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INDEPENDENT EVALUATION GROUP

THE WORLD BANK

IEG Review of World Bank Assistance for Financial Sector Reform

INDEPENDENT EVALUATION GROUP

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WORLD BANK INDEPENDENT EVALUATION GROUP

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Foreword

After more than a decade of borrowing from the World Bank for financial sector reforms, most of the 96 borrowing countries have witnessed improvements in their financial sectors, in terms of the 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 during 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 fiscal years (FYs) 1993 and 2003, Bank assistance for financial sector reforms was supported by about US$56 billion in lending, or 24 percent of the Bank's total commitments; most of this lending was embedded in multisector loans. During 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 Independent Evaluation Group (IEG) review of World Bank assistance for financial sector reforms finds that the objectives of Bank assistance generally followed good practices 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 has been weak at times—e.g., advocating the privatization of banks while simultaneously supporting the expansion of government ownership of banks—and should be improved. The coherence of the Bank's approach to financial sector reforms across countries has also been weak at times—e.g., 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 an ad hoc approach to prioritization for Bank support, include payments systems, deposit insurance schemes, and capital market development. The

combination of ongoing debates within the Bank (e.g., whether and how to support deposit insurance schemes), an 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 that cannot be fully explained by differences in country circumstances or the willingness to reform.

Outcomes of loans classified under the Bank's Financial Sector Board (FSB) were significantly better than the outcomes of financial sector components of multisector 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 to crisis countries for financial sector reforms constitute about 50 percent of the lending reviewed here. Crisis lending differs from noncrisis lending in several important respects. The former is prepared under stressful conditions; speed is important; sometimes it is done without prior analysis or dialogue with the government about issues; and it is typically part of a large, publicly announced international rescue package. Because of these exceptional factors, IEG examined crisis lending separately, in 14 countries.

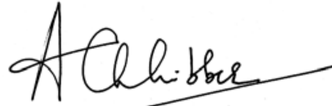
IEG found that the Bank was ill-prepared to respond quickly in the earlier crises in Mexico (1994); and in Thailand, Korea, and Indonesia (1997); but was better prepared in Argentina, Russia, and Turkey. Even in countries where it recognized signs of vulnerability (Indonesia and Turkey), official Bank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

Collaboration with the International Monetary Fund (IMF) in countries that experienced crises 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 division of duties 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 crises remains a challenge. Finally, recommendations from an earlier, high-level, internal Bank review suggested that the Bank should prepare guidelines on the triggers for action as well as clear lines of responsibility in crisis situations; these recommendations have not been implemented and still remain valid today.

Recommendations

- The Bank's FSB should provide more guidance for Bank staff and client countries in areas such as the restructuring of banks (if, when, and how); asset management companies (if, when, and how); the privatization of banks; the promotion of capital markets (if, when, and how, and in conjunction with the International Finance Corporation); and on topics related to strengthening the legal, regulatory, and supervisory environment, with a particular focus on implementation. In addition, the Financial Sector Network should be more proactive in its quality control of financial sector components in multisector 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 crises, the Bank should, in partnership with other relevant institutions, develop a ratings system for vulnerability to crisis, using

readily available information 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 develop guidelines for dealing with crises, including the possibility, if circumstances warrant, of lending liquidity support to countries experiencing a crisis without stipulating ambitious reforms (which may not get achieved) as justification for the loan.



Ajay Chhibber
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Preface

This evaluation presents an independent assessment of the Bank's support for financial sector reforms during the period FY93–FY03.

It is the second part of a two-part evaluation; the first part of the assessment looked at lines of credit.

This volume focuses on Bank lending for financial sector reforms, including lending categorized both as being under the financial sector and as financial sector components of multisector 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 undergoing crises.

The evaluation was done using information obtained from a database developed by IEG on all Bank lending for financial reforms, background papers on selected topics, and country case studies based on desk reviews.

The report was 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). The Management Response is attached as Appendix G to this report.

This evaluation was discussed at the Committee on Development Effectiveness (CODE) meeting held on March 30, 2005.The Chairman's Summary is attached as Appendix H.

Executive Summary

This Independent Evaluation Group (IEG) review of World Bank assistance for financial sector reforms finds that the objectives of Bank assistance generally followed good practices 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.

The 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 the Bank gives to support for payments systems, deposit insurance schemes, and capital market development. The combination of ongoing debates within the Bank (e.g., whether and how to support deposit insurance schemes), the 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 that cannot be fully explained by differences in country circumstances or the willingness to reform.

After well over a decade of borrowing from the Bank for financial sector reforms, most of 96 borrowing countries have witnessed improvements in their financial sectors. These improvements can be associated with Bank borrowing. In most of the countries, however, 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 about US$56 billion in lending, or 24 percent of the Bank's total commitments; these figures take into account lending that is categorized by the Bank as being under the Financial Sector Board (FSB) as well as components of multisector loans categorized as being under other boards (mostly Economic Policy). These types of support are 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.

Most of the lending for financial sector reforms was embedded in components of multisector loans. Out of 385 loans containing support for these reforms, only 36 percent (137 loans) were in the financial sector; the remainder were components of adjustment and

technical assistance (TA) loans and lines of credit (LOC) in other sectors. During the period FY93–FY03, lending for financial sector reforms declined, owing mainly to the sharp drop in LOC. Apart from LOC, support for financial sector reforms through adjustment and TA lending declined only slightly, with a more noticeable drop in (formal) nonlending assistance.

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

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 do not. 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.

At the country level, IEG examined whether Bank borrowing could be associated with changes in outputs, outcomes, and impacts. *Outputs* were defined as decreases in government ownership of banks and stronger regulatory and supervisory frameworks for banking. *Outcomes* were defined as: (i) market structure, as measured by concentration rates; (ii) contestability, as measured by the ease of entry and absence of restrictions on activities (freedom to compete) in banking; (iii) efficiency, as measured by interest rate spreads; and (iv) the health of the banking system, as measured by capital adequacy and nonperforming loans. Finally, *impacts* were defined as (i) financial sector depth in banking, measured by the money supply as a proportion of gross domestic product (GDP) and the 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 deficits, and institutional capacities. IEG also tested whether the results were different for countries that borrowed as compared with those that did not borrow for financial sector reforms during 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 do not borrow, the results of the econometric analysis show an association of Bank borrowing with outcomes, rather than causality, although further econometric tests (including treatment-effects regressions, which explicitly account for self-selection, and propensity score-matching techniques) provided evidence that reinforce the main findings.

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 client countries that were also privatizing their banking systems but 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 nonbank 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 the privatization of banks, support from the Bank 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 commitments to change their ownership, and this has also led to poor results, such as the reappearance of poor loan portfolios and insolvencies.

Improvements in laws and regulations governing the financial sector were uneven in borrowing countries. Between 1998 (the earliest year for which systematic information is available) and 2003, capital requirements remained about the same, while rules on loan classification were stricter; the opposite was true for nonborrowing 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 countries than in nonborrowing ones. On the critical aspect of implementing laws and regulations, there is little information, and thus it is 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 the Basel Core Principles.

Outcome at the Country Level

Concentration levels have decreased significantly since the early 1990s for all countries, although more so in nonborrowers, while contestability, as measured by lower restrictions on banking activities, since 1998 (the earliest year for which data are available) increased in borrowing countries and decreased in nonborrowing countries. Interest rate margins (since the early 1990s) narrowed significantly in borrowing countries and did not change in nonborrowing countries. Finally, data on the health of financial systems are not sufficient for a comparative analysis of countries "with" and "without" borrowing, but they do point to an improvement (nonperforming loans decreased, capital adequacy increased) in the borrowing countries. Overall, Bank borrowing by countries is associated with good outcomes and, where information permits comparisons, with mostly better outcomes than in nonborrowing countries.

Impact at the Country Level

The positive results on outcomes discussed above do not translate into equally positive findings on impacts during the last decade, although developments have been in the right direction. Financial sectors became deeper in countries that borrowed for financial sector reforms during the period, although not significantly more so than in nonborrowing countries. In any case, they remain, on average, relatively shallow—for example, M2/GDP was below 40 percent in Bank borrowers in 2002 (as compared with about 80 percent in the Organisation for Economic Co-operation and Development (OECD) countries). Liquidity preference or cash as a proportion of the money supply (seen as the inverse of public confidence in the banking system) decreased significantly (at roughly the same rate as in nonborrowing countries), which could be the result of reforms aimed at downsizing, restructuring, and privatizing banks and proactive efforts by governments to regulate and supervise them.

Credit to the private sector (as a percentage of GDP) grew at an annual rate of 0.4 percent per year in 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 for the modest growth in credit is that the process of strengthening both governance and prudential regulations could lead to greater prudence in lending. Therefore, although the growth is slower than in nonborrowing countries, it may be more prudent lending. On average, though, credit to the private sector remains very low—at below 30 percent of GDP in the 62 borrowing countries for which information is available (in 17 of these countries, it was below 10 percent). As a

point of comparison, it was over 110 percent in OECD countries. Finally, IEG found no pattern in terms of improved stability of financial systems in countries that borrowed from the Bank relative to those that did not.

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

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

IEG found that the Bank was ill-prepared in Mexico (1994), and in Thailand, Korea, and Indonesia (1997) to respond quickly; but was better prepared in Argentina, Russia, and Turkey. Even in countries where it recognized signs of vulnerability (Indonesia and Turkey), official Bank documents gave optimistic assessments of risks. Although the stated objectives of the loans were similar in scope and nature to financial sector reforms pursued in noncrisis countries, outcome ratings of the 31 closed operations (US$18 billion) were lower by about 15 percentage points than outcomes of noncrisis lending. This is a somewhat surprising finding given the high relevance of the objectives and the fact that crises often induce or strengthen the commitment of governments to address the problems. The lower ratings are likely the result of the need to state overly ambitious objectives in order to justify the large loans needed to fulfill a preannounced assistance package (see Chapter 10).

Collaboration with the International Monetary Fund (IMF) in countries that experienced crises 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 division of duties 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 crises remains a challenge. Finally, IEG found that prior recommendations for the Bank to prepare guidelines on the triggers for actions and clear lines of responsibility for crisis situations have not been implemented and still remain valid today.

Recommendations

- The Bank's FSB should provide much clearer guidance for Bank staff and client countries and the Financial Sector Network should become more proactive in its quality control of financial sector components in multisector 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 on which guidance is needed include the restructuring of banks (if, when, and how); asset management companies (if, when, and how); the privatization of banks; the promotion of capital markets (if, when, and how, in conjunction with the International Finance Corporation); deposit insurance (what to do if the government seeks support, issues to consider) and topics related to strengthening the legal, regulatory, and supervisory environment, with 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) the implementation of laws and regulations governing the financial sector; (iii) strengthening the supervision of financial intermediaries; and (iv) increasing access to credit by

improving collateral laws and creditor rights, and providing technical assistance and training.

- The Bank should develop monitorable indicators to assess progress on achieving objectives in the areas of prudential regulations and supervision for financial intermediaries.
- In terms of supporting countries prior to and following a crisis, the Bank should do the following:
  - (i) In partnership with other relevant institutions, develop a ratings system for vulnerability to crisis, using readily available information 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.
  - (ii) Make internal arrangements to develop guidelines for dealing with crises, including the possibility, if circumstances warrant, of lending liquidity support to countries experiencing a crisis without stipulating ambitious reforms (which may not get realized) as justification for the loan.
  - (iii) Improve coordination with the IMF and other IFIs extending crisis assistance, and at the outset of a crisis the IFIs should reach quick agreement on the division of responsibilities among themselves.

ACRONYMS AND ABBREVIATIONS

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
EFSAL	Enterprise and Financial Sector Adjustment Loan
ESW	Economic and Sector Work
FSAC	Financial Sector Adjustment Credit (general name)
FSAP	Financial Sector Assessment Program
FSB	Financial Sector Board
FSE	Financial Sector Network
FY	Fiscal Year
GDP	Gross Domestic Product
IEG	Independent Evaluation Group (formerly OED)
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
LAC	Latin America and the Caribbean Region
LOC	Lines of Credit
MNA	Middle East and North Africa Region
NPL	Nonperforming Loan
OD	Operational Directive
OECD	Organisation for Economic Co-operation and Development
OED	Operations Evaluation Department (changed to IEG)
QAG	Quality Assurance Group
SAC	Structural Adjustment Credit
SAL	Structural Adjustment Loan
SAR	South Asia Region
SFO	Special Financial Operations
TA	Technical Assistance
WDI	World Development Indicators

Introduction

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.

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 sectorwide reforms, particularly in banking, but also in capital market, pension,[1] and insurance reforms.

The present review examines Bank assistance for financial sector reform during the past decade. Between FY93 and FY03, the Bank made financial sector loans (excluding pension reforms) totaling about 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 in loans involved some financial sector reforms, representing 24 percent of Bank lending during this period.

Objectives of the Review

This review answers a series of questions:

- What has Bank lending for financial sector reforms looked like in the aggregate, over time, and by Regional department, including such lending as part of multisector loans?

Between FY93 and FY03, about one quarter of all Bank lending included support for financial sector reforms.

- Are Bank *policies* on financial sector reforms well defined and do they follow good practices, as defined by the literature?
- Have the *actions* of the Bank followed good practices, 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, or 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 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–FY03, was characterized by several 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 were the outcomes, and what lessons can be drawn for the future from these experiences?

Caveats on Scope of Review

This review is one of a series of ongoing Independent Evaluation Group (IEG) reviews covering financial sector issues. In 2005, IEG 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 an analysis of LOC. In addition, IEG is currently reviewing the Financial Sector Assessment Program (FSAP), a major joint initiative of the Bank and the IMF; it is the most significant form of Bank nonlending assistance since 1999 (in terms of resources and use of Bank staff) in the financial sector. The present review, therefore, does not cover the FSAP. Finally, Bank support for pension reform is the subject of a separate ongoing IEG review and is not discussed here.

Research finds that the overall level of financial sector development is more important for economic growth than whether the financial sector is dominated by banks or a capital market.

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.

A final caveat is that the Bank is only one source of support for financial sector reforms and not always the most important; thus, separating out the Bank's contribution from the context of joint efforts by many donors is a challenge. Given IEG's mandate to evaluate Bank activities, it was beyond the scope of this review to examine the extent of cooperation within the World 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 during the past decade in support of financial sector reforms, it is important to examine the results of these efforts.

