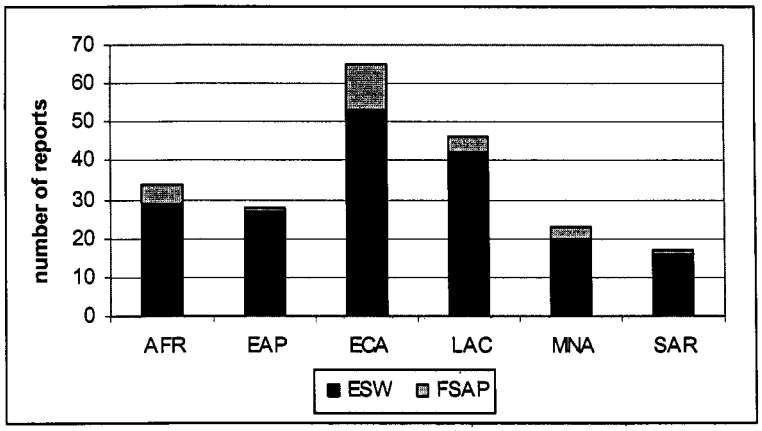


Table 2: Bank lending for capital market reform, number of projects, by Region and total

Region	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Total
AFR	2	1		2			1	2				8
EAP			1			1	2	1				5
ECA				4		3	3		1		2	13
LCR	1	3		2	2	2	2	1	1	1	1	16
MNA				2	1	1	2					6
SAR												0
Total	3	4	1	10	3	6	10	4	2	1	3	48

Figure 6: Number of ESW by region, FY93-03



Annex on Chapter 6: Outcome ratings of Bank loans

Table 1: Upgrades and downgrades* by source of rating of financial sector components of multi-sector loans

Source of rating	----------*OED*----------			*ICR validated by OED*	*Grand Total*
	PAR	Desk Review	Total OED		
	27	60	87	12	99
upgraded	1	8	9	1	10
downgraded	4	7	11	2	13
disconnect	3	1	2	1	3

*Upgrade and downgrade refer to a change in outcome rating between the overall project rating and the component rating

Table 2: Outcome ratings and sector classification of loans

Sector classification of loans	*Number of loans*	*Number of satisfactory loans*	*Percent satisfactory*
Financial sector adjustment loans plus financial sector components in multi-sector loans	142	106	75
All adjustment loans (excl. financial sector)	243	192	79
Financial sector TA loans plus financial sector components of multi-sector TA loans	49	38	78
All investment loans (excluding financial sector)	839	642	77
Sector classification			
Financial Sector adjustment loans	43	38	88**
Financial Components of multi-sector adjustment loans	99	68	69**
Financial sector TA loans	17	14	82
Financial components of multi-sector TA loans	32	24	75
Sector classification and 2003 CPIA rating			
Financial sector loans, low CPIA rating (CPIA between 1 and 3.5)	17	15	88**
Components of multi-sector loans, low CPIA rating (" ")	51	34	67**
Financial sector loans, high CPIA rating (above 3.5)	43	37	86**
Components of multi-sector loans, high CPIA rating (above 3.5)	80	58	73**
Sector classification and 2002 per capita income			
Financial sector loans, low income	18	13	72
Components of multi-sector loans, low income	54	37	69
Financial sector loans, middle income	42	39	93**
Components of multi-sector loans, middle income	77	55	71**

* significantly different at the 10 percent level of confidence
** significantly different at the 5 percent level of confidence

Table 3: Outcome ratings and country characteristics

Country characteristics	Number of loans	Number of satisfactory loans	Percent satisfactory
Income Levels			
1993 per capita income			
Loans in low income countries	80	63	79
Loans in middle income countries	109	79	72
2002 per capita income			
Loans in low income countries	72	50	69*
Loans in middle income countries	119	94	79*
2002 per capita income, transition countries separate			
Loans in low income countries, excl. Transition	56	34	61**
Loans in middle income countries, excl. Transition	62	49	79**
Loans in transition countries	73	61	84
CPIA Ratings* **			
1996 ratings			
Loans in low CPIA (1-3.5) countries	127	94	74
Loans in high CPIA (3.6-5.0) countries	53	41	77
2003 ratings			
Loans in low CPIA (1-3.5) countries	68	49	72
Loans in high CPIA (3.6-6.0) countries	123	95	77
2003 ratings, transition countries separate			
Loans in low CPIA (1-3.5) countries, excl. transition	42	25	60**
Loans in high CPIA (3.6-6.0) countries, excl. transition	76	58	76**
Loans in transition countries	73	61	84

* significant at the 10 percent level of confidence
** significant at the 5 percent level of confidence
* ** The index was changed from a five point scale to a six point scale, and this is reflected in the categories for 1996 and 2003, which show different ranges for CPIA values. The analysis was also carried out with different cuts for 1996 CPIA ratings (1-3.0; 3.1-6.0) with similar results; for 2003, there were too few observations in the CPIA rating 1-3.0 to be meaningful.

Table 4: Outcomes of adjustment loans with and without technical assistance

With and without technical assistance loans	*Number of loans*	*Number of satisfactory loans*	*Percent satisfactory*
All financial sector adjustment loans and			
Loans with associated TA loans	48	36	75
Loans without associated TA loans	94	70	74
Income level and TA			
Low income countries: loans with TA (excl.	17	11	65
Low income countries: loans without TA ("	20	13	65
Middle income countries: loans with TA	12	9	75
Middle income countries: loans without TA (	39	30	77
1996 CPIA and TA*			
Low CPIA countries, loans with TA (excl.	11	10	91**
Low CPIA countries, loans without TA (")	16	9	56**
High CPIA countries, loans with TA (excl.	17	9	53
High CPIA countries, loans without TA (")	40	31	78
Note: transition countries			
Transition countries: loans with TA	19	16	84
Transition countries: loans without TA	35	27	77

Outputs at a country level, with and without Bank lending

Table 1: Capital adequacy, 1998 and 2003, with and without Bank lending

	With Bank lending for legal and regulatory reforms			Without Bank lending for legal and regulatory reforms		
Number of countries	11			19		
	1998	2003	No. of countries with changes	1998	2003	No. of countries with changes
1. Average minimum capital-asset ratio requirement	9.50	9.60	2 up, 0 down	8.40	10.20	7 up, 0 down
	Number of countries requiring deduction			Number of countries requiring deduction		
2. Items deducted from capital:						
Market value of loan losses	5	5	2 up, 3 down	10	11	5 up, 4 down
Unrealized securities losses	6	4		9	14	
Unrealized for. exchange losses	6	6		13	12	