Inputs

Nine background papers were commissioned for this review; they are listed in the references at the back of the report and will be available on IEG's website. These papers, combined with desk reviews of Bank assistance (lending and nonlending) 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 the IMF's *International Financial Statistics*, central banks, and IMF and Bank sector reports.

Organization of the Review

Chapter 2 summarizes the literature on factors associated with financial sector development,

reviews Bank guidelines and strategies 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 experiences, respectively, in 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 crises. Part II focuses on results at the country level: Chapter 8 examines changes in bank ownership and the prudential and regulatory regime of financial sectors. Chapter 9 focuses on the incentive framework, including regulatory measures and banking supervision. Chapter 10 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 the health of the banking system; Chapter 11 examines the impact at a country level in terms of financial sector depth, liquidity preference, access to credit, and stability. Chapter 12 draws conclusions and presents recommendations for the future.

What Constitutes Good Practice?

Historical Perspective

Ideas about the basic ingredients of a sound financial system have evolved over time. In the early 1900s, free banking, whereby banks could set up and operate without government oversight,[1] was popular. Until the late 1980s, most OECD member countries had substantial government ownership of banks; more than a few still do today.[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 (introduced in the United States in 1934, following widespread bank failure), and is the subject of debate and research concerning its impact on financial sector stability. Also, the emphasis on regulatory requirements and the supervision of financial institutions may be shifting toward greater reliance on the role of "market forces" (discussed below).

Literature Review[3]

There are, however, certain tenets on which theoretical and empirical literature agree. One is that *macroeconomic stability is important for financial sector development*. Both theory and empirical evidence support the view that financial depth tends to increase with stability.

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 allocations 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, and Stiglitz, 2001; World Bank, 1989).

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

Financial Market Structure

Research on the best mix of financial institutions, in terms of bank-based systems versus market-based (capital markets), shows a striking lack of results. The debate on the issue started in the early 1960s (Gerschenkron, 1962) and continues to this day.[4] Although theoretical arguments have been advanced for one type over the other, recent empirical research

Recent evidence suggests that in weak institutional environments, explicit deposit insurance is associated with a higher incidence of banking crisis.

suggests that neither bank-based nor market-based financial systems are better associated with higher growth rates for firms, industries, or the economy. Levine (2002) examined GDP growth rates; Beck and Levine (2002) looked at industry growth rates; and Demirguc-Kunt and Maksimovic (2002) focused 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.

For banking systems, the findings from research are ambiguous on whether more concentration or more competition leads to more efficiency and/or more stability. Theory suggests that a 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 greater concentration has a negative effect on access to finance, although the results do not 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 crises, which is likely due to the diversification in banks' lending and products rather than reduced competition. Finally, recent empirical research suggests that measures of concentration are less relevant for 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).

The Bank has sometimes been overly focused on bank privatization as an end in itself and too little focused on having well-managed banks with appropriate incentives.

Thus there is no compelling argument for reducing banking concentration; the appropriate degree of concentration depends on institutional 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

Although theoretical arguments exist for the state control of banks (see, for example, Calomiris and Himmelberg, 1993; Greenwald and Stiglitz, 1986; Stiglitz, 1994; and Caprio and Honohan, 2001), *empirical research finds that state ownership is associated with poorer financial sector performance than privately dominated systems*. Poorer performance means less financial sector development, slower growth, lower productivity, and greater tendency to banking crises (Barth, Caprio, and Levine, 2001a and 2001b; LaPorta, Lopez-de-Silanes, and Shliefer, 2002; and Beck, Demirguc-Kunt, and Levine, 2003). At the same time, however, the privatization of state banks has not always been successful. Studies show postprivatization 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 11 transition countries in Central and Eastern Europe (Bonin, Hasan, and Wachtel, 2003). However, experience also includes 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.[5] In both countries, the banking system experienced subsequent crises: banks were either closed or renationalized and privatized a second time with more success.

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

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 it is in privately dominated banking systems. In Argentina and Chile, for example, public banks lend less to small businesses than do other banks (Clarke, Crivelli, and Cull, 2003; Clarke, Cull, and Martinez-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 do large domestic banks, although, on average, all foreign banks lend less than do domestic banks to small firms. In addition, studies have found that foreign banks may concentrate on certain market segments, so increasing foreign ownership could 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 the entry of foreign banks, but it also shows that the quality of the purchaser matters for outcomes.

Incentive Framework for Banking

An incentive framework would include regulation and supervision, safety nets such as deposit insurance, a 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 requires the external auditing of banks, the rating of banks by international rating agencies, and the disclosure of accounts and other types of information. Moreover, restrictions on bank activities and entry restrictions for domestic and foreign banks are associated with worse performance of banking systems. Theory and empirical research concur that private monitoring—with incentives such as no explicit deposit insurance and requirements for accounting and auditing—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 needed for market participants to monitor financial institutions*.

The Bank deserves credit for situations where it reduced the amount of lending or did not lend at all when the client was not committed to reforms.

Theory argues both for and against deposit insurance. It can make runs on banks less likely and therefore serve as a stabilizing influence on banking systems. In addition, if governments already provide an implicit guarantee on all deposits, establishing an explicit system can both protect some depositors while limiting the government cost of 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

The Bank sometimes sends mixed signals on reforms within a country.

The Bank appears to have an ad hoc approach to many reforms and "speaks with many voices" on important matters of financial sector policy.

of banks (Demirguc-Kunt and Detragiache, 2002; Honohan and Klingebiel, 2003; Martinez-Peria 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 presumably belong to wealthier clients or are interbank deposits; in this case, it would be generally wealthier clients who are uncovered and who have an incentive to monitor the banks*.

Although there is some debate about 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, the 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 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 1999).

Causes of Crises

Finally, this review examines the Bank's role in assisting countries experiencing crises. 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 followed a wave of liberalization in the 1980s and early 1990s (supported by the IFIs, which, to varying degrees, included the opening of current accounts and capital accounts, freeing exchange rates, freeing interest rates, and lifting restrictions on entry into the financial sector and on lending by domestic banks, thereby creating the conditions for rapid credit growth and larger and more volatile global capital flows.

Outcomes are significantly better for loans under the Financial Sector Network than for financial components of multisector loans under other Networks.

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 a discussion of the literature on this subject). Many authors examining the causes of crises agree, however, that liberalization per se has not been the underlying culprit.[6] Mishkin (1999) and Feldstein (2002), for example, point to a lending boom, characterized by excessive risk taking and poor banking regulation and supervision, as the root cause for the crisis of the 1990s. Demirguc-Kunt and Detragiache (2002) found that 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 sequencing of reforms aimed at moving toward a more open economy are still the subject of some debate (Claessens, 2005). The question of whether the IFIs 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

The Bank's 1989 *World Development Report* on financial systems and development was the first public document to set out the Bank's views on the financial sector. At the time, the importance of the financial sector to 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 report 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, whereby market participants would perform their functions of mobilizing resources, allocating credit, and managing risks in an efficient manner. The elements included a legal framework that ensures creditor rights and a functional court system to enforce them, information flows 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.

The views described above 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 to 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 the resolution of bad debts, but very little on the privatization of banks.[7] In addition, the Bank's Development Economics Department (DEC) issued three official notes in 1995 on directed credit, lending rates, and restructuring banks. Although the notes never had the formal standing of directives, they were intended to provide guidance to staff on these issues. Given the relatively heavy emphasis on privatization in Bank lending in the 1990s (see Chapter 3 and Appendix A), the Bank should have provided more guidance on this important type of reform.

In 1998, OD 8.30 was replaced by *Operational Policy 8.30 on Financial Intermediary Lending*, which dealt primarily with LOC, leaving a vacuum in Bank policy on financial sector reforms.[8] In 2001, the Bank issued a Financial Sector Strategy, containing the prerequisites for a well-developed financial system. The strategy's emphasis is interesting because of its contrast with the 1992 OD 8.30, reflecting the shift in the political environment that had occurred in the intervening decade. Whereas the OD had focused on the macroeconomic environment and policies on interest rates and subsidized credit, the strategy focused on the importance of (i) a reliable legal and judicial environment; (ii) a strong banking system, including a good incentive, regulatory, and supervisory environment; adequate governance of banks; and a well-functioning payments systems; (iii) promotion of capital markets and other nonbank 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 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 Development Economics Department and Financial Sector Network have active research, policy, and dissemination programs and have provided intellectual guidance on a range of topics.[9] Nevertheless, there is currently no written guidance for Bank staff on good practices for bank privatization support, for example, on the resolution of nonperforming loans, or under what circumstances prudential regulations should be aligned with those contained in the

An odd finding is that in countries with stronger institutional capacity, outcomes of adjustment lending are better when there is no associated TA loan than when there is a TA loan associated with lending.

Roughly 50 percent of lending for financial sector reforms took place in a postcrisis situation.

1988 Basel Accord or the more recent Basel II, or for the entire gamut of reforms addressing constraints to financial sector development.

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. Also consistent with research findings on competition is the strategy's point that increasing competition in the financial sector may be inappropriate for small financial systems, which characterize many of the Bank borrowers. The strategy is arguably less consistent with the literature in promoting capital market development, to the extent that the literature is ambiguous on this point.

Past IEG Recommendations and Management Response

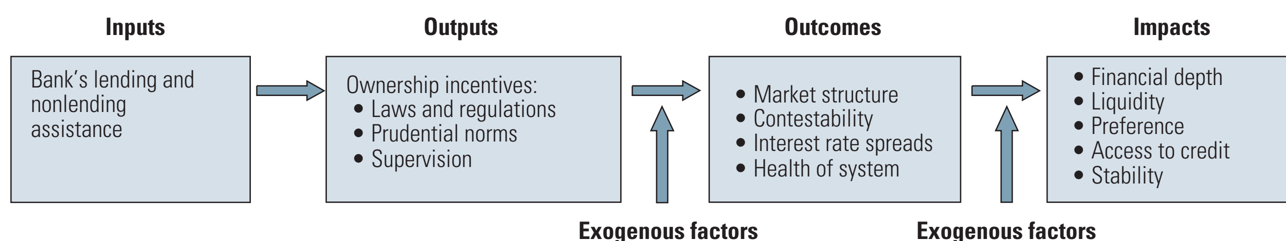
A previous IEG review of Bank support for financial sector reforms (OED, 1998) recommended that (i) the Bank follow OD 8.30 (Operational Policy 8.30 had not yet replaced the OD); (ii) economic and sector work (ESW) precede lending (because outcomes at the country level were better when this was the case); (iii) financial sector staff have a greater role in quality control; (iv) more resources be used for systematic monitoring of financial sector outcomes; (v) TA loans be used more judiciously than in the past (only where there is a 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 International Finance Corporation (IFC). Management agreed to these recommendations, and gave them prominence in the financial sector strategy that followed in 2001.

Framework for Evaluation

This IEG 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 only Bank lending and nonlending assistance although, as noted in Chapter 1, inputs such as other donor assistance and, in particular, the government's own reform programs, are also highly relevant to the picture.

Part I (Chapters 3–7) of this report analyzes inputs. Apart from the trends and Regional patterns of lending, inputs are assessed in two ways: by the quality-at-entry of Bank assistance (see Chapter 5) and by the outcomes of Bank loans (see Chapter 6). For quality-at-entry, IEG presents the findings from background papers prepared for this review and the desk reviews of 37 case-study countries carried out by IEG, and supplemented by findings from the Quality Assurance Group (QAG). IEG examined the relevance of the objectives and designs of the loans vis-à-vis standards of good practice, as 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 a strong prudential environment, consistent with international norms; supervision consistent with international principles; decreased government control of banks

Figure 2.1: Evaluation Framework



and nonbank financial institutions; and putting into place the tools and the incentives for the monitoring of financial intermediaries by market participants. For lending outcomes (Chapter 6), IEG analyzed financial sector loans as well as outcomes of the components supporting financial sector reforms in multisector loans.

Part II (Chapters 8–11) of this report analyzes the rest of the results chain in Figure 2.1 at the country level. Outputs are intermediate achievements that may be necessary but are not sufficient by themselves for achieving the ultimate objectives for the financial sector. Based on the discussion above on good practices, Chapter 8 examines changes in the private ownership of banks in countries that borrowed from the Bank for financial sector reforms. With the appropriate caveats, these outputs are compared with outputs in countries that did not borrow from the Bank for financial sector reforms during the period under review.

Chapter 9 presents a description of a variety of incentives that countries need to put into place in order to maximize the benefits of financial sector reforms, including improving the legal and regulatory environment and improving banking supervision. Two special topics are also spotlighted and discussed: legal immunity for supervisors and deposit insurance.

Chapter 10 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.[10] Although market structure is an 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 (the percentage of banking assets held by the largest three banks) of 100 percent, and one of the objectives of Bank assistance, sometimes implicit and 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 during 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, nonperforming loans, and profitability.

Chapter 11 examines the extent to which the ultimate objectives for financial sector development have been achieved at a country level, that is, how well does the sector serve as an intermediary between savers, by mobilizing relatively large amounts of resources, and efficient investors, by 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 (measuring M2, which consists of cash, demand deposits, and time deposits, as a proportion of GDP); and for capital market reforms, the size and turnover of the market; (ii) increasing confidence in the banking system, as measured by the inverse of the preference for liquidity (cash as a proportion of M2); (iii) credit to the private sector, as a percentage of GDP; and (iv) stability of the financial system in terms of the absence of a major systemic banking crisis. Finally, Chapter 12 concludes the report with a summary of the findings and recommendations.

Part I

Assessing Bank Assistance

Trends in Lending and Nonlending

Overview

Beginning in the late 1980s, the Bank recognized the important role that the financial sector could play in growth[1] and shifted its focus from supporting individual financial institutions (which, in any case, had had disappointing results) to supporting sectorwide improvements in the financial sectors of client countries. In the first half of the 1990s, the Bank dramatically increased its analysis of financial sectors as it sought to understand the constraints to better financial sector performance and to underpin its adjustment lending for financial sector reforms.

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 a particular focus on banking, and to develop a set of core monitoring indicators to identify vulnerabilities to crises. The Asian crisis in the second half of 1997 put urgency to supporting financial sector reforms as well as 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, which will be examined separately in a forthcoming IEG report. 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, as expressed in the 1997 Strategic Compact, was realized in both lending and diagnostic work in the second half of the period under review, FY98–FY03.

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 all CASs during the FY00–FY01 period had some discussion of recent progress in the financial sectors, and there had been significant improvements in both the quantity and quality of the coverage of financial sector issues compared with earlier periods.