Table 2: Comparison of classification of loans, by average number of days

	1998			2003			
	Substandard	Doubtful	Loss	Substandard	Doubtful	Loss	Number of countries with changes
Countries with Bank lending	87	173	272	64	129	256	4 up, 2 down
Countries without Bank lending	74	153	318	79	164	332	2 up, 2 down

Table 3: Indicators on strength of financial regulations for banking, transition countries

	1998	*2002*	*Change*		*1998*	*2002*	*Change*
With Bank lending				*Without Bank lending*			
Armenia	2	3-	0.66	Albania	2-	1+	-0.33
Azerbaijan	2-	1	-0.66	Belarus	1	2	1
Bosnia-Herzegovina	1	1	0	Croatia	3	2	-1
Bulgaria	3	3	0	Czech Republic	3	3	0
Hungary	4	3+	-0.67	Estonia	3	4-	0.66
Latvia	3	4-	0.66	Georgia	1	2+	1.33
Lithuania	3-	3+	0.67	Kazakhstan	2	3-	0.66
FYR Macedonia	2	3-	0.66	Kyrgyz Republic	2	2-	-0.34
Romania	3-	3+	0.67	Moldova	2	3	1
Russian Federation	3-	3-	0	Poland	4-	3+	-0.33
Tajikistan	1	3	2	Slovak Republic	3-	3-	0
Ukraine	2	2+	0.33	Slovenia	3	3	0
				Uzbekistan	2-	2-	0
Average			***0.36***	***Average***			***0.20***

Note: The EBRD indicator for each country is a composite measure, scaled from 1 to 4, with pluses and minuses; an increase from 2 minus to 2 was counted as an increase of 0.33; from a 2 to a 2 plus was 0.33, etc.
Source: EBRD Transition Report, various years

Table 4: Indicators on strength of regulations for securities markets and non-bank financial institutions, transition countries

With Bank lending				Without Bank Lending			
	1997	2003	Change		1997	2003	change
Armenia	1	2	1	Albania	2-	2-	0
Croatia	2+	3-	0.33	Azerbaijan	1	2-	0.66
Georgia	1	2-	0.66	Belarus	2	2	0
Kyrgyz Republic	2	2	0	Bulgaria	2	2+	0.33
Romania	2	2	0	Czech Republic	3	3	0
Ukraine	2	2	0	Estonia	3	3+	0.33
Uzbekistan	2	2	0	FYR Macedonia	1	2-	0.66
				Hungary	3+	4-	0.33
				Kazakhstan	2	2+	0.33
				Latvia	2+	3	0.67
				Lithuania	2+	3	0.67
				Moldova	2	2	0
				Poland	3+	4-	0.33
				Russian Federation	3	3-	-0.34
				Slovak Republic	2+	3-	0.33
				Slovenia	3	3-	-0.34
				Tajikistan	1	1	0
				Turkmenistan	1	1	0
Average			***0.28***	***Average***			***0.22***

Table 5: Change in government ownership of banks

with Bank lending for privatization		*without Bank lending for privatization*
Albania	Macedonia	Bangladesh
Argentina	Madagascar	Benin
Armenia	Malawi	Chile
Azerbaijan	Mali	Congo, Rep.
Brazil	Mongolia	Costa Rica
Bulgaria	Morocco	Czech Republic
Burkina Faso	Mozambique	Dominican Republic
Cameroon	Nicaragua	Egypt, Arab Rep.
Chad	Pakistan	Ethiopia
Colombia	Philippines	India
Cote d'Ivoire	Poland	Kenya
Croatia	Romania	Lao PDR
El Salvador	Slovak Republic	Lesotho
Georgia	Slovenia	Mauritania
Ghana	Tanzania	Mauritius
Hungary	Togo	Moldova
Kazakhstan	Tunisia	Nigeria
Kyrgyz Republic	Uganda	Oman
Latvia	Ukraine	Panama
Lithuania	Yemen, Rep.	Peru
		Sri Lanka
		Venezuela, RB
		Zambia

Table 6: List of OECD countries

Australia
Austria
Belgium
Canada
Denmark
Finland
France
Germany
Greece
Iceland
Ireland
Italy
Japan
Luxembourg
Netherlands
New Zealand
Norway
Portugal
Spain
Sweden
Switzerland
United
Kingdom
United States

List of countries for desk studies, value of operations, by Region, and as percent of lending

AFR	Value of Loans, $M
Burkina Faso	25
Cameroon	545
Chad	85
Cote d'Ivoire	200
Ghana	340
Guinea	23
Madagascar	221
Mozambique	420
Tanzania	134
Togo*	--
Uganda	226
Zambia	262
Total	**2,482**
As percent of regional lending	74%
EAP	
Lao PDR	57
Mongolia	42
Philippines	500
Vietnam	500
Total	**1,099**
As percent of regional lending	78%
ECA	
Albania	100
Armenia	285
Georgia	195
Hungary	225
Kazakhstan	540
Lithuania	179
Macedonia	215
Moldova	120
Poland	450
Romania	1,230
Slovak Republic	257
Ukraine	1,410
Total	**5,206**
As percent of regional lending	61%

LCR	Value of Loans, $M
Brazil	808
El Salvador	50
Nicaragua	150
Peru	400
Total	**1,408**
As percent of regional lending	28%
MNA	
Algeria	750
Morocco	600
Tunisia	412
Yemen, Rep	82
Total	**1,844**
As percent of regional lending	85%
SAR	
Pakistan	850
Total	**850**
As percent of regional lending	74%

Total number of case countries	37
Total value of loans in case countries	12,888
As percent of all countries borrowing for financial reforms**	54%
As percent of total Bank lending for finance **	59%

* Togo had a TA operation that was to be followed by an adjustment credit that did not materialize. Included here because the TA operation was a substantial part of Bank program in sector.