Bank Lending for Financial Sector Reforms

Lending Classified as Finance

The data on lending classified under the Financial Sector Board during FY93–FY03 reflect the trends in financial sector progress. First, Bank support to financial sectors in countries undergoing crises was so large that it caused wide year-to-year fluctuations in lending (see Figure 3.1). Out of a total of US$24.8 billion in finance loans, 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 were lent to Mexico and US$800 million to Argentina in response to the Tequila crisis; in FY98, US$5.0 billion were 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.

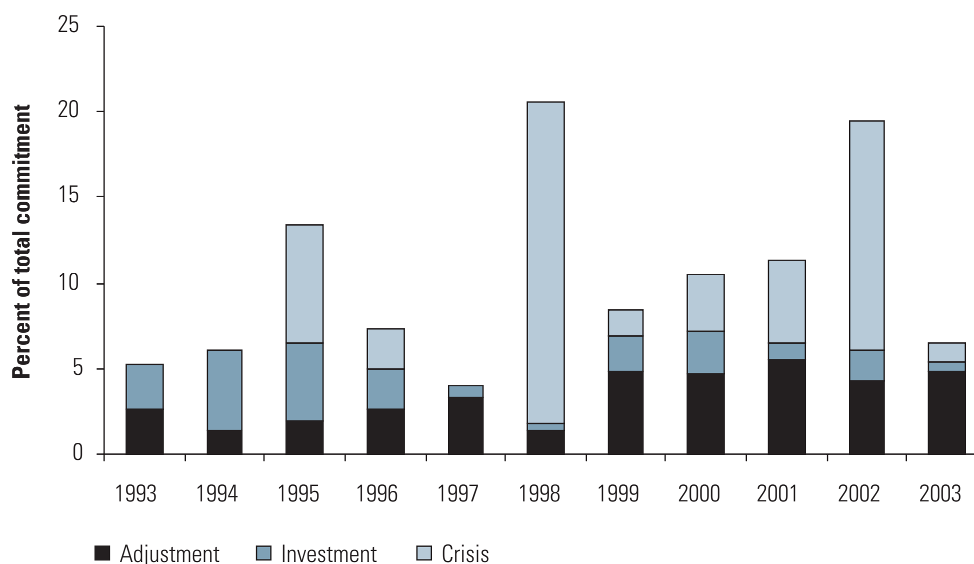
Aside from crisis lending (discussed in Chapter 7), there was a slight upward trend during FY93–FY03 in the proportion of annual Bank commitments classified as finance. This was driven by an increase in adjustment lending, which began in the late 1980s and helped to offset the drop in lending for LOC.[2] Noncrisis adjustment lending, which totals to about US$9.2 billion in commitments during the entire period, roughly doubled between the first and second half of the period.

Lending with Financial Sector Components

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

As shown in Figure 3.2, financial reforms in multisector operations classified under other sectors outnumbered loans classified as finance in most years (for a breakdown by sector, see Appendix A, Figure A.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

Figure 3.1: Bank Finance Loans as a Percentage of Total Bank Commitments, FY93–FY03



Box 3.1: Identifying Bank Assistance for the Financial Sector

Most Bank lending for financial reforms has taken the form of multisector adjustment or technical assistance loans and credits. IEG read through more than 2,000 Bank loan documents to identify support for reforms or investments in the financial sector, and found some 385 operations (excluding pensions, which account for an additional 130 or so) that contained conditionality or funding related to the financial sector.

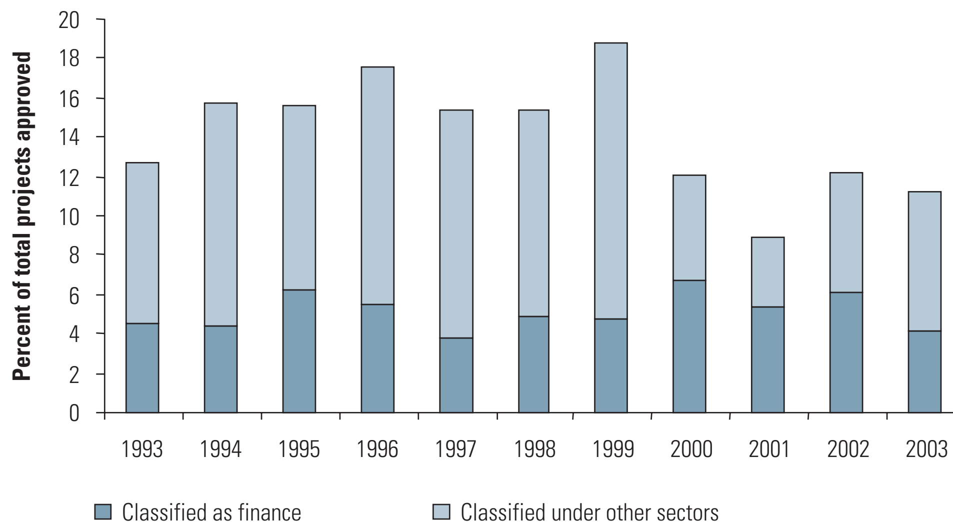
Of the total number of Bank operations containing financial sector components, only 36 percent of them were classified as finance; another 23 percent were classified under economic policy; private sector development accounted for about 14 percent; and the remainder was for other sectors (see Appendix A, Figure A.6 for a breakdown). It is not possible to allocate lending amounts in Bank multisector adjustment loans to specific sectors, thus making it difficult to distinguish multisector adjustment loans that focus primarily on the financial sector from those where the sector is a minor part. For this reason, 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–FY03

Sectoral loan classification	Adjustment		Investment		Totals		As percent of Bank's total	
	Number	Amount US$ m	Number	Amount US$ m	Number	Amount US$ m	Number	Amount
Financial sector	54	19,683	83	5,122	137	24,805	5	11
Other sectors	115	23,356[a]	133	7,912[a]	248	31,268[a]	9	13[a]
Total	169	43,039[a]	216	13,034[a]	385	56,073[a]	14	24[a]

a. These figures show the total amount of lending that included some focus on financial reforms; they overstate the amount dedicated only to financial reforms. Appendix A contains more details on Bank-wide and Regional trends.

Figure 3.2: Bank Loans with Financial Sector Reforms, by Number of Loans, FY93–FY03



mostly to a dramatic drop in the number of LOC approved. Without LOC, the downward trend, although still evident, is less strong. LOC are discussed in a separate IEG report (2006) and thus are not included in the remainder of this review unless otherwise indicated.

Focus of Financial Sector Reforms

Banking reforms[3] dominate the agenda in most Bank loans, compared with nonbanking 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.

Within banking, restructuring and privatization dominated the agenda between FY93 and FY03. 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 nonperforming loans (NPLs), 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).[4] 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 Appendix A, Figure A.5).

By contrast, lending for capital market reforms was about 22 percent of loans and insurance reforms comprised only 10 percent of loans during the period,[5] and tended to be concentrated in middle-income countries, mostly in Europe and Central Asia (ECA), Latin America and Caribbean (LAC), and the Middle East and North Africa (MNA) Regions (see Chapter 4). Support of capital markets declined during the period; by FY01–FY03, fewer than 10 percent of loans contained capital market reforms (Appendix A, Figure A.5). The shift away from capital markets may have been, in part, the result of the 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.

Although adjustment lending comprised the bulk of Bank support, investment projects also

Figure 3.3: Types of Reforms as a Percentage of Bank Projects with Financial Sector Components

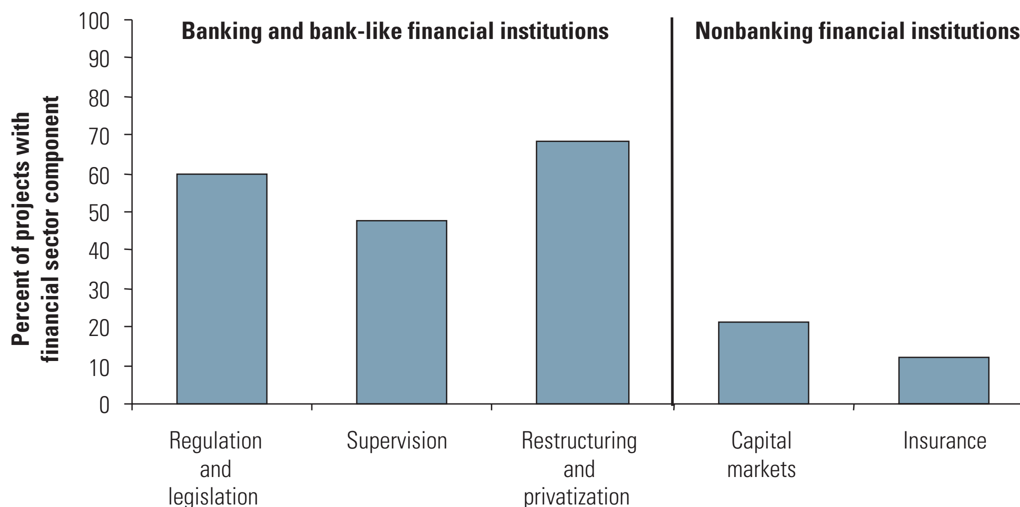


Figure 3.4: Investment Loans Supporting Financial Sector Reforms, by Year

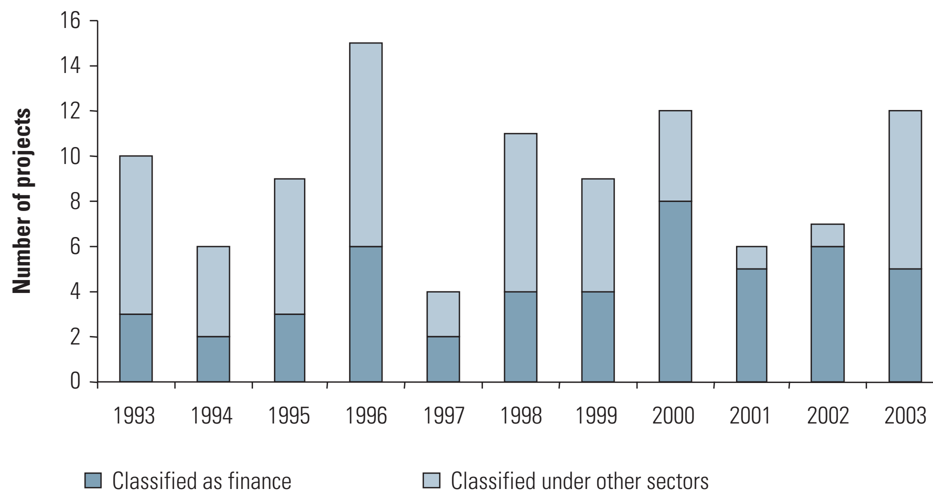


Table 3.2: Investment Lending with Financial Sector Components, by Category,[a] FY93–FY03

Category	Number	Amount (in thousands of dollars)
TA	69	1,112
Guarantees	7	631[a]
Specific Investment	35	1,359
Total	111	3,102

a. Excludes LOC; categories are somewhat arbitrary; most specific investment loans were TA.

played a role in supporting financial sector reforms (Figure 3.4), mainly through technical assistance (TA) loans, which were usually approved in tandem with adjustment loans.[6] Out of 111 investment projects (excluding LOC) with financial sector objectives approved during the period, 69 were categorized as TA loans (Table 3.2). With the exception of three large investment projects discussed below, the other specific investments are mostly identical in content with those categorized as TA, and include support to improve the payments 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, diagnosis or audit banks or other financial institutions, prepare them for privatization, or, generally, to provide technical support to the reforms supported through adjustment lending. Slightly less than half of these operations (50 of 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.

Among the specific investments, three large projects accounted for over half of the total commitment. These were actually adjustment loans disbursed in stages connected with privatization. In Pakistan, the Banking Sector Restructuring and Privatization Project for US$300 million financed severance payments for the downsizing of banks prior to privatization. And in two Brazil loans—the Rio de Janeiro and Minas Gerais State Privatization projects for US$250 and

US$170 million, respectively—funds were disbursed in stages, but not for severance payments related directly to banking reforms.

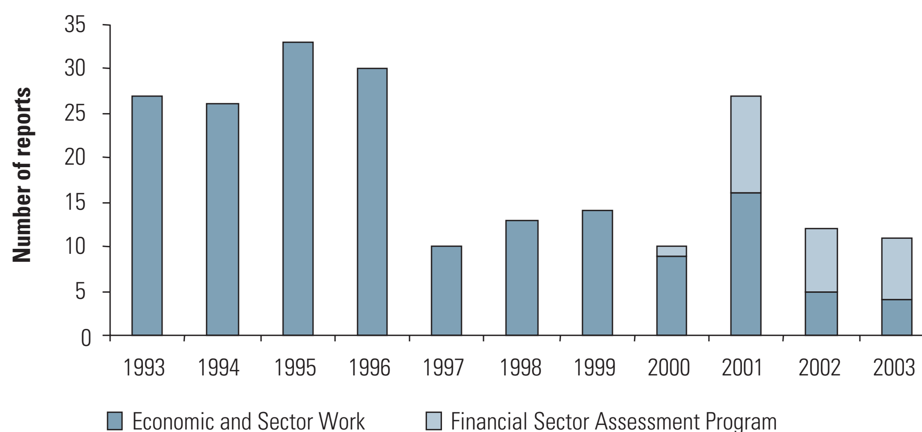
The third category of investment lending is guarantees: six were approved during the period, for US$630 million (one was a loan to Argentina for US$500 million alone).

Bank Nonlending Assistance for Financial Sector Reforms

The shift in focus in the late 1980s to sectorwide reforms was accompanied by the need for a better understanding of financial sector constraints and issues. This need was reflected in the surge in formal ESW reports containing financial sector analysis from fewer than 10 per year in the 1980s to between 25 and 30 reports per year in the first half of the 1990s. In the first five years of the period under review, FY93–FY97, about 126 formal ESW reports were produced. By the second half of the period, the number had declined to about 74 ESW reports (48 if the highly specialized FSAP reports are excluded, see Figure 3.5 and Box 3.2).

The drop in formal reports was likely due to several factors. In the late 1990s, there was a shift to informal sector work, such as policy notes, 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 activities[7] may have replaced (or displaced, depending on one's point of view) other financial sector work.