** Excluding crisis countries

Tables 1-4: Measures of contestability, 1998 - 2003

Table 1: Entry requirements: average number of licenses

	1998	2003
With Bank borrowing	7.7	7.6
Without Bank borrowing	7.4	7.3

Scale: No = 0; Yes = 1

Table 2: Minimum capital requirements: average change

	Change between 98-03
With Bank borrowing	1.04
Without Bank borrowing	1.00

Scale: decrease = 0; no change = 1; increase = 2

Table 3: Minimum capital requirements: number of countries that changed, 1998 and 2003

	With Bank lending	Without Bank lending
Decrease	5	5
No change	13	19
Increase	6	5
Total	24	29

Table 4: Restrictions on activities

	1998	2003
With Bank borrowing	2.55	2.45
Without Bank borrowing	2.53	2.62

Scale: unrestricted=1; permitted = 2; restricted = 3; prohibited = 4; higher average indicates more restrictive

Table 5: Foreign Ownership

with Bank lending	*without Bank lending*
Argentina	Benin
Armenia	Botswana
Azerbaijan	Chile
Brazil	Czech Republic
Burkina Faso	Estonia
Cameroon	Gabon
Chad	Guinea
Colombia	Kenya
Cote d'Ivoire	Korea, Rep.
Georgia	Lesotho
Ghana	Mauritania
Hungary	Mauritius
Kazakhstan	Moldova
Kyrgyz Republic	Niger
Lithuania	Nigeria
Macedonia, FYR	Peru
Madagascar	Russian Federation
Malawi	Senegal
Mali	South Africa
México	Swaziland
Mozambique	Tajikistan
Poland	Thailand
Tanzania	Venezuela
Togo	Zambia
Turkey	Zimbabwe
Uganda	

Table 6: Concentration, interest rate spread, financial sector depth, liquidity preference, and credit to the private sector*

----------*with Bank lending*----------		------*without Bank lending*----------
Albania	Lithuania	Bangladesh
Algeria	Macedonia, FYR	Benin
Argentina	Madagascar	Botswana
Armenia	Malawi	Cambodia
Azerbaijan	Malaysia	Chile
Bolivia	Mali	China
Bosnia and	Mauritania	Costa Rica
Herzegovina	México	Czech Republic
Brazil	Moldova	Dominican Republic
Bulgaria	Mongolia	Egypt, Arab Rep.
Burkina Faso	Morocco	Estonia
Cameroon	Mozambique	Ethiopia
Central African	Nicaragua	Gabon
Republic	Niger	Gambia, The
Chad	Pakistan	India
Colombia	Peru	Iran, Islamic Rep.
Congo, Democratic	Philippines	Kenya
Republic of	Poland	Lebanon
Cote d'Ivoire	Romania	Lesotho
Croatia	Russian Federation	Mauritius
Ecuador	Slovak Republic	Nepal
El Salvador	Slovenia	Nigeria
Georgia	Tanzania	Oman
Ghana	Thailand	Panama
Guatemala	Tunisia	Papua New Guinea
Guinea	Turkey	Paraguay
Honduras	Uganda	Senegal
Hungary	Ukraine	South Africa
Indonesia	Uruguay	Sri Lanka
Jamaica	Vietnam	Swaziland
Jordan	Yemen, Rep.	Syrian Arab Republic
Kazakhstan	Zambia	Togo
Korea, Rep.		Trinidad and Tobago
Kyrgyz Republic		Venezuela
Lao PDR		Zimbabwe
Latvia		

*Definitions and sources of information for these variables are in Annex 6

Table 7: Capital Markets

With Bank lending	*with Bank lending but not for capital markets*	*without Bank lending at all*
Argentina	Cote d'Ivoire	Bangladesh
Bolivia	Ecuador	Botswana
Brazil	Hungary	Chile
Colombia	Malaysia	China
Croatia	México	Czech Republic
Ghana	Pakistan	Egypt, Arab Rep.
Indonesia	Philippines	India
Jamaica	Poland	Iran, Islamic Rep.
Jordan	Russian Federation	Kenya
Korea, Rep.	Slovak Republic	Mauritius
Morocco	Slovenia	Nigeria
Peru	Thailand	Oman
Romania	Turkey	Panama
Tunisia		South Africa
Uruguay		Sri Lanka
		Swaziland
		Trinidad and Tobago
		Venezuela
		Zimbabwe

Definitions and sources of information

Table 1: Financial instability* and Bank borrowing for financial sector reforms, 1995-2002

	Countries without systemic instability	*Countries with systemic instability*
Countries that didn't borrow from Bank	Count: 9 Botswana, Gabon Costa Rica, Gambia Egypt, Senegal Ethiopía, Trinadad & Tobago India	Count: 13 Burundi, Nigeria Czech Rep., Parguay Djibouti, Sao Tome & Principe Estonia, Swaziland Eritrea, Venezuela Kenya, Zimbabwe Liberia
Borrowed from Bank		*Borrowed during instability and improved*
	Count: 18 Angola TA only, Lesotho TA only Belarus TA only, Mauritania* Central African Rep.*, Mauritius TA only Chad, Rwanda Ghana, Tajikistan TA only Guatemala, Togo* TA only Guinea*, Tunisia Hungary*, Ukraine* Jamaica*, Zambia*	Count: 15 Armenia, Mexico Brazil, Mozambique Bulgaria, Nicaragua Burkina Faso, Poland Cameroon, Russia Croatia, Slovenia Kyrgyz Rep., Tanzania Macedonia
		Borrowed during instability but didn't improve
		Count: 23 Albania, Latvia Argentina, Malaysia Azerbaijan, Níger Bolivia, Romania Bosnia-Herzegovina, Sierra Leone Cape Verde, Slovakia Congo, Dem. Rep., Thailand Congo, Rep. TA only, Turkey Ecuador, Uganda Georgia, Uruguay Indonesia, Yemen Korea, Rep. of
		Borrowed and instability followed
		Count: 2 Jamaica Ukraine

* Financial instability as defined in Caprio and Klingebiel (2003): banking systems in which much or all of the capital is exhausted, based on official statistics or the estimation of experts familiar with the banking system in that country.

Definitions and sources of information

OED/DEC model

Indicators used to measure outputs, outcomes, and impact on the financial sector

Variable	*Definition*	*Sources*	*Reference or comment*
Government ownership of banks	Share of banking assets held by government	La Porta et al (2002); Sherif et al (2001): EBRD Transition Report, various years; Barth et al (2001); Mozes (2003); Dujovne and Kiguel (2003)	Definitions vary slightly by source: in Laporta et al, it was share of assets of the top 10 banks
Foreign ownership of banks	Fraction of the banking system's assets in banks that are 50 percent or more foreign owned	Barth et al (2001); IMF, 2000	
Concentration Ratio	Share of assets held by three largest banks as percent of total assets	Various Bank documents	
Interest Rate spread	Difference between lending and borrowing interest rate	SIMA	
Financial sector depth	M2/GDP	SIMA	
Liquidity preference	Cash/M2	IFS	Lines (34+35) – Lines (24+25)
Credit to private sector	Banking claims on private sector/GDP	SIMA	

Definitions and sources of information
OED/DEC model

OED/DEC models

The basic model tested was:

$$Y_{it} = \alpha_i + \beta_{wb}t + \beta_{no\text{-}wb}t + \beta_1 adj_{it} + \beta_3 X_{it} + \epsilon_{it}$$

Where:

Y_{it} – M2/GDP, Private Credit/GDP, Cash/M2, Interest Rate Spreads, or Concentration
Country i, Year t (1...12)
α – country-specific fixed effect
wb – world bank lending for financial sector reforms between FY93 and 01
no-wb – no world bank lending for financial sector reforms between FY93 and 01
adj – number of adjustment loans
X – vector of macro/institutional controls
(inflation, CPIA, deficits, etc.)

Test: $\beta_{wb} = \beta_{no\text{-}wb}$

Variations on this model were as follows:

$$Y_{it} = \alpha_i + \beta_{wb}t + \beta_{no\text{-}wb}t + \beta_1 adj_{it} + \epsilon_{it}$$

Where the macro/institutional controls were excluded;

$$Y_{it} = \alpha_i + \beta_{wb}t + \beta_{no\text{-}wb}t + \beta_1 adj_{it} + \beta_2 ref_{it} + \beta_3 X_{it} + \epsilon_{it}$$

Where the macro/institutional controls were included, along with:

ref – vector of dummies for reform areas covered (privatization, regulation/supervision, microfinance, etc.)

Management Response

OED Review of Bank Assistance for Financial Sector Reform

April 28, 2005

I. Introduction

1. Management welcomes OED's comprehensive review of Bank assistance for financial sector reform during the decade 1993 to 2003. The review provides a rigorous discussion of the Bank's financial sector program. We are happy to note the review's key finding that the objectives of Bank assistance in the financial sector generally followed good practice. We also appreciate the recommendations of the Review. This response summarizes the main findings and conclusions of the OED Review. It then sets forth Management's comments on the analysis, conclusions, and recommendations. The Management Action Record is attached.

II. Summary of OED's Findings and Recommendations

2. The main findings of the review are:

- Bank assistance in the financial sector to most borrowing countries in the past decade is associated with improvements in bank governance, efficiency measures, financial sector depth and access to credit. Challenges remain in improving the impact of reform programs on financial depth and private sector access to credit.
- The objectives of Bank assistance generally followed good practice. Consistency in the approach to reforms should be improved, especially in the areas of payments systems, deposit insurance schemes, and capital market development.
- Outcomes of operations under the responsibility of Regional units that were members of the Financial Sector Board were significantly better than Bank-wide averages for other sectors and also than outcomes of financial sector components of multi-sector loans. The latter points to a strong quality assurance role for the sector board as well as the need for strong support from financial sector officials in borrowing countries.
- In terms of Bank support for financial sector reforms in crisis countries, which account for 50 percent of the lending reviewed, the review found that the Bank was ill-prepared to respond quickly in the earlier crises (Mexico, Thailand, Korea, and Indonesia) and better prepared in Argentina, Russia, and Turkey. OED outcome ratings of closed operations in crisis countries were significantly lower than for non-crisis lending. Collaboration with the IMF in these crisis countries has not always been smooth.

3. ***Recommendations.*** The following are the recommendations for Management:

- The Bank's financial sector anchor should provide more guidance for Bank staff and client countries in areas such as restructuring of banks, asset management companies, privatization of banks, promotion of capital markets, and strengthening of legal, regulatory, and supervisory environment, with a particular focus on implementation. The financial sector network should also be more pro-active in quality control of financial sector components in multi-sector loans.

- The Bank should develop monitorable indicators to assess progress on objectives in the area of prudential regulations and supervision for financial intermediaries.

- On support for countries prior to and following crisis, the Bank should: (i) develop a rating system, in partnership with other relevant institutions, for vulnerability to crisis, and present its risk assessments more candidly in its documents; (ii) make internal arrangements to respond better to crisis by developing guidelines for dealing with crisis, including the possibility of liquidity support to countries experiencing a crisis without stipulating ambitious reforms; and (iii) coordinate better with the IMF and other IFIs, and at the outset of the crisis, IFIs should reach quick agreement on division of responsibilities.

III. Management Comments

Impact

4. The OED Report documents that after a decade of borrowing from the Bank for financial sector reforms, most of the 96 borrowing countries have witnessed improvements in their financial sectors, in terms of ownership and governance of banks, efficiency measures, financial sector depth, and access to credit. These improvements can be associated with Bank borrowing, in that financial sector outcomes in countries that borrowed from the Bank for financial sector reforms are generally better than in countries that did not. Nevertheless, in most of the countries, the financial sectors deepened only modestly and remain relatively shallow, and private sector access to credit remains low.

5. ***The Lagged Impact of Financial Sector Reforms.*** The Bank's recent work "Economic Growth in the 1990s: Learning from a Decade of Reform,"[69] shows the importance of financial infrastructure and institutions for finance, especially in ensuring efficient credit allocation and better access to financial services. The same work showed that the greatest impact of financial reforms on the institutional changes in the sector occurred in the latter half of the 1990s with the growing movement away from state-owned banks. These reforms, along with improvements in market discipline and supervision and regulatory capacity, proved to take longer to carry through, and may have limited the gains from policy liberalization over the decade under review by OED. Moreover, reforms have often resulted in more conservative loan provisioning and write-off policies, which have caused the capital base of banks to shrink, at least initially, thus reducing their capacity to lend. This, combined with institutional changes, has encouraged more prudent lending that has led to short-run reductions in private sector credit over the period of transition following reforms. It is likely, therefore, that expecting well-developed financial systems that provide increased outreach within a decade or less of policy and institutional reforms is unrealistic as a yardstick for assessing the impact of financial sector reforms and associated Bank assistance.[70]

6. ***Macroeconomic Considerations.*** The OED review also shows that the ratio of private sector credit to GDP in countries that borrowed from the Bank for financial sector reforms increased only slightly over the period. It has also remained at a low level for most Bank borrowing countries. While this may indicate that the financial sector reforms take time to achieve their full impact, as noted above,

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[69] PREM Network, draft for comment, http://www-wbweb.worldbank.org/prem/premcompass/know_learn/economicgrowth.htm

[70] For example, the many years of financial sector reforms in Mexico appeared to have shown little improvement in the sector's support for private sector development. However, recently, credit to the private sector rose by 25 percent, albeit from a low base. This may be an indication that key institutional reforms, including with regard to the judicial process, are finally taking hold. Another example is Sub-Sahara Africa, which has undergone major financial sector reforms within the decade, and where the aggregate private sector credit to GDP ratio fell initially because of greater prudence in lending but began to pick up (now on a more sustainable basis) in 2002.