Figure 3.5: ESW Reports Containing Financial Sector Analysis, by Count, FY93–FY03[a]



a. Includes only formal sector reports.

Box 3.2: 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 began in May 1999, initially as a 12-country pilot exercise (allowing expansion for additional volunteer 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, more than 80 countries were involved in the FSAP, and of those, eight countries have already begun reassessments. The program has involved a significant use of Bank resources—reassessments were initially planned for every four to five years, but the frequency was later set at seven to 10 years because of resource constraints and their implications for the pace of the program.

The FSAP has been assessed separately by IEG and the IMF's Independent Evaluation Office.

Regional Patterns of Bank Assistance

Countries undertook financial sector reforms in the last decade at different times, with different initial conditions, capacities, and degrees of commitment. These differences are reflected in Regional patterns and Bank lending reflects these patterns.

For lending categorized as finance (excluding LOC), three Regions: Latin America and Caribbean (LAC), East Asia and Pacific (EAP), and Europe and Central Asia (ECA), account for 90 percent of commitments (Table 4.1 and Appendix A, Figures A.1 and A.2), although the large sums are due mainly to crisis lending (as defined here), which is concentrated in these three regions. Excluding crisis lending, EAP received almost no loans classified under the financial sector board. The Africa (AFR) and South Asia (SAR) Regions also received little, in absolute terms or as a percentage of the Region's own lending. In SAR, Pakistan was the only country that had financial sector adjustment loans, although financial sector reforms were introduced recently in TA projects in Bangladesh and Nepal. By contrast, even aside from the crisis lending, ECA and LAC received 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 the Middle East and North Africa (MNA) Region, financial sector adjustment

Table 4.1: Lending Categorized as Finance, Percent of Total, FY93–FY03

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
LAC	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

lending was concentrated in a few years in a few countries (Jordan, Morocco, and Tunisia).

Europe and Central Asia (ECA) Region Was Most Active

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 the proportion of its loans (16 percent) with financial reforms during the FY93–FY03 period (Table 4.2 and Appendix A, Figure A.4). At its peak in FY95–FY96, as much as 25 percent of ECA's loans contained financial sector components, and out of 28 borrowers in the Region, only one (Estonia) received no loans with financial sector reforms included[1] (see Box 4.1 on lending in ECA). This clearly reflects the focus of the countries' commitment to transitioning from the state-controlled mono-banking to an entirely different banking structure and method of governance; financial reforms were often accompanied by other reforms to establish private ownership and market mechanisms. Accession to the European Union provided further incentive and impetus to the reforms. Lending for financial reforms in ECA has decreased in recent years compared with the early part of the period (Appendix A, Figure A.4).

Africa (AFR) and Latin America and the Caribbean (LAC) Regions Were Early Reformers

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

In Africa, about 10 percent of lending operations contained financial sector components during the period FY93–FY03, with the majority of projects in sectors other than the finance sector. This may reflect the need in smaller countries to package together reforms across sectors. Out of about 40 active borrowers at any given time in the Africa Region, 24 borrowed for financial reforms, with a heavy emphasis on bank restructuring and privatization (Table 4.3). 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.[2]

In LAC, a significant portion of lending for financial sector reforms was connected to crisis support. Out of a total of 59 loans with financial sector components, about one-third was crisis-related. Noncrisis loans form a heterogeneous group, tailored to the conditions and commitments of the borrowing country. In addition to a focus on banking—restructuring and privatization (Table 4.3); regulatory and legislative

Table 4.2: Lending with Financial Sector Components, FY93–FY03

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

a. See note in Table 3.1.

Table 4.3: Regional Concentration of Reforms

	Total	AFR	EAP	ECA	LAC	MNA	SAR
Number of loans with financial sector components	280	69	29	99	59	14	10
Percent of loans 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
Payments system		14	14	21	5	21	20

Box 4.1: Financial Sector Reforms in ECA Region: Bank Strategy, Analysis, and Lending

Strategy. 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 made. In some country programs, the priority on financial sector development was reduced in later CASs, either because the job was seen as largely completed, e.g., Hungary, Poland, and Kyrgyz Republic (in the last case, a judgment that turned out to be wrong), or because progress was very slow, e.g., Romania, Russia, and Uzbekistan. In other countries, after significant progress was achieved, e.g., FYR Macedonia and Lithuania, the Bank shifted its focus to diagnosis (FSAP) and policy dialogue, with further reforms financed by other agencies, including the IFC.

Analysis. A considerable body of financial sector analysis 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 1990s. 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), and the 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, and six LOC) aimed, at least in part, at financial sector objectives; or Bosnia and Herzegovina, with 16 loans with financial sector components (three adjustment; one TA, and 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 FY03, five Structural Adjustment Credits (SACs) and two accompanying TA credits supported restructuring and 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 and FY98), with conditions on privatizing the majority of shares of former state banks, and afterward, meeting agreed performance targets. SAC II also had measures in it to support capital market infrastructure. Latvia, Lithuania, Kazakhstan, Moldova, Tajikistan, and the Ukraine each had several multisector adjustment loans addressing banking reform, although in some the financial sector components were relatively minor.

By contrast, Poland had one adjustment loan, the EFSAL (in FY93, preceded by an FY91 loan focusing on financial institutional reforms) that included recapitalizing state-owned banks and empowering them to reduce their nonperforming loans by restructuring enterprises, and then privatizing the banks. Similarly, Hungary, Croatia, Slovenia, and the 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: Levy (2003); IEG database.

changes, such as aligning prudential regulations with Basel standards; and the introduction of deposit insurance schemes or reforming existing schemes—loans focused more on capital market reforms than in most other regions (see Appendix A, Table A.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 noncrisis lending to LAC countries that supported financial sector reforms consisted of only one adjustment loan and one TA loan per country during the period under review.

East Asia and Pacific (EAP) Region Was Mostly Crisis Driven

In the 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 for help to restructure it. This was followed by an adjustment loan to provide continued support for banking regulation and supervision and for the 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; no further financial sector reform lending took place until FY01. In China, the Bank made only one loan for TA (Box 4.2). Mongolia and Lao People's Democratic Republic, by contrast, each had two adjustment credits and accompanying TA operations (in Lao PDR, it was an Institutional Development Fund grant) for banking reforms.

Middle East and North Africa (MNA) and South Asia (SAR) Regions Took Conservative Approaches

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

In SAR, only Pakistan borrowed frequently during the period for financial sector reforms (Box 4.3), although the Bank has recently resumed lending to address financial issues in

Box 4.2: Bank Assistance to China

In the past 10 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. The project aimed to make improvements in the accounting and auditing of banks, supervision by the central bank, and building a modern payments system. Its underlying purpose, however, 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, and supervised 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. The process revealed worrisome operational procedures, but the larger purpose was not accomplished. The project's outcome was considered satisfactory but the Bank, for reasons related to reluctance on the part of the Chinese authorities as well as disagreement within the Bank about the approach, made no other loans in the financial sector in the 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 nonlending activities, producing four (informal) policy notes (on interest rate liberalization, deposit insurance, bank supervision, and the reforms of state banks).

Source: Ramachandran (2003).

Box 4.3: Pakistan and Bangladesh: Commitments Explain Differences in Bank Lending

Pakistan began to reform its financial sector in the late 1980s, supported by an FY89 adjustment loan and an FY95 LOC with substantial policy content (which followed a series of earlier LOCs 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, overstaffing, 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 multisectors) and one TA loan. The pace of reforms was uneven, but significant progress was made in downsizing and restructuring the large state banks; the asset share in government-owned banks dropped from 92 percent in 1990 to 45 percent in 2002. Central bank supervision improved and 22 of the 25 core principles of good supervision were met. Prudential regulations were also strengthened. Weaknesses remain, particularly in state-dominated nonbank 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 nonperforming; 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 microfinance, 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 multisector credit addressing prudential regulations and bank restructuring with a view to eventual privatization and a TA credit. Although stronger prudential regulations were passed, political opposition to bank privatization was stronger than expected and the process of preparing banks was slower than planned.

Source: Long (2003b).

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 15 years (since FY89) to address financial sector reforms.

Quality-at-Entry of Bank Assistance

Overview

This chapter reviews the quality-at-entry in lending and the quality of nonlending assistance. In addition to reviewing assessments of individual products (loans and sector reports), IEG relied on background papers and desk reviews of 37 country case studies[1] 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 account specific conditions in borrowing countries. This chapter also reviews whether past IEG recommendations for the financial sector are reflected in Bank assistance.

Quality-at-Entry in Lending

Since 1998, QAG has carried out six quality-at-entry assessments 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 quality-at-entry assessments, 32 financial sector operations were assessed, representing about 25 percent of total financial sector lending covered by this IEG 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 during the six years (Table 5.1). QAG's assessment is consistent with IEG's own review in background papers and case countries, with several important caveats.

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 IEG review to be poor and to deviate frequently and in significant ways from the Bank's guidelines on LOC (see IEG, 2006 for details).

The second caveat is that most of the support for financial sector reforms, both in numbers of operations and in amounts lent, occurred during the last decade as components of multisector loans (see Chapter 3 on trends in

lending), so it is not possible to get a 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 multisector loans.

The IEG review of country case studies found that the *objectives* of reforms supported by the Bank were consistent with the literature (in areas where there is widespread agreement in the literature and within the Bank) in reducing government ownership of banks and other financial intermediaries, improving prudential regulations consistent with international standards, and strengthening bank supervision so as to be consistent with international principles.[2] Examples of good practice exist in every Region, even where outcomes were unsatisfactory (Box 5.1).

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 government commitment to change their governance, particularly through privatization, for example, 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 investments 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 reaccumulation of bad debts (this issue is discussed further in Chapter 10).

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. In Mozambique, this led to considerable expense for the government, and in Georgia, it 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 renationalization and reprivatization, also at considerable expense to the government.[3]

One type of assistance that will never show up in quality-at-entry assessments 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 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 Economic Competitive Adjustment Loan 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 10 years, yet the dialogue continued in both countries until FY03, when a TA credit addressing financial sector reforms was approved in each country.

Box 5.1: Highly Relevant Objectives for 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, where 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.

Quality of Nonlending Services

QAG also carried out assessments of ESW over five years (FY98–FY02), 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 quality-at-entry assessments, 22 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.[4]

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 microfinance) 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, p. 42). Nevertheless, different views on major issues sometimes emerged in ESW within a country, which sent mixed signals to the borrower.

IEG 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 adopt all the recommendations in the ESW, the reforms addressed in the loans had usually been identified as important in the diagnosis.

Exceptions to this pattern occurred 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 postconflict 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 ongoing 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; IEG'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

Table 5.1: QAG Assessment of ESW Quality, FY98–FY02

	Financial sector network			Other networks	
	Number	Average score[a]	Number	Average score[a]	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

Source: World Bank.

a. A lower score indicates higher quality.

* Statistically significant at the 5 percent level.

of the early attempts at sector reform was lack of adequate diagnosis, focus, or prioritization.

Consistency of Bank Approaches within Countries

Synergies among ESW, adjustment lending, and TA loans (and, on occasion, LOC) in a given country were 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.

But in some countries the Bank 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 CAS 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 that it was encouraging privatization of commercial banks.

Box 5.2: Strong Consistency among Bank Products

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 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 the sharing of credit information. This analysis fed directly into the design of the Financial Sector Adjustment Loan program that followed.

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

The Bank has also sent mixed signals, within a country, on deposit insurance: a sector report for the Ukraine in FY95 recommended that creation of a deposit insurance scheme should be an objective only for the long term. Such a scheme was 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 Financial Sector Adjustment Loan. 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.

In addition, the Bank supported the establishment of stricter prudential regulations, which were followed by Bank-funded LOC; although some of the LOC involved nonbank financial intermediaries, there were no requirements for these intermediaries to meet any prudential regulations. In the 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 Approaches across Countries

Bank support has followed international norms and principles in support of prudential regula-

tions and banking supervision and, to a lesser extent, with respect to government control of financial intermediaries (see Figure 3.3 for a breakdown of Bank lending by objectives). These elements were central to most loans and other features, such as improving the accounting and auditing frameworks, introducing or improving bankruptcy laws, and ensuring the independence of the supervisory authorities 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.

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.[5]

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 (e.g., 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, for example, even within ECA, where there was acknowledged urgency to reform 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.[6]

Payments systems

There is wide agreement that an efficient, reliable payments system, is an important building block for financial sector development. During the 10-year period under review, however, the Bank addressed issues of payments 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.

In many of the crises reviewed here, the Bank was not well informed or well prepared to respond.

Instead, support for improving payments systems came late in the cycle of Bank assistance in a number of countries. Improvements to Pakistan's payments systems, for example, were addressed for the first time in FY03, although the Bank had supported financial sector reforms in the country since 1989. In Uganda, the Bank first addressed a payments system upgrade in FY99, although it had been involved in financial sector reforms since the early part of the decade. In Albania and Mongolia, the pattern was similar, where the Bank supported reforms in FY93 (Albania) and FY97 (Mongolia) but did not finance investments in payments systems in either country until about six years later. In a number of countries, payments systems improvements appear 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 bank privatization (in systems dominated by state banks), for example, was not on the agenda.

Deposit insurance schemes

By contrast with payments systems strengthening, where there is widespread agreement on its importance, deposit insurance is a more

The joint FSAP, initiated in the wake of the Asian crisis, is intended to identify the vulnerability of financial systems to crisis. It could be used to establish priorities for contingency planning in the event of a crisis.

Table 5.2: Bank Loans Supporting Deposit Insurance, by Fiscal Year

Fiscal year	93	94	95	96	97	98	99	00	01	02	03
Number of loans	1	1	2	5	3	10	12	7	7	8	4

controversial area. Yet, the Bank has supported deposit insurance schemes in 35 countries and 60 operations (mostly adjustment), considerably more than for improving payments systems (Table 5.2). Most of these loans aimed at improving other components of a financial safety net:[7] support for the supervisory agency and the prudential framework, and restructuring and/or privatization of banks.

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 LAC, and four in ECA) or with the future prospect of accession to the European Union, where deposit insurance systems had been mandatory since 1994. Although the timing of setting up deposit insurance has not been optimal,[8] 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 ongoing 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.

Capital market development

Finally, the Bank has taken an ad hoc approach in the level of priority it has given to capital market developments and in determining 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 level of priority given to it by governments. About 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–FY99), and concentrated in the ECA and LAC Regions. Of the 30 countries where the Bank supported capital markets, most (19) are middle-income countries, but a number of the countries had 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 what country conditions, is most evident.