Management would also like to note the importance of macroeconomic influences. The Bank's report on the lessons of the 1990s cited earlier and other work shows that much of the increase in bank deposits over the 1990s tended to be absorbed by government and central bank debt.[71] A major reason for the rise in government debt was post-crisis bank restructurings, involving replacement of weak private sector credits, growing government deficits, and the Banks' increased net holdings of central bank debt and increased net holdings of foreign assets for hedging purposes. It is also conceivable that introduction of the Basel Capital Accord in 1988, with its favorable treatment (a zero risk weight) of government securities for capital allocation markets, may have encouraged banks to hold larger quantities of the latter.

Scope

7. ***Knowledge and Learning Activities***. The Review recognizes (footnote 11) the variety of instruments from DEC that disseminate research findings for operational use. Management would like to note that the financial sector anchor unit, FSE, has produced a wide variety of knowledge products, including global and regional learning events for client countries and staff, policy papers and numerous conferences on all manner of issues relevant to financial sector reform and development, and a help desk for the financial sector. All of these activities—which have put the Bank at the forefront of policy analysis in the Financial Sector—are also geared toward raising policy maker and staff awareness of lessons and good practices in financial sector reforms.

8. ***Role of IFC.*** The Review acknowledges the importance of close coordination within the Bank Group, although it notes that a review of IFC and MIGA activities is beyond OED's mandate. Nevertheless, Management would like to note areas where World Bank Group support was instrumental in achieving good outcomes, notably bank privatization and restructuring. For example, in many cases IFC participated in the equity of banks being privatized as part of Bank supported programs, almost always helping to bring along a suitable strategic partner. A few examples include Tanzania, Madagascar, Cameroon, Burkina Faso, Zimbabwe, Macedonia (Stopanska), Bosnia, and Romania. The review cites some of these privatizations (Macedonia and Tanzania), but does not mention IFC's involvement and contribution to a successful outcome.

9. ***Analysis of Bank Support for Crisis Countries.*** OED regards the Bank support for crisis countries highly relevant for their return to economic growth and stability. The review notes, however, that the proportion of satisfactory ratings received by crisis operations is lower than all other adjustment operations (the review period predates development policy loans) and below financial sector operations. It attributes this performance in part to project objectives that were too ambitious to be realized in the short time frame of single adjustment operations. The review also discusses the difficulties posed by Bank-Fund collaboration and the perception of some staff that Management could have given greater weight to staff views on some issues. Against this background, the review suggests ex-ante agreements between the Bank and IMF on approaches and respective roles and, within the Bank, clear lines of responsibility for coordinating the Bank's support in times of crisis. Management appreciates these lessons of experience in crisis country support, although it also notes that the stated objectives of lending at the time of crisis may not accurately capture the underlying motivation and may not fully reflect the realities on the ground at the time of crisis when quick decisions by multiple donors and policy makers may have to be made without full information.

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[71] For example, in the 25 developing and transition countries with the largest banking systems, the average ratio of net government debt to bank deposits rose by more than 60 percent, from about 13 percent in 1993 to about 21 percent in 2000. See Hanson, James (2003) *Banking in Developing Countries in the 1990s.* World Bank Policy Research Paper, No. 3168.

10. ***Readiness for Crisis Response.*** The Review notes that a 1996 internal review of the Bank's response to the 1995 Mexico crisis led to recommendations for the Bank to prepare guidelines with triggers for action, clear lines of responsibility, and procedures for concentrating resources, putting in place a core team, and providing a framework for debating and agreeing expeditiously on recommended actions. The Review further states that these recommendations have yet to be acted upon by management. While factually correct, two initiatives undertaken by Management responded to much of the essence of those recommendations. In 1996, the Bank created the Short Term Risk Monitoring Group (STRMG) as the forum to monitor regularly the short terms vulnerabilities of the Bank's client countries. The STRMG pulls together the various sources of systemic risks, including those from the financial sector, ranks countries by risk categories, and reports its findings regularly to Senior Management. Regional management puts in place monitoring systems and contingency plans for countries in the highest risk categories. In 1997, the Bank's Strategic Compact enhanced the Bank's resources for financial sector work, especially on its ability to respond to crisis situations. In 1998, the Bank also created the Special Financial Operations Department (SFO) to provide the team and the concentrated resources to respond to financial crises. While the SFO was disbanded, Management still retains the knowledge of financial sector expertise within the Bank and has the ability to pull together strong teams on short notice when necessary.

11. Recommendations

Recommendation 1. *The Bank's financial sector anchor should provide more guidance for Bank staff and client countries, in areas such as restructuring of banks (if, when, and how); asset management companies (if, when, how); privatization of banks; promotion of capital markets (if, when, and how, in conjunction with IFC on this); and for topics related to the strengthening the legal, regulatory, and supervisory environment, a particular focus on implementation. In addition, the financial sector network should become more pro-active in quality control of financial sector components in multi-sector loans.*

12. The OED review notes that Bank support has generally followed good practice and international norms. The review also notes the generally good quality and outcomes of operations under the direct control of the Financial Sector Board. According to the review, however, there have been a number of areas where the Bank's approach may have lacked coherence, in terms of differences in the process of reforms (how), sequencing (when), and the selection of specific reforms. Specific areas where a wider variation of approaches may have been more apparent were in bank privatization, payments systems, deposit insurance schemes and capital market development. In this context, the report recommends that the financial sector anchor provide good practice notes on a range of topics, including those where there is ongoing debate on various approaches to reforms. There is a large body of literature based on Bank research and policy work, as well as that of other institutions, on financial sector reform approaches, including the areas mentioned in the review, that are available to our clients and our staff. This knowledge is evolving, as empirical work carried out by the Bank and others often challenges conventional wisdom. The availability of such knowledge is important, as policy makers, with Bank support, need to adapt known best practices to local conditions, including the capacity to implement reforms. [72] Management nevertheless recognizes the need for operational guidance to staff that will distill

[72] OED recognizes in footnote 26 that its concerns about the variation of policy approaches in a number of areas does not mean that the Bank should prescribe a one-size-fits-all prescription for reforms, as there are large differences in initial local conditions, levels of economic development, government commitment to reform, and institutional capacity to implement reforms; and these factors all need to be taken into account in supporting a successful sector reform program.

in a comprehensive way best practice principles to reforming a particular policy and set of institutions. Against this background, and in view of OED's recommendation, Management will build within the anchor program an operational and ongoing practice note series as an additional tool for knowledge sharing into the anchor's work program. FSE is also strengthening its staff training program. That training will include many of these practical operational lessons. Within the Bank's existing review processes, FSE will strengthen its review efforts on financial sector programs to ensure appropriate consistency of financial sector reforms (without ignoring the need for customization). Management also notes that the planned update of the Bank's 2001 financial sector strategy will provide an opportunity for guidance to staff on key priorities and approaches in financial sector reforms.

13. ***Multi-Sector Operations with Financial Components.*** The review concludes that outcomes of financial components in multi-sector loans have lower outcome ratings on average than adjustment loans done by units linked to the Financial Sector Board, although these outcomes are not out of line with those of other sectors included in multi-sector operations. As these results could not be explained by country characteristics and differences in reforms, the review notes that these findings may be a result of a number of factors, including the presence of specialized financial sector staff in programs under the management of finance network staff, the review process, and the quality of supervision within the network. In the recent *sector strategy implementation update* (SSIU), Management highlighted the growing importance of finance components in multi-sectoral operations managed by other Sector Boards, and the need for addressing the quality assurance processes of these finance components. Within this context, the Financial Sector Network has been promoting greater partnerships with other networks on thematic activities (notably, economic policy and rural finance) to encourage a better sharing of technical expertise across networks. As part of the Bank's regular review process, FSE has also systematically reviewed multi-sector development policy and other operations, and plans to strengthen monitoring of the outcomes of these components. Finally, FSE is strengthening its Bank staff training program to reach out to non-specialists to raise awareness of financial sector issues.

> ***Recommendation 2.*** *The Bank should develop monitorable indicators to assess progress on objectives in the area of prudential regulations and supervision for financial intermediaries.*

14. Management welcomes this recommendation. FSE has undertaken a priority work program to develop financial indicators for operational use in the next few years. It will go beyond prudential regulation and supervision to include indicators of financial stability, efficiency, and access to financial services. FSE has a good starting point on indicators for bank regulation and supervision, as it has a large database[73] with more than 200 variables for over 150 countries, and it is updated every 3-4 years, and on the findings of FSAPs on bank supervision on a wide number of countries. This database has been widely used outside the Bank and has also provided the foundation for ground-breaking research on effectiveness of regulatory approaches in banking (see forthcoming book "Rethinking Bank Regulation and Supervision: Till Angels Govern" by Barth, Caprio, and Levine). Going forward, FSE (without ignoring the need for customization), with strong support from network staff will continue to implement a work program on financial sector indicators that it trusts will be helpful to the Bank and to our clients.

> ***Recommendation 3.*** *On support for countries prior to and following crisis:*
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> *(i) The Bank should develop a rating system, in partnership with other relevant institutions, for vulnerability to crisis, making use of readily available information that can be used to engage countries in crisis prevention measures and issues in crisis response. The Bank should also do a better job than in the past of presenting assessments more candidly in documents.*

[73] (http://worldbank.org/research/projects/bank_regulation.htm)

15. As mentioned above, after the East Asian crisis, the World Bank put in place the STRMG that identifies and monitors countries that Management considers vulnerable to crisis, and flags the risks to senior management on a regular basis. The STRMG has representation from all regions and several central units, notably from Finance. In ranking vulnerability, the STRMG appropriately uses a broader set of indicators that include political, macroeconomic, finance and other indicators to determine vulnerability. In view of OED's recommendation, FSE plans to provide the STRMG a more systematic framework for assessing the vulnerabilities arising from the financial sector. This work will draw on research, FSAPs, the IMF's financial soundness indicators (see below), and other analytical work. In addition, the Bank and the IMF use the results of FSAPs to engage authorities in identifying sources of vulnerability in the financial sector and ways to decrease vulnerability.[74] In its review of CASs and development policy operations, FSE also systematically integrates findings from FSAPs, including recognition of vulnerabilities in the financial sector. Management will continue to pursue these efforts.

16. ***IMF Indicators.*** The IMF, consistent with its mandate, is currently working on deepening its financial soundness indicators. Bank staff have been working with the IMF on the development of these indicators. Bank Management will work on ensuring that it maintains the partnership with the IMF in this area and will draw upon these indicators in improving assessments of vulnerabilities in the financial sector.

> *(ii) The Bank should make internal arrangements to respond better to crisis by developing guidelines for dealing with crisis, which should include the possibility, if circumstances warrant, of lending liquidity support to countries experiencing a crisis without stipulating ambitious reforms (that may not be realized) as justification for the loan.*

17. The OED Review notes that the Bank has been better equipped to respond to the more recent crises in Russia, Argentina, and Turkey than it had been in the earlier crises. Staff members who have expertise in dealing with financial crisis are now present in both the anchor and the Regions. In addition, internal papers have been written and disseminated on the lessons of experience on this subject. Having said this, Management recognizes the problems associated with maintaining an appropriate level of knowledge in systemically important countries where there is no ongoing financial sector program. One of the roles of the financial sector Vice Presidency is to coordinate with Regional management to address these risk management concerns.

18. ***Reform Versus Liquidity Support.*** Supporting countries with a series of development policy loans, perhaps starting with one that seeks only to supply liquidity and establish the framework of future supports, is one of the options that the Bank can use in time of crisis. As the review itself points out, this was the approach the Bank used in assistance to Korea. Going forward, Management will draw upon this approach as appropriate, in coordination with the IMF. Management wishes to highlight an important lesson of experience in assisting crisis countries: the onset of a crisis creates windows of opportunity to address fundamental issues. The Bank's response in a crisis situation will, therefore, require judgment on how it can balance its assistance to support realistic opportunities for reform while also providing urgent liquidity support. The framework and internal guidelines for dealing with crisis will be developed in conjunction with the ongoing update of the financial sector strategy.

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[74] Ultimately, however, following up on FSAP recommendations depends on the country's ownership of the reforms.

(iii) Coordination with the IMF and other IFIs in crisis assistance needs to be improved, and at the outset of the crisis, the IFIs should reach quick agreement on division of responsibilities.

19. Management has continued to work on improved coordination with the IMF. The Review does not note the creation and ongoing operation of the Financial Sector Liaison Committee to oversee joint Bank-IMF programs and the fact that Bank-Fund cooperation has, in fact, significantly improved over the past five years, partly because of the FSAP program. On coordination in times of crisis, Management is aware that one of the lessons of support for crisis countries is the importance of IFIs working together as a team with agreed and assigned lead and secondary responsibilities for the reform program at a time of crisis. Thus, Management considers sustaining these strong partnerships with the IMF and other IFIs very important to enable joint programs and facilitate division of responsibilities at critical times, including at the outset of a crisis.