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 variation of approach, particularly in support for payments systems, deposit insurance schemes, and capital market reforms. The combination of ongoing debates within the Bank (e.g., whether and how to support deposit insurance schemes), an 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.[9]

Outcomes of Bank Loans and Credits

Overview

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 during the FY93–FY03 period, 159 operations (142 adjustment and 17 TA), or over 55 percent of the operations by number of loans, had closed and been rated by IEG. By commitment value, US$35 billion out of a total of US$46 billion had been rated.[1]

For financial sector adjustment operations, outcome ratings are better than overall adjustment ratings, both by the number of loans and by commitment amounts. For financial sector TA operations, outcomes are similar for outcomes of other TA lending, slightly better than outcomes for other investment lending by number of loans 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.

Because closed multisector loans addressing financial reforms outnumber those categorized as finance loans (130 closed and rated multisector versus 60 closed and rated financial sector adjustment loans), IEG rated the financial sector components of multisector loans.[2] This provided a more complete database of ratings of financial sector components and allowed more robust testing of trends over time and of characteristics that might be associated with success.

Financial Sector versus Multisector Loans

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 multisector adjustment loans have only a 69 percent satisfactory rating (by number), which is about 20 percentage points lower, than outcomes of adjustment loans under the financial sector board. Among TA loans, outcomes for components of multisector loans are slightly lower than for financial sector loans (Figure 6.2 and Appendix B, Table B.2).

These results cannot be explained by differences in the reforms or conditionality, as they were similar in financial sector and multisector

Figure 6.1: Outcomes of Adjustment and TA Loans, FY93–FY03

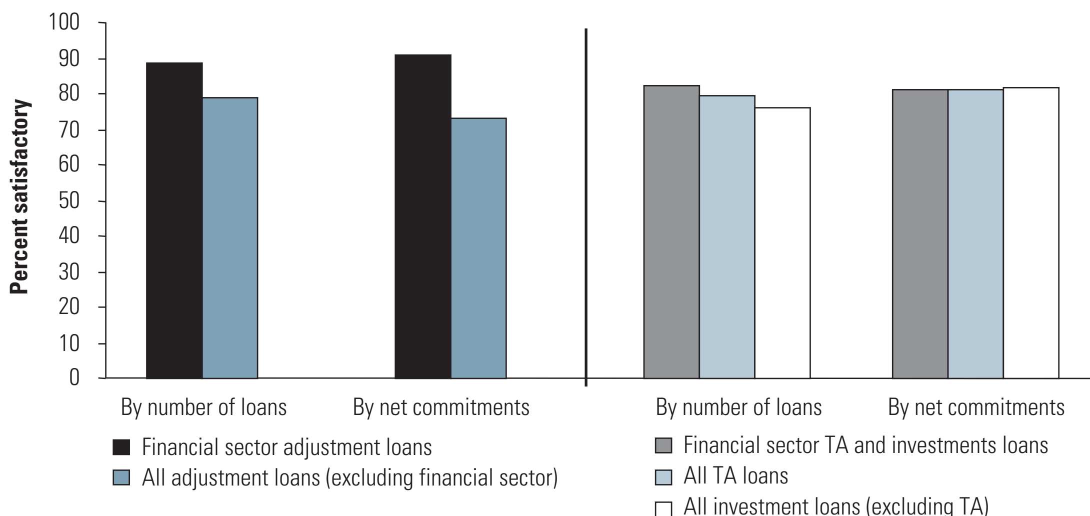


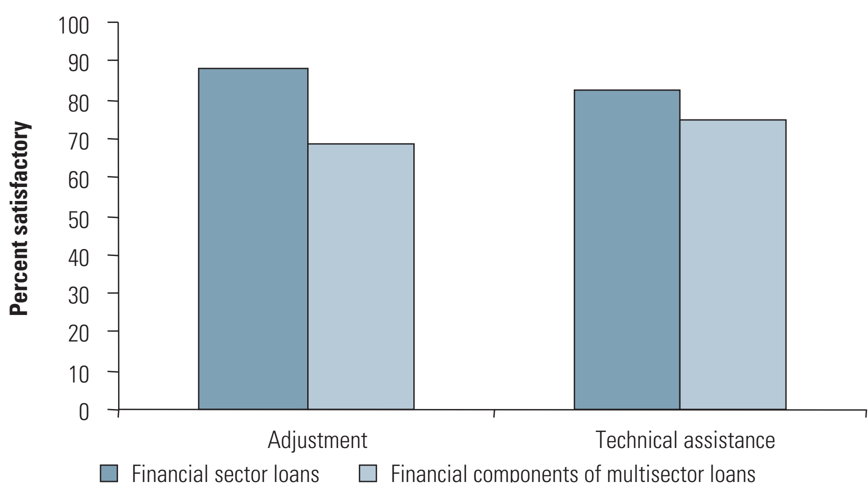
Table 6.1: Outcomes of Financial Sector Lending and Components, FY93–FY03

	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

Note: For further details, see Appendix B, Table B.2.

loans. Neither do financial sector loans tend to be made in noncrisis situations, while multisector loans are for the crisis situations—there is a mixture of both types of loans in crisis and noncrisis lending. But the poorer outcomes for multisector lending may be the result of other country characteristics—if multisector loans are clustered in smaller countries with poorer institutional and policy capacities and lower incomes, this could explain the poorer results. To test this, IEG examined outcomes in

Figure 6.2: Outcomes by Sector and Classification, by Number of Loans, FY93–FY03



countries with different ratings on Country Policy and Institutional Assessment (CPIA) and different per capita income levels.[3] The results in Figure 6.3 show that even among countries with similar low CPIA ratings, outcomes of financial sector components in multisector 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 Appendix B, Tables B.2–B.4). These differences persist between countries categorized 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.

These findings suggest that reforms under the control of 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 reasons 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

Not surprisingly, country characteristics mattered for outcomes, particularly when measured by 2002 or 2003 characteristics (Figure 6.4 and Appendix B, Table B.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

Figure 6.3: Outcomes by Sector and CPIA Ratings, by Number of Loans, FY93–FY03

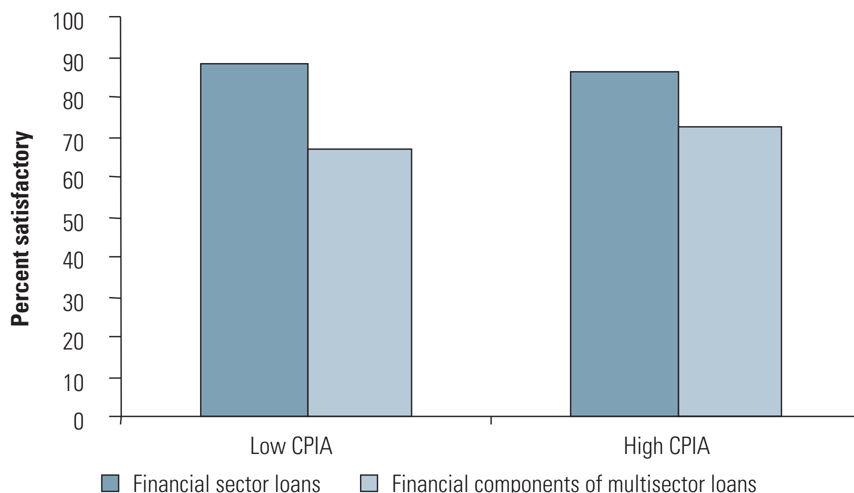
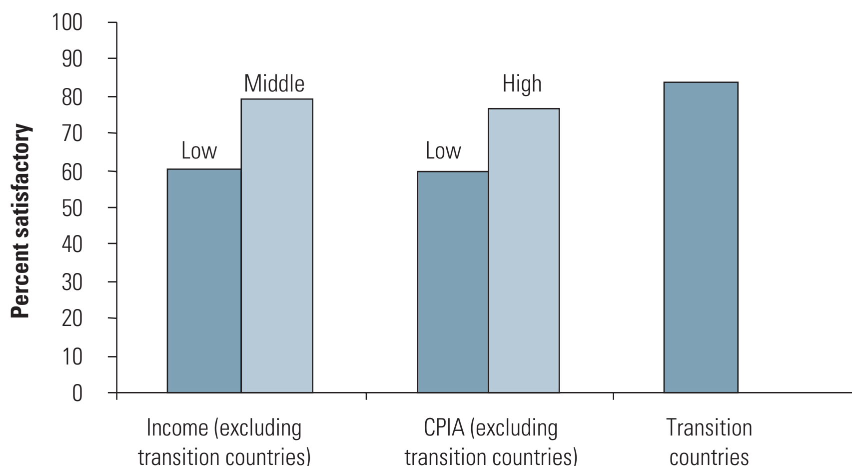


Figure 6.4: Outcomes by Country Characteristics, FY93–FY03



outcomes between the remaining low- and middle-income countries are significantly larger.

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 Sequencing of Adjustment Loans

The Bank has been lending for policy reforms for almost 20 years and many lessons have emerged, for example, on the importance of government commitment, on keeping the design of the adjustment loans relatively simple, and on setting realistic time frames for conditionality. In addition, during 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.

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).[4] 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-crises and widespread banking insolvencies happened at different times in different countries during 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 crises or near crises had little impact on the 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.

Does the Provision of Technical Assistance Help Outcomes?

Conditionality in adjustment loans aimed at the financial sector often involves highly technical issues, such as passage of banking laws, stricter prudential regulations, and the privatization of banks. If a country does not have the relevant in-house experience or expertise to carry out the

Table 6.2: Outcomes of Adjustment Loans, by Period and 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 reforms	91	71	78*

* Statistically significant at the 10 percent level.

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 the 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 adjustments 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 underwent full-blown crises (Chapter 7) had been 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 LOC. **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 renationalized (with Bank support) and reprivatized its banks, allowing foreign banks to participate. Similarly, in **Turkey,** outcomes of Bank adjustment lending in the financial sector were unsatisfactory until the crisis in 2000.

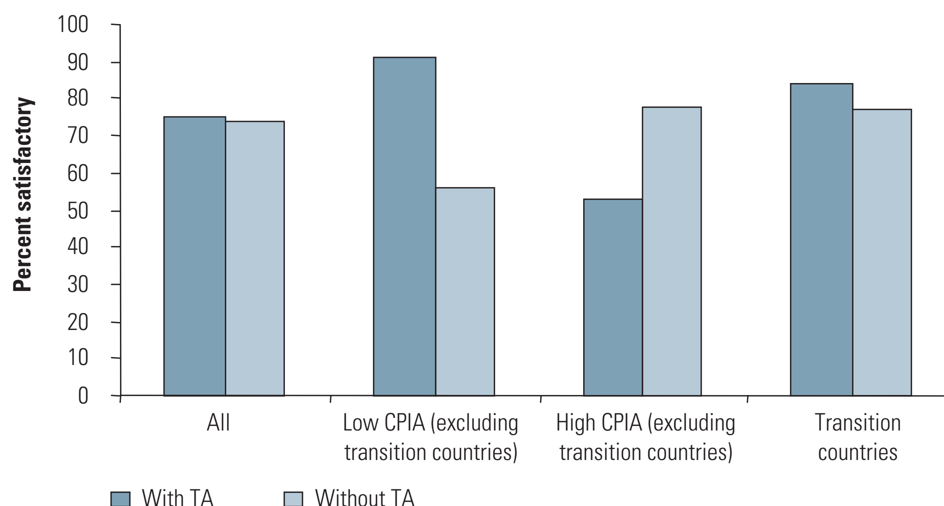
Mongolia began its transition to a market-based economy in 1991, and had banking crises in 1992, 1994, 1996, and 1998. The FY97 FSAC and TA credit supported liquidation of two banks and establishment of two new public banks, debt recovery mechanisms, and the establishment of a credit information bureau, 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 to 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, reached a level of insolvency that implied negative capital. Two adjustment loans were approved (FY95, FY96) which 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.

reforms, it is reasonable to expect that the provision of TA may be the difference between timely and successful implementation and failure. The following analysis compares outcomes of Bank loans for financial sector reforms 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.

The results of the analysis showed 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 in 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 were better when a TA loan accompanied the adjustment loan (details are in Appendix B, Table B.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 measurable value added for the outcomes of adjustment lending.

By contrast, for the higher-CPIA countries, with better institutional capacities and policies, the difference in outcomes was the opposite of what would be expected, that is, *outcomes were better when there was no associated TA loan*. This finding holds 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 cases 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 request for a TA loan from the Bank is an attempt to address some other, nontechnical constraint, such as lack of widespread ownership or the 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 payments system).

Figure 6.5: Outcomes of Adjustment Loans, with and without Technical Assistance



Bank Support to Crisis Countries

Overview[1]

Much has been written about the financial crises that occurred in the developing world in the 1990s—their causes, their costs, their consequences, and their aftermaths. The causes were complex and varied across countries. The costs were 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 as well.

The consequences in terms of corporate bankruptcies, unemployment, increased poverty, decreased access to international capital markets, and political and social upheaval were 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.

There is no agreed definition of what constitutes a country in crisis. The one used here is a country that had experienced both a banking crisis and a macroeconomic crisis, either simultaneously or in quick succession.[2] The run on banks resulted in illiquidity 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.

Using the above definition, 15 countries in three Regions experienced crises during the FY93–FY03 period. The 1994 Tequila crisis in Mexico spread to Argentina; the 1997 crisis, which 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 experienced crises.[3]

The rationale for assessing Bank lending to these countries separately from other financial sector support is twofold. The first reason is the importance of this type of lending. Financial sector loans to countries experiencing or following a crisis represents over 50 percent of total financial sector lending during the period (US$12 billion out of US$21 billion); all loans, including

Outcomes of crisis loans are well below outcomes of noncrisis lending.

multisector ones, to these countries that include financial sector reforms also account for almost 50 percent of total loan amounts approved by the Bank containing any financial sector components (US$21 billion out of US$46 billion).[4] Thus crisis lending looms large in the Bank's portfolio of financial sector support.[5]

The second reason for considering crisis lending separately is because such lending is usually prepared and approved quickly, under emergency situations, and in the context of large financial aid packages put together by IFIs. Such lending may not benefit from prior diagnostic work on the sector or from a close dialogue with government on reforms. However, governments that are reluctant reformers prior to a 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 would not apply (or apply to a much lower degree) under less urgent conditions.