20. ***Management Action Record.*** The Management Action Record provides more specific responses to OED's recommendations. It is attached below.

OED Review of Bank Assistance for Financial Sector Reform
Management Action Record

OED Recommendation	Management Response
The financial sector anchor should also be more pro-active in quality control, especially for financial sector components of multi-sector loans. The anchor should also provide clear guidance for Bank staff and client countries on a range of issues connected with financial sector reforms, including privatization of banks, restructuring banks (if, when, how), use of asset management companies; promotion of capital markets; and other topics related to the legal, regulatory, and supervisory environment.	Management is putting in place an operational practice note series as an additional tool for knowledge management for financial sector support. Management will consider this action complete once this series is firmly established, anticipated at the end of FY06. Within the Bank's existing review processes, financial sector staff will strengthen their review of the finance components in multi-sector projects with a view to providing systemic solutions to quality assurance. This will be done mainly by FS staff in the Regions, supported as necessary by anchor staff. FSE will use the Sector Strategy Implementation Update and the revised strategy to report on progress; Management will consider this action complete when FSE reports that it is a well-established practice. FSE is strengthening its Bank staff training program and improving its outreach to staff in other networks. Management will consider this action complete after one year of implementation of the strengthened training program, the end of FY06.
The Bank should develop monitorable indicators to assess progress on objectives, especially in the area of strengthening prudential regulations and supervision for financial intermediaries.	FSE, in collaboration with regional finance units, is developing financial sector indicators for operational use as a priority task in the next few years. Indicators will also be developed on access to finance. Management will consider this action complete when these indicators are available as reported in the Sector Strategy Implementation Update.
On support for countries prior to and following crises, the Bank should develop a rating system, in partnership with other relevant institutions, for vulnerability to crisis, making use of readily available information, and should use the rating system to try to engage countries in developing policies and measures for crisis prevention and response. The Bank should also develop guidelines for providing assistance following crisis, and should include the possibility, if circumstances warrant, of lending liquidity support to countries experiencing crisis without stipulating ambitious reforms. Finally, as part of crisis response, the Bank and other IFIs should	Drawing on existing research in the Bank and on the IMF's financial sector soundness indicators, FSE will produce an operational note to provide a framework for assessing financial sector vulnerabilities. This framework will be used in support of the broader STRMG framework for assessing country risks. Management will consider this action complete when the framework is available and in use, as reported in the Sector Strategy Implementation Update. The Bank and the IMF will continue to use FSAPs to engage authorities in identifying sources of financial

OED Recommendation	Management Response
reach quick agreement at the outset of the crisis, on the division of responsibilities.	sector vulnerabilities and ways to decrease these risks. Since this action is ongoing, Management considers it complete. The framework and internal guidelines for dealing with financial sector support in crisis situations will be developed in conjunction with the ongoing update of the Financial Sector Strategy. This action will be considered complete when these guidelines are cleared by senior management and available to staff.

Chairman's Summary
Committee on Development Effectiveness

OED Review of Bank Assistance for Financial Sector Reform and Draft Management Response to the OED Review of Bank Assistance for Financial Sector Reform

(Meeting of March 30, 2005)

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1. On March 30, 2005, the Committee on Development Effectiveness met to discuss the report entitled *OED Review of Bank Assistance for Financial Sector Reform* and the *Draft Management Response to the OED Review of Bank Assistance for Financial Sector Reform.*

2. **Background.** Between FY93 and FY03 the World Bank assistance for financial sector reforms (FSR) was supported by some US$56 billion in lending, or 24 percent of the Bank's total commitments. Most of the lending was embedded in multi-sector loans. Over the period, lending for financial sector reform (FSR) declined, due mainly to the sharp drop in lines of credit (LOC). CODE discussed OED review on LOC on October 13, 2004. The earlier 1998 OED review of Bank support for financial sector reform presented several recommendations that management gave prominence in the financial sector strategy of 2001.

3. **OED Finding and Recommendations.** The OED review examined the Bank assistance to financial sector reform over the decade. The OED review found that (i) the objectives of Bank assistance for FSR were generally consistent with good practice in terms of reducing government ownership of banks, improving prudential regulations and strengthening banking supervision; (ii) consistency within a country and coherence of the Bank's approach to FSR across countries need improvements; and (iii) there is wide variation in Bank support in payments systems, deposit insurance schemes, and capital market development. The report also highlighted that outcomes of financial sector programs – in terms of financial depth and credit to the private sector had been weaker than had been anticipated, partly because of continuing instability in the macro-economic situation, and partly because further reforms were needed.

4. OED recommended that the Bank should (i) provide more guidance to Bank staff and client countries, in areas such as restructuring of banks, asset management companies, privatization of banks, promotion of capital markets and for strengthening the legal, regulatory and supervisory environment; (ii) develop monitorable indicators to assess progress on objectives in prudential regulations and supervision for financial intermediaries; and (iii) develop a rating system for vulnerability to crisis, make internal arrangements to respond better to the crisis, and improve coordination with the IMF and other International Financial Institutions (IFIs) in crisis assistance. OED found in the current review that a prior management recommendation for the Bank to prepare guidelines for crisis situations has not been implemented and continue to remain valid.

5. **Management Response.** Management is preparing an operational practice note series as an additional tool for knowledge management for financial sector support. The financial sector anchor unit (FSE) is committed to (i) strengthen the review of the finance components in multi-sector projects and provide systemic solutions to quality assurance, and the training program while improving outreach to other network staff; (ii) collaborate with regional finance units in developing financial indicators for operational use; and (iii) produce an operational note in collaboration with the Fund and provide a framework for assessing financial sector

vulnerabilities. Both the Bank and the Fund will continue using Financial Sector Assessment Programs (FSAPs) to engage authorities in identifying sources of financial sector vulnerabilities. The framework and internal guidelines for dealing with financial sector support in crisis situations will be developed in conjunction with the ongoing update of the financial sector strategy.

6. **Overall Conclusions and Next Steps.** Members welcomed the opportunity to discuss the report, which they praised for its high quality and candor and agreed with its recommendations. They also expressed their appreciation for management's draft response (MR). They noted that the report and the MR together appeared to be a good basis for updating the financial sector strategy. Some members felt that the coverage of the evaluation report could have been more complete, with the inclusion of FSAPs and Report on the Observance of Standards and Codes (ROSC) as well as of IFC and MIGA activities. Suggestions were made for (i) highlighting further the critical role of the broader macroeconomic situation, as well as structural and institutional factors in determining the outcomes of Bank operations; and (ii) deepening the analysis on country-wide impacts such as those related to investment and employment generation.