The next section reviews the Bank's record on predicting crises and assessing vulnerabilities, followed by a review of the Bank's response to the crises, and how its assistance fit in with larger international rescue efforts. Also discussed are the objectives and outcomes of loans that focused on financial sector reforms. Finally, the chapter examines cooperation between the Bank and the IMF during crises, 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.

The Bank should be more candid and realistic about the objectives of its lending under crisis conditions.

Did the Bank Anticipate the Crisis?

All of the countries that experienced financial crises during FY93–FY03 had systemically weak financial systems, but not all countries with weak financial systems underwent crises. Two other elements were evident in most of the crisis countries examined. One was an economic or political shock (e.g., 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 element 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, a 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 the timing of crises.[6] 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 begins.

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 postcrisis assistance to Mexico concluded that, given the warning signs of potential trouble in the banking system—a lending boom, a rapid increase in nonperforming loans (NPLs), a weak legal and regulatory framework for banks—the Bank should have been better prepared to respond to a crisis. The IEG 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."

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.

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.[7] In Indonesia, for example, a financial sector report which 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 macroeconomy of the financial sector's vulnerability to shocks. Yet the assistance strategy for Indonesia discussed at the Bank's Board of Executive Directors in the summer of 1997 was optimistic 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 in September 2000 and the country strategy both presented an optimistic scenario for the reforms and the likelihood of success.[8]

Two reasons cited by proponents for providing an optimistic treatment in public documents of the vulnerability of a country's financial system to crisis are that: (i) publicizing high vulnerability in the financial sector of a client country could precipitate a crisis which 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. IEG disagrees with both of these arguments.

Coordination with the IMF and other international financial institutions still needs improvement.

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 undergone 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. Rather, drawing conclusions from publicly available information on risks could help both the Bank and the client government focus on contingency planning.

Since the 1997 Asian crisis, the Bank and IMF have started FSAP, a joint program 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 were completed or ongoing. The details of the assessment are confidential, but both institutions produce summary assessments to their Boards of Executive Directors. On the basis of these summary assessments, the Bank could develop risk categories for

The decrease in government ownership has been greater in borrowing countries than in countries that did not borrow from the Bank for bank privatization.

financial systems, which would signal to the Bank, other donors, and stakeholders as well as the government (if it had not already received the message from the FSAP itself) the priority that should be given to financial sector reforms and resources devoted to contingency planning (that is, 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 Crises

The Bank made postcrisis loans to all but two of the 15 crisis countries. In Russia, the Bank approved a large Structural Adjustment Loan (SAL) for US$1.5 billion as part of a US$23 billion rescue package in the month *before* the crisis, in an attempt 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 IFIs and G-7 countries (Table 7.1), and the amounts pledged and lent by the Bank were relatively small compared with 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 lent US$4 billion. In Korea, although Bank lending reached a record high of US$7 billion over six months to one country, it was a modest portion of the US$58 billion emergency package put together by the IFIs (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 less than 5 percent of the total package, compared with the IMF's share of more than 50 percent.

The Bank often pledged lending amounts prior to any dialogue with the government concerned. Thus the Bank's intentions on both timing and amounts 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

Table 7.1: International Rescue Efforts and Bank Responses

	Rescue package US$ billion[a]	As percent of country's GDP[b]	IMF Stand-By Arrangement or Extended Fund Facility 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 1996–97	2.0	33	0.0	0.23
Korea, Rep. of, 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, 2001–03	22.2	15	19.0	3.23
Uruguay, 2002	3.3	27	2.2	0.40

a. Announced; full amount includes bilateral pledges, which were not typically committed. For example, the US$58 billion for Korea included a US$20 billion "second line of defense" from bilaterals, which was never used.

b. 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.

issues or the government's capacity to address them was secondary. These factors provide perspective for the following discussion of the outcomes of Bank lending in crisis.

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 in suppport of financial sector reforms in the decade prior to the crisis. The crises either caused changes in the governments themselves or their attitudes about reform, or both, thus underscoring again the oft-repeated finding that government ownership is critical to the 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 Designing Loans

Although all of 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 an analysis of banks' financial conditions, the establishment of asset management companies (AMCs) and/or deposit insurance institutions (to take over troubled financial institutions, restructure them, reprivatize them, and dispose of loans and other assets), and the establishment of support for corporate bankruptcies 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 earlier 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.

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 the quickly needed reforms, these TA loans were, appropriately, flexibly designed to adjust to the circumstances as they developed. At the same time, several of the projects 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 in stemming bankruptcies and further deterioration in the economy.

Relevance of Objectives

IEG assessments of these loans did not question their relevance or design. Because 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, IEG considered them to be highly relevant to reestablishing economic growth and stability. Nevertheless, many critics have questioned whether the Bank and other IFIs should be providing large rescue packages and liquidity during crises,[9] 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 reforms, rather than after reforms were actually undertaken, the large financial flows provided no guarantee that the reforms would occur. In fact, recipients could decide not to make reforms because the donors would feel pressure to deliver on their publicly announced commitments irrespective of actual progress on reforms.[10]

Table 7.2: Crisis Loans with Financial Sector Components

Country	Loan name	Loan type	Commitment amount (US$ m)	Approval fiscal year	Outcome
Argentina	Provincial Bank Privatization	SAL	500.0	1995	Satisfactory
Argentina	Bank Reform	SAL	500.0	1996	Satisfactory
Argentina	Special Structural Adjustment Loan	SSAL	2,525.3	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[a]
Bulgaria	Financial and Enterprise Sector Adjustment Loan	FESAL	100.0	1998	Satisfactory[a]
Bulgaria	Critical Imports Rehabilitation	SAL	40.0	1997	Satisfactory[a]
Colombia	Financial Sector Adjustment Loan	FSAL	505.6	2000	Moderately satisfactory
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[a]
Indonesia	Policy Reform Support (PRSL I)	SAL	1,000.0	1999	Moderately unsatisfactory[a]
Indonesia	Second Policy Reform Support (PRSL II)	SAL	500.0	1999	Moderately unsatisfactory[a]
Jamaica	Bank Restructuring & Debt Management	PSAL	75.0	2001	Satisfactory
Jamaica	Bank Restructuring & Debt Management II	PSAL	75.0	2003	Moderately satisfactory
Jamaica	Jamaica Emergency Recovery Loan	SAL	75.0	2002	Moderately satisfactory
Korea, Rep	Structural Adjustment	SAL	2,000.0	1998	Satisfactory
Korea, Rep	Structural Adjustment II	SAL	2,000.0	1999	Satisfactory
Korea, Rep	Financial and Corporate Restructuring Assistance	TA	48.0	1999	Satisfactory
Korea, Rep	Economic Reconstruction	SAL	3,000.0	1998	Satisfactory
Mexico	Financial Sector Restructuring	FSAL	1,000.0	1995	Unsatisfactory
Mexico	Financial Sector Technical Assistance	TA	37.4	1995	Satisfactory
Russian Fed.	Structural Adjustment Loan III	SAL	1,500.0	1999	Unsatisfactory
Thailand	Finance Companies Restructuring	SAL	350.0	1998	Moderately unsatisfactory[a]
Thailand	Financial Sector Implementation Assistance	TA	15.0	1998	Satisfactory
Thailand	Economic and Financial Adjustment Loan	EFAL	400.0	1999	Moderately unsatisfactory[a]
Thailand	Economic and Financial Adjustment Loan II	EFAL	600.0	1999	Moderately unsatisfactory[a]
Turkey	Financial Sector Adjustment Loan	FSAL	777.8	2001	Moderately satisfactory
Turkey	Programmatic Financial and Public Sector Adjustment (PFPSAL I)	PSAL/SSAL	1,100.0	2002	Satisfactory
Turkey	Second Programmatic Financial and Public Sector Adjustment (PFPSAL II)	PSAL/SSAL	1,350.0	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**		**21,408.2**		

Note: Ratings as of March 3, 2006.
a. Based on an IEG assessment review.

Below-Average Achievement

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$18 billion in gross commitments. Fifth-nine percent of the number of loans and 62 percent of net commitment values had satisfactory

Box 7.1: Objectives of Crisis Lending: Ambitious Reforms

In **Colombia,** prior to the 1999 crisis, the only Bank lending since FY93 for financial sector reforms had been a TA loan, which did not go well. After the crisis, two adjustment loans (in FY00 and FY03) addressed a large program of bank restructuring, downsizing, liquidation, and/or privatization of state banks, and the closing or restructuring of 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 reforms covering government auctions of debt instruments, and improved competition policies.

In **Turkey,** early Bank support in the 1980s for financial sector reforms was not successful. By the late 1990s, however, the Bank and the government had agreed on a four-pillar strategy for reforming the sector: creating 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, and incorporated 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.

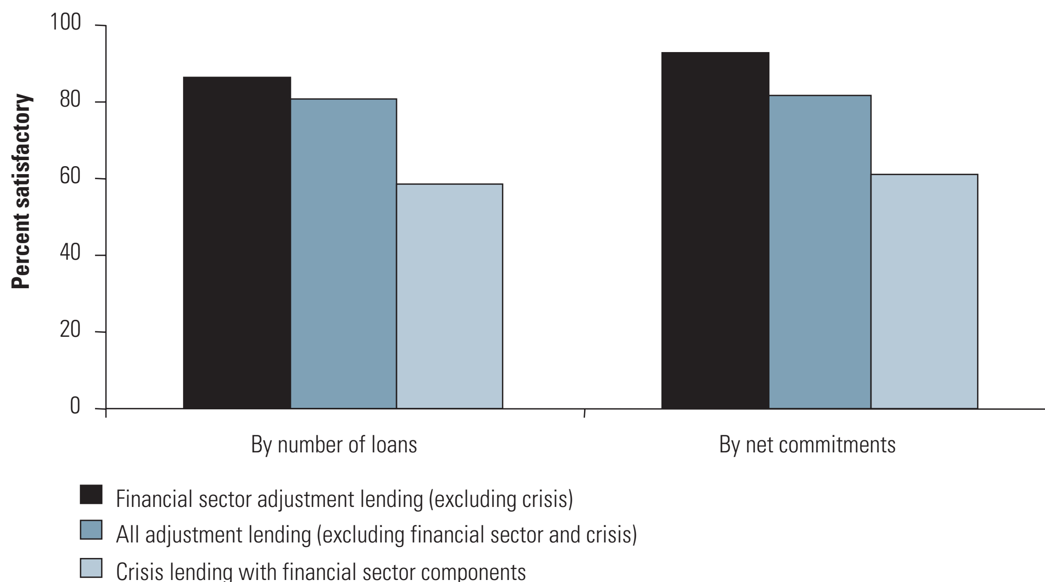
outcomes, averages that are below all other adjustment lending and below financial sector lending (Figure 7.1). Of the seven TA loans that were put in place, five have closed and been rated; of these, two were rated satisfactory.[11]

These outcomes are somewhat surprising, given the later finding that banking distress or near crises often focused attention on the need for reforms, which 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 get realized in the short time frame 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 to supply liquidity and establish the framework for future reforms; subsequent operations then relied on that framework to specify the reforms.

Table 7.3: Postcrisis 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	16	11,109	2	49	18	11,158
Percent satisfactory	59	62	40	68	57	62

Figure 7.1: Outcomes of Adjustment Loans, Crisis versus Noncrisis Lending



Box 7.2: Mixed Outcomes

In **Argentina,** the first round of financial reforms after the 1994 crisis focused on privatization of provincial government-owned banks, 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 an 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 Kiguel and Dujovne, 2003). The 1999 crisis was followed by two adjustment loans; one aimed at strengthening banking supervision, reducing public involvement in banks by privatizing the mortgage banks, and improving regulation of the capital market. The second loan was to provide liquidity to stem a banking run. Both loans 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 hit, 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 reprivatization of the banks and disposal of assets made little progress. By 2003, the pace of reforms had improved, but the government still controlled over 60 percent of the banking system, the disposal of assets moved slowly, and the banking sector remained vulnerable to further shocks.

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

Within the Bank, the case of Bank support to

postcrisis Thailand was one of the most contentious: the three adjustment loans to Thailand containing financial sector reforms had been rated satisfactory by both the Region's self-evaluations and IEG's desk reviews, which were carried out shortly after the loans closed. But in the course of this current IEG 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, IEG undertook an assessment on three adjustment loans, the Finance Companies Restructuring (FY98), and the two Economic and Financial Adjustment Loans that followed (both in FY99); the report is forthcoming.[12] The experience in Thailand raises difficult questions about coordination and cooperation with the IMF, the subject of the next section.

Collaboration with the IMF

The division of responsibility between the Bank and IMF on financial sector work is not clear. Precrisis diagnostics, monitoring, postcrisis lending, and TA all lie within the mandates of both organizations. On substance, macroeconomic policies, fiscal, and financial areas are covered, albeit to differing degrees, by both organizations and are also the areas that, if weaknesses exist, can lead to crises. The absence of a clear division of responsibilities has, in some cases, led to a duplication of efforts, confusion, and disagreements between the Bank and the IMF in postcrisis assistance efforts, in some cases in a public forum (Box 7.3), which only added to the uncertainties about the crisis.

Since 1999, the Bank and IMF have collaborated on the Financial Sector Assessment Program, assessing the vulnerabilities of financial systems (this is the subject of a separate IEG review). In addition, the IMF has primary responsibility for ongoing 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.[13] The IMF will 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 will tackle the longer-term reconstruction of the financial system, including bank restructuring and reprivatization, disposal of banking assets, corporate restructuring, and improving the legal, regulatory, and accounting structures for both banking and corporations.

In practice, however, the boundary between these roles is still not clear. The way in which the IMF oversees a government's actions to guarantee financial liabilities and to intervene with 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: Improved Coordination Needed between World Bank and IMF

In **Mexico** and **Russia,** the Bank and IMF disagreed on the extent to which the currencies were overvalued. As a result, the Bank carried out its own macroeconomic analysis. In the early stages of the crises in **Thailand** and **Indonesia,** there was confusion about the division of responsibilities among the Asian Development Bank, the World Bank, and the IMF. In Thailand, even after an agreement was reached where 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 obtained by the IMF regarding the financial sector because the IMF was concerned about maintaining the confidentiality of the information. Moreover, public criticism by the Bank's Chief Economist of the 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 crises (IMF, 2003) noted that the degree of cooperation depended mostly on the personalities of the mission leaders.

Source: Long (2003b).