7. Members supported recommendations for improving Bank's operational consistency and policy coherence as well as coordination with the IMF. They were concerned with OED's opinion that management had not implemented a recommendation in a management document several year ago to establish clear guidelines for responding to crisis situations and requested management clarification. Management noted the establishment of the short-term risk monitoring function in the Bank and a close working relationship on financial sector issues with the Fund in response to the financial crisis of the 1990s. Members had some questions regarding ongoing work on indicators of crisis vulnerability. Finally, members sought the views of OED and management on policy implications going forward. The committee endorsed the OED report and the MR.

The main issues raised during the meeting were the following:

8. **Coverage of the Report.** Many members and speakers noted the reports findings on the positive outcome of the Bank's assistance in financial sector reform. In discussing the findings on the weaker impact of financial sector reforms on outcomes – such as financial sector depth and credit to the private sector some members felt that other factors such as the macroeconomic situation, political context, corporate governance could be important contributory factors. Some members also felt that a discussion of FSAP's and ROSC's should have been included in the study and a review of IFC and MIGA work related to the financial sector could have been included here as well. *OED concurred that the macroeconomic situation could partially explain the weak impacts. OED also informed CODE that the review of the FSAP program will integrate the findings from reports on standards and code, as well as the Bank's ESW. In addition, it was mentioned that two evaluation briefings were being prepared on IFC equity investment in the banking sector and leasing.* Some members highlighted that the evaluation of financial sector initiatives should be linked to the judicial sector, enforcement of contracts, accounting and auditing systems, corporate finance and corporate governance, and other aspects, as well as considering the role of the private sector. *OED responded that it will conduct an evaluation on judicial reforms, which will cover extra-judicial issues, such as out-of-court resolution of non-performing financial assets.* A member felt that the report should have addressed the issues of asymmetric information in client countries, promotion of global and regional integration, impact on small economies, and investment promotion and employment creation. Another member regretted that there was no specific MDG target on financial sector. *Management found that financial sector issues relate to MDGs in areas such as promotion of growth and support to private sector, and link to income distribution.*

9. **Country-Wide Impact.** While recognizing the challenges of reducing the government's role in financial intermediation, several members highlighted issues of sequencing; governments' short-term needs to finance the huge costs of reform including restructuring of staff, branches and portfolio cleanup; and country specific context. Other situations, for example, where state-owned banks support state-owned enterprises, could have been covered in the report as well. In this regard, a few members recommended addressing the issues of sequencing or prioritization of reforms in the financial sector strategy update. A member sought clarifications on the difference of outcomes between first and second generation reforms in the financial sector, particularly on the Bank's role to improve developmental impact of the second phase of reforms taking into account the OED's recommendations. Management indicated that second generation reform is the most critical issue shaping the financial sector strategy update because of their multi-sector dimension, cross-sectoral nature and high visibility, as well as need for strong country ownership.

10. **Lending and Non-Lending Instruments.** One member noted the important lesson regarding the need for selectivity in identifying technical assistance (TA) opportunities and country ownership, which emerged from the outcomes of adjustment loans accompanied by TA loans; on the one hand, in countries with limited institutional capacity, adjustment loans accompanied by TA loans had better outcomes than adjustment loans without TA. On the other hand, in countries with better institutional capacity adjustment, loans accompanied by TA loans had significantly worse outcomes than adjustment loans without TA loans. While preferring more emphasis on lending programs, another member wondered whether new lending instruments could be developed that could benefit from ESW and could support financial sector reforms in an innovative way. Management recognized that there is increasing need for advisory services. However, the Bank's lending instruments to promote financial reforms are somewhat limited in a non-crisis context. Management felt that a more strategic coordination with IFC would be desirable, given the latter's flexibility, knowledge of the private sector, and range of financial and advisory instruments.

11. **Coordination and Coherence.** Many members and speakers suggested improving the Bank's operational consistency and policy coherence; strengthening coordination with the IMF based on each institution's comparative advantage; and broadening coordination with other IFIs. *Management noted the concerns related to consistency in designing early reform packages, which were attributed to inadequate assessment of the market conditions such as competitiveness of the financial services industry, and lack of collateral laws or insolvency regimes. Regarding coordination with the IMF, management highlighted that the Bank concentrates in areas where it has greater advantages such as in TA and capacity building for bank supervisors, without competing with the IMF or Bank for International Settlement.* Speakers recognized the importance of country ownership and accountability as basis for support, and in implementation of reform initiatives. A few members sought more information on the set of indicators being developed to better track progress in the financial sector, and on the Bank's work with the IMF to strengthen the IMF financial indicators. *Management responded that an extensive database was built covering about 200 variables of financial regulation and supervision in 150 developed and developing countries. This database is available to outside sources. Management also shared that the Bank (Finance and PSD) in collaboration with outside partners (IMF, UN) was developing indicators to assess progress in areas like outreach of financial services, depth and breadth of the financial system, and diversification. These indicators will be used in the context of the FSAP program.*

12. **Bank Support to Countries Facing Financial Crisis.** Members requested management to address the need for expanding guidance (i) to respond to crisis situations as previously recommended by a review commissioned by management; and (ii) to provide liquidity support,

which was not fully addressed in the MR although they recognized the difficulties in developing universal guidelines. *Supplementing MR regarding this matter, management indicated that Bank's experts have been identified within the regions, FSE, and other networks, particularly PREM, who are prepared to respond to financial crisis situations. Management also commented that lessons learned in past crisis were applied in dealing with recent cases in Turkey and Argentina. Moreover, the Bank has developed a system for monitoring country risk, it has improved coordination with the IMF and other IFIs, and it has redesigned the lending instrument such as the development policy lending.* One member noted the challenges in evaluating the outcomes of the Bank assistance to crisis countries because the implementation of reforms and the full recovery of the financial sector, especially credit to private sector, require time. *Management acknowledged that there is a time lag for increasing credit to the private sector and increased outreach of financial services that may be attributed to a wide range of factors from weak institutional capacity to macroeconomic policies.* Other speakers highlighted the importance of Bank policy dialogue with the countries in non-crisis but potentially vulnerable situations. Regarding the recommendation to develop a rating system for vulnerability to crisis, a member observed that there were enough analytical tools, including those at the Fund in addition to the Bank.

Chander Mohan Vasudev
Chairman