Effectiveness and Sustainability of the Bank's Crisis Unit

"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."[14] As the Asian crisis unfolded, the Bank created a specialized central unit in January 1998, the Special Financial Operations (SFO), to oversee the Bank's assistance to the Asian crisis countries. The SFO was generously funded, through a special budget allocation from the Bank, a trust fund from industrialized countries, and the regular Bank budget connected with the Region's TA loans.

In countries where capacity is limited, the Bank needs to be involved in the process of privatization to ensure effective reforms.

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 former senior 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.

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; the SFO staff overcame this handicap in time. In addition, and more fundamentally, the centralized unit, with responsibility for managing the Bank's lending for the crisis, was a source of friction with the Region Departments, which 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 its existence was contentious. Its generous budget was 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.

It is important for the Bank to develop indicators to measure progress in the reforms it supports.

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.

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 such a plan proved insufficient to deal with a multicountry crisis (as occurred in Asia) the Bank could again put together resources and external staff to work with the virtual, experienced Bank staff.

Bank Leadership during Crisis

Because the Bank deals with almost all sectors and themes touching on 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 the 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 responsi-

bility 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 an internal Bank-wide coordination of efforts.

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

Recommendations

Although the Bank cannot predict crises, it can do a more systematic job of assessing vulnerabilities to crises, particularly now that the Financial Sector Assessment Program is in place. 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. IEG does not think this will affect the Bank's access to information in the client countries nor the behavior of the markets.

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 make clear that in the first instance, lending 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 the 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 the selection of consultants.

Coordination with the IMF and other IFIs needs improvement. At the outset of a crisis, the Bank, the IMF, and any other IFIs 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 postconflict assistance, the Bank should develop similar guidelines for dealing with crises.

Part II

Analyzing Results at the Country Level

Country-Level Outputs: Ownership

Overview

The three main pillars of Bank lending for financial sector reforms in FY93–FY03 were the privatization of banks, establishment or improvement of prudential regulations, and strengthened supervision of banks (see Figure 3.3 and discussion in Chapter 3). This chapter reviews changes in measures at the country level of these reforms, as well as lessons learned from the quality of the reform processes.

Shift to Private Ownership

Although the empirical literature is fairly unambiguous in its findings on the benefits of private ownership compared with state ownership of banks in the Bank's client countries, the Bank sometimes focused on privatization as an end in itself rather than a means of improving the governance of banks, which was the underlying objective of the process (this issue is further discussed below). Nevertheless, privatization was an objective, or the means to achieving a deeper objective, in Bank lending in about 40 countries. This chapter thus examines progress in privatization, as measured by the change in assets in government-owned banks,[1] as a percentage of total banking assets (Appendix C, Table C.5, contains the countries for which 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.

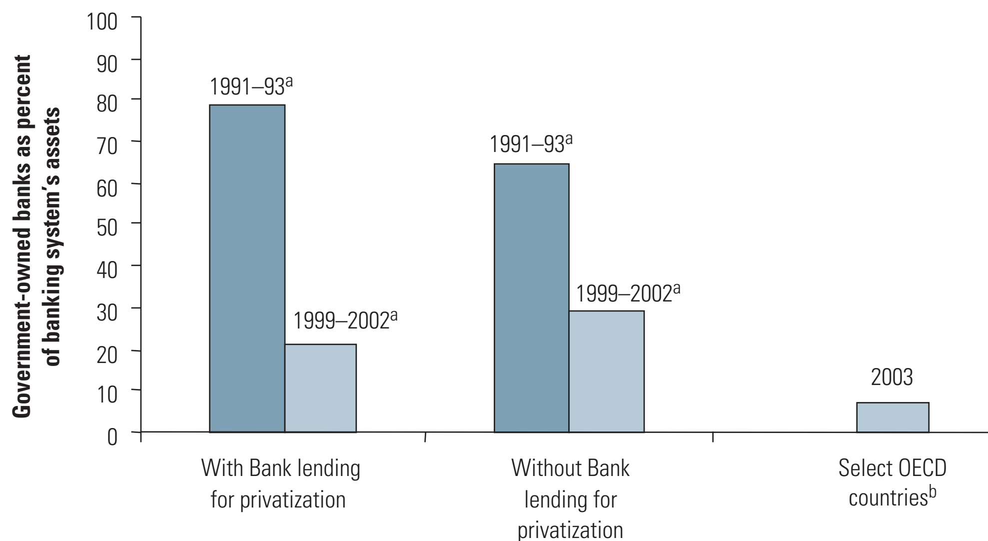
This chapter also draws on background papers and case-study countries to gain insights into data limitations, factors associated with success (or failure), and experiences with different approaches to bank restructuring and privatization, including support for AMCs.

Considerable Progress Has Been Made

At the beginning of the period under review, assets in government-owned banks comprised an average of 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. Bank support for privatization, by this measure, can be considered, on the whole, successful (see Figure 8.1).

In addition, the average change in government ownership is higher in countries that

Figure 8.1: Changes in Government Ownership of Banks



a. Latest year available.

b. Include OECD members as of 1993 and exclude Bank borrowers; see Appendix C, Table C.6.

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 select OECD countries is shown for information only and not as a standard against which Bank client countries should be assessed; the select OECD countries are listed in Appendix C, Table C.6).[2] 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 IEG made an effort to avoid any bias (Box 8.1), it is likely that some bias still existed 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 are missing in countries with no Bank lending.

Neither the number of loans nor the inclusion of TA loans affected the results, as

Box 8.1: Problems Comparing Results among Countries

In an effort to avoid obvious problems in comparing the two groups of countries—those that borrowed for bank privatization with those that did not—only countries that had an active bank privatization program were included. 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, raises 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 a policy dialogue on financial sector issues. Any of these reasons could introduce a bias in the results. A list of the countries in each group for this analysis is contained in Appendix C, Table C.5.

shown in Table 8.1.[3] By contrast, country characteristics mattered: Table 8.2 shows that progress in transition countries stands out as particularly successful, where the banks changed from being almost completely government owned (except for Hungary, Poland, and the Slovak Republic) at the beginning of the period to almost completely privately owned by 2002. For nontransition countries, differences between groups are not as great: low-income countries did (somewhat surprisingly) better than middle-income countries (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 with smaller systems were also somewhat behind in terms of reducing the 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.

Privatization Far from Complete in Many Countries

Data on commercial bank ownership show only part of the story, because they may overstate the extent to which the government has reduced its role as an intermediary. First, some governments retain a large minority ownership in banks that are considered legally private, and

Table 8.1: Changes in Government Ownership, with and without TA

Privatization: Reducing government ownership	Number of countries	Change in percent
One Bank adjustment loan	12	–59
More than one Bank adjustment loan	27	–58
Significantly different?	—	no
Countries with Bank-funded TA	23	–59
Countries with no Bank-funded TA	16	–58
Significantly different?	—	no

Table 8.2: Changes in Bank Ownership

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

a. Latest year for which data is available.

b. Argentina, Brazil, Colombia, Morocco, Pakistan, and the Philippines.

thus retain effective control. Second, some banks are owned by state enterprises or public utilities and are controlled de facto by the 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. Near-banks can include specialized banks, like housing or agricultural banks, and development banks, which may account for a substantial portion of more broadly defined total banking assets. This can introduce distortions by nonmarket-based lending and represent considerable contingent liabilities for the government (Box 8.2).

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 retained (in 2003) over 30 percent of banking assets. The situation in Argentina and Brazil was the same, due to a combination of ambivalence by government and difficulty in selling the banks. In these last two countries, there was a clear pattern of success at the subnational 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, underscore the fact 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.

It is unrealistic to expect governments to have no involvement in financial intermediaries (see IEG 2005 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

Although research shows that private banks and foreign banks often have a positive impact on banking performance in client countries, the Bank's experience demonstrates that neither privatization nor foreign entry has been a

Box 8.2: Data on Bank Ownership Can Be Misleading

Restructuring and privatization of commercial banks were supported in **Cameroon** by three adjustments 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. The government, however, has retained ownership of between 25 to 45 percent of the top three banks, which account for over two-thirds of the assets of the banking sector and a much higher percentage of retail banking in the country. The government does not appear to be actively involved in the daily management or policies of these banks; nevertheless, in one of them, the 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, the government retained a 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 **Côte d'Ivoire** the government retains about 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 done 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), which account for a significant share of term lending and which are not part of the statistics on commercial banks.

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 reaccumulation 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 or not the government retains significant minority shares. The Bank's experiences with different types of restructuring prior to privatization is discussed below. The quality of the investor(s) who bought the banks also made a difference to the performance of the privatized bank (Box 8.3).

Better Outcomes with Prior Financial Restructuring

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

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 also supported several methods for removing the banks' NPLs (both in the context of privatization and for restructuring alone): this involved taking them off the books of the banks entirely and putting them into an asset recovery unit, which essentially shrank the bank, or replaced them with government bonds, which could provide a theoretically risk-free asset at government expense.[4] 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 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 units in banks or independent AMCs.

Asset Management Companies

AMCs were supported by Bank lending in a number of the case-study countries.[5] Based on limited information, AMCs were not successful in terms of rates of loan recoveries when the NPLs

Box 8.3: 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 the 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 reprivatized a second time, having already been recapitalized four times by the government.

In **FYR 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 cleanup, supported by a second FSAC (FY01), it was sold to a foreign commercial bank, which then recapitalized it.

Box 8.4: Absence of Prior Financial Restructuring Does Not Work Well

In **Georgia,** under the Bank's FY97 SAC I, banks were operationally restructured (branches were closed) but not recapitalized. Also, NPLs were not dealt with and 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 that it needed financial restructuring, and the other (BNDE) because the two attempts to sell it brought unacceptably low bids (the reasons for the low bids were not clear and may have been unrelated to the quality of its assets). A waiver was required on the sales of these banks 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. The government did not follow up on the bank restructuring and only one out of seven of the banks was sold, although this may have been due to lack of government commitment as well as the poor financial situation of the banks.

were owed by loss-making state-owned enterprises, or even defunct enterprises that could not pay or politically well-connected borrowers that would not 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 AMCs 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. 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 tradeoffs in approaches (centralized versus decentralized) and on factors associated with effective loan recoveries.

Other Forms of Bank Restructuring

Downsizing

Pakistan is the only case where Bank funds (US$300 million for the Bank Sector Restructuring and Privatization Project in 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 subnational investment loans supporting employee retrenchment in the context of bank privatization, although the loans were not directly tied to this cost. Many other Bank loans

Box 8.5: Empowerment of Asset Management Companies

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 the end of 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 had been sent to the Bailiffs' Office for execution. In the **Slovak Republic,** a plan was established under an AMC, but was unsuccessful because of attempts by the AMC to use the assets to become a real bank; Bank intervention was successful in stopping it.

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 for their banks. However, 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.

Twinning

Bank support of twinning—matching foreign banks with weak domestic ones—has had mixed experiences. 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, because some of the banks were uninterested while others were not sufficiently well organized to make the necessary arrangements.

Avoiding Buildup of NPLs

Credit ceilings do not 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 NPLs in banks that the government was determined to retain). In Albania, under FY94 Enterprise and Financial Sector Adjustment Credit, and in Romania, under FY95 Financial and Enterprise Adjustment Loan, 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, for which information is available, suggest that governments or the banks themselves may not be able to resist the pressures from well-connected enterprises.

Banking sectors in developing countries have become less concentrated over time, with a greater drop in concentration in countries that did not borrow from the Bank.

Closure as an Alternative to Bank Privatization

The Bank 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 reduced 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 unviable banks.

Privatization Took Longer Than Expected

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 government ambivalence 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 reaccumulation of NPLs. In Tanzania, for example, differences between the Bank and the IMF on how to split up the

Competition levels appear to have increased somewhat in borrowing countries.

Box 8.6: Liquidations Have Been 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. The Federation of **Bosnia and Herzegovina,** under an adjustment operation (FY99 Enterprise and Bank Privatization Credit), agreed in principle to liquidate all insolvent banks, which the Bank had identified through diagnostic work, but Bosnia and Herzegovina's own diagnosis found all of the banks to be solvent. In the **Ukraine,** two Bank adjustment loans have addressed the closure of Bank Ukraina, which is taking some time.

In **Côte 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.

largest state-owned bank took several years to sort out, and in the meantime, NPLs continued to accumulate. The delay caused by this debate ended up costing the government considerably more to resolve the NPLs than if the differences could have been resolved expeditiously.

Unanticipated Problems

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 that had merged with a larger bank in the same country which also happened to be 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, which held over two-thirds of the assets of the banking system. In retrospect, bank privatization should have been accompanied by safeguards against high levels of concentration.

Restructuring without Privatization Is Seldom Successful

Contrary to Bank guidance on restructuring banks in the absence of a plan to privatize (1995 DEC Note), 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

Box 8.7: Restructuring Banks without a Commitment to Change Ownership

Albania: The first round of restructuring, supported by an FY95 Bank credit, involved credit ceilings, clearance of interbank loans, and 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 reimposition of credit ceilings. The banks have since been privatized.

Lao PDR: The country restructured its state banks in the mid-1990s with Asian Development Bank 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 the 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: The country restructured in the early 1990s with Bank support and intended to privatize, but privatization did not happen fast enough; Ghana needed to restructure again under FY99 Economic Recovery Support Operation II.

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

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).

Recommendations on Restructuring and Privatizing Banks

The recommendations that emerge from this review are that the Bank needs to be involved in countries where capacity is limited and help in the process of privatization to ensure the following:

- Financial restructuring precedes or accompanies the privatization—in the absence of financial cleanup, the privatization process is unlikely to attract good investors;
- Recapitalization of banks is in the context of a government plan to privatize;
- For debt recovery mechanisms, AMCs, if they are created, are given special judicial powers;
- The 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 postprivatization;
- Any strategic investor involved is "fit and proper"[6]—the Bank may need to provide support for due diligence on potential owners; and
- Appropriate competition policies are in place to avoid unanticipated mergers and the creation of exceptional market concentrations.

Country-Level Outputs: Incentives

Overview

The Bank has supported a wide range of changes in the 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 about 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 Basel (international) norms for prudential regulations and principles for bank supervision.[1]

In capital market reforms, the majority (about 80 percent) of the 48 operations in 30 countries supported the ratification of laws, establishment of regulatory frameworks, 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.

Changes in the Regulatory Regime Present a Mixed Picture

To measure improvements in the regulatory regime for banks, IEG compared data on changes in prudential requirements for banks in countries that borrowed from the World Bank between FY98 and FY02 against changes in countries that did not borrow from the World Bank for regulatory changes during this same period (see Box 10.1 for caveats to this comparison).[2] 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.

There are only 11 countries in the sample for which loans during this 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 the ratio and Argentina, after lowering it temporarily after the crisis, is now gradually increasing it again). However, all 11 countries were already requiring banks to be above the internationally recommended ratio of 8 percent prior to 1998. By contrast, among the 19 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 nonborrowers (Table 9.1). 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 nonborrowers, 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 nonborrowing countries*.

On loan classification, the picture is different: four of the 11 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 nonborrowing countries; among nonborrowing 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 9.1). On loan loss provisioning there is no major difference between the two groups of countries.

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 24 countries that had borrowed 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 in ECA Region Transition Countries

European Bank for Reconstruction and Development (EBRD) indicators exist (only) for ECA transition countries, for the regulatory framework for banks during the period 1998–2002, and for the regulatory framework for the securities market and nonbank financial institutions, during the period 1997–2002. Assuming that reforms supported by Bank lending in years prior to FY97 would already be reflected in "baseline" indicators, IEG compared average progress for countries that borrowed from the Bank for legal and regulatory reforms during the period FY97–FY01 and for capital market reform during the period FY96–FY02. Changes in indicators were compared with those for the transition countries that did not borrow from the Bank during the relevant period (see important caveat on selection bias in Box 8.1). The results on banking indicators are in Table 9.2 and show that for the countries that borrowed during the period, there was an overall improvement in banking regulations averaging a little over one grade (0.36), whereas for the countries that did not borrow during this period, the improvement was more modest, at an average of 0.2 (see Appendix C for details by country). These

Table 9.1: Capital Adequacy and Loan Classification, Changes between 1998 and 2003

	Countries that borrowed from the Bank	Countries that did not borrow from the Bank
	2003 compared with 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 Appendix C, Tables C.1 and C.2.

Table 9.2: Indicators on Strength of Financial Regulations in Transition Countries

	Banking	Securities markets and nonbank financial institutions
	Increase in quality of financial regulations: 1998–2002	
With Bank lending for regulatory changes	0.36	0.28
Without Bank lending for regulatory changes	0.20	0.22

Source: EBRD Transition Report, various years.

Note: The EBRD indicator for each country is a composite measure, scaled from 1 to 4, with pluses and minuses; an increase from 2– to 2 was counted as an increase of 0.33; from a 2 to a 2+ was 0.33, etc. See Appendix C, Tables C.3 and C.4 for detailed indicators by country.

results, for a relatively small sample of countries, are consistent with the findings on privatization: borrowing countries have done better than countries that did not borrow during the relevant period, although a closer look at the details reveals a more nuanced picture.

A similar analysis was carried out for the reforms in capital markets; the results in Table 9.2 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 nonborrowing). In four of the seven countries that borrowed from the Bank, there was no change in the regulatory framework for securities markets and nonbank financial institutions, while in over half of the 18 countries that did not borrow there was improvement in the framework.

Implementing Regulations and Better Banking Supervision

An equally important issue on prudential regulations and legislative reforms is their implementation.[3] From the 37 country case 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 support whether supervisory agencies had been strengthened. The FSAPs found that out of the 24 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. Again, a mixed picture is presented.

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) lack of a solid legal framework for dealing with bankruptcy; and (iii) lack of political support for the supervisory agency (see Box 9.1).

Box 9.1: Lack of Political Support: Algeria

At the end of 2002, Algerian 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

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 did not 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 Financial Sector Adjustment Loan, but the government did not 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 37 case-study countries examined, 11 countries had 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.

Interest rate spreads have decreased in borrowing countries.

Special Topic: Deposit Insurance[4]

Out of the total of 35 countries where the Bank lent for deposit insurance schemes (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 (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.

The health of the banking sectors in borrowing countries appears to have improved.

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 scheme's 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. The elimination of automatic government guarantees for state banks was achieved only in Lithuania, 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 the Philippines (no information on Argentina).

Recommendations on Improving the Incentive Framework

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.[5] Indicators are necessary to measure progress toward objectives, for example, on the degree to which banking supervision adheres to Basel principles for good supervision, whether prudential regulations are consistent with international principles (Basel 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 currently consists mostly of support for actions rather than requiring progress on outcomes, it is important to establish measurable, realistic, medium-term indicators that will enable all stakeholders to monitor whether targets are being met.

Country-Level Outcomes: Market Structure, Contestability, Efficiency, and Health

Overview

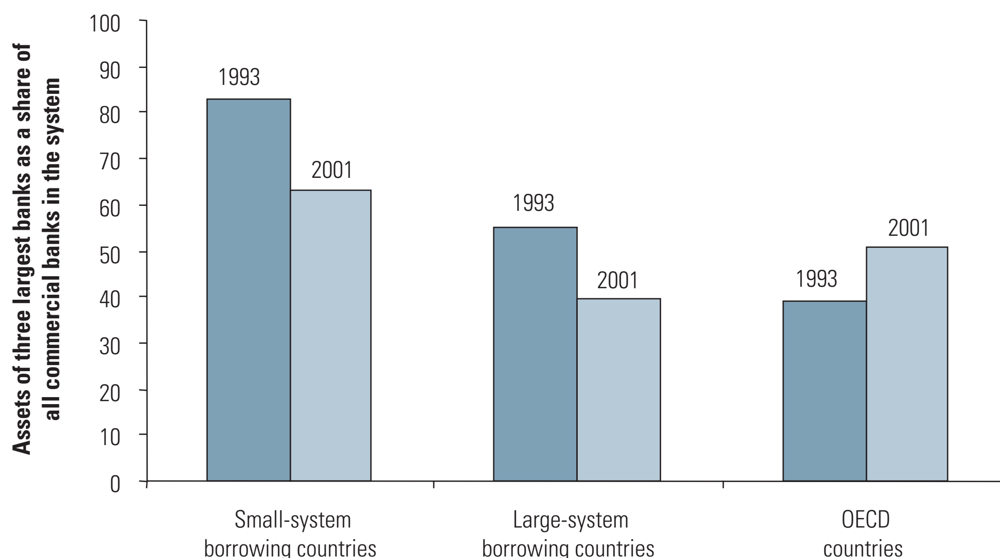
This chapter examines whether outcomes at a country level have been achieved in terms of changing market structure,[1] competition levels through greater contestability, efficiency, and health of the banking system in countries that borrowed from the Bank for these purposes during the period under review. This chapter draws on both quantitative indicators and case studies for insights into the reforms and qualitative results.

Changes in Market Structure: Bank Concentration

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, 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 54 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 during the period under review. The reforms pursued included deliberate downsizing, liquidation, and/or allowing entry of new banks. Because larger systems[2] might be significantly less concentrated than smaller ones, Figure 10.1 shows results separately for each group. By 2001 (latest year with available data), only Algeria had a concentration ratio over 60 percent among the larger systems, although among the smaller systems, 12 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.[3]

In order to examine whether the yearly changes in banking concentration could be associated with Bank lending during the period under review, IEG and DEC developed a model to compare annual changes in these indicators in countries that borrowed from the Bank for financial sector reforms with changes in indicators in nonborrowing countries (see Box 10.1 for a discussion of the challenges of this analysis

Figure 10.1: Bank Concentrations in Countries That Borrowed for Financial Reforms, 1993–2001



and how they were addressed). The results presented in Tables 10.1 and 10.3 and in Chapter 11 are for the model that includes macroeconomic 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.

Table 10.1 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 did not borrow. Thus, banking sectors in developing countries have tended to become less concentrated during 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.

Changes in Contestability

Recent literature has argued that contestability is more important for competition in a banking system than concentration ratios. 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 (see reference list for Web address), IEG 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 FY02 with changes in 29 countries that did not borrow from the Bank during this period.

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 nonborrowing 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 10.2). For the minimum-capital-at-entry requirement, Table 10.2 shows, again, both sets of countries changed very little in terms of minimum capital

Box 10.1: IEG/DEC Model 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 Chapter 8, comparisons of Bank borrowers with nonborrowers face a problem: countries that borrowed from the Bank may have had factors influencing reforms that are not captured by whether or not they borrowed. To address this, the IEG/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 Appendix F.

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 environments: 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 improvements in 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 with 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. However, 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 the bias would thus work against the borrowers. To address this issue, IEG/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 nonborrowing countries, these are presented in the table below; on a number of variables, they were not very different in the two groups, although the nonborrowers have somewhat better indicators.

Additional variants of the model reveal *no strong statistical links between the timing of loans and the outcomes.* That is, postloan growth rates for these indicators were not, for the most part, significantly larger than preloan rates, although in several alternative models, postloan improvements in variables were larger than preloan growth rates. *Some indicators, however, declined as the number of adjustment loans increased*, an indication that countries receiving multiple loans tended to perform worse than others, or, more probably, 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, and so would not be included in the "with" category for this analysis). Thus, although these countries are included in "without borrowing," the dialogue may have nonetheless 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; the impact of these may have emerged only in later years. What this discussion points to is the difficulty of constructing a counterfactual.

Initial conditions in variables in borrowing and nonborrowing countries, early 1990s

Variable	Indicator	Borrowers	Nonborrowers
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 rates	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

Table 10.1: Annual Growth Rates in Banking Sector Concentrations

	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 the 1 percent level.

Table 10.2: Changes in Contestability

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

Note: For details, see Appendix E, Tables E.1–E.4.

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 nonborrowers.

Restrictions on Activities

In 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 did not borrow increased the restrictions on banks' activities, on average (Table 10.2). Thus, in this dimension, contestability increased, on average, in borrowing countries, while it decreased in nonborrowers.

Change in Foreign Ownership

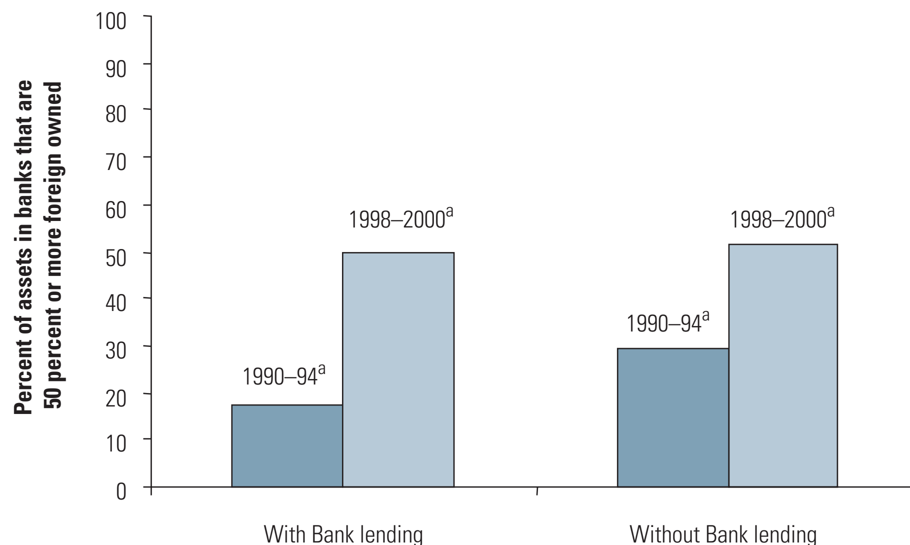
Rather than examine the data on prudential changes in the de jure ability of foreign banks to establish partnerships or ownership, IEG examined the de facto change in foreign ownership of banks, defined as the share of assets held in banks that are 50 percent or more foreign owned, in the borrowing and nonborrowing 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 26 borrowing countries for which information is available, foreign ownership more than doubled during the period,[4] while it increased by about two-thirds in the 25 countries that did not borrow from the Bank (Figure 10.2). 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 with nonborrowers.

In sum, the picture is mixed on the indicators of contestability, but when 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 with nonborrowers.

Interest Rate Spread

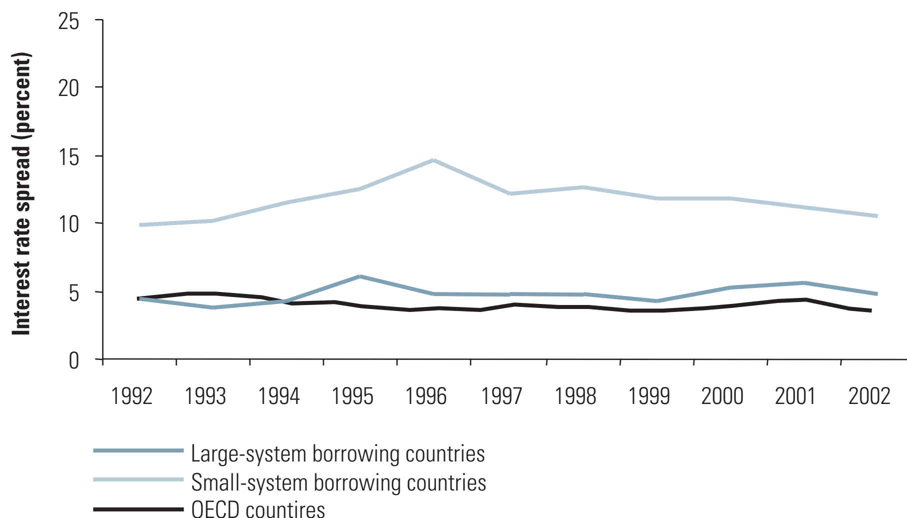
Although the spread between interest rates on deposits and loans is far from an ideal measure of efficiency for a number of reasons, it is used here as an imperfect proxy to capture changes in efficiency and to serve as one more indicator of the evolution of the banking system in Bank client countries.[5] Median interest rate spreads are shown in Figure 10.3, with OECD countries 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 10.2: Changes in Foreign Ownership



a. Latest year for which data is available.

Figure 10.3: Median Interest Rate Spreads in Countries That Borrowed, 1992–2002



The results of the DEC/IEG model on changes in interest rate spreads are shown in Table 10.3. 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 the results for the number of adjustment loans or the presence of TA operations.

Table 10.3: Annual Growth Rates in Interest Rate Spreads

	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 the 1 percent level.

Health of the Financial System

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 during the entire period under review, for a number of reasons. First, data were hard to find in the early part of the period (1992–93): only 10 borrowing countries had information on NPLs, for example, 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 the state of poor health. For 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, as well as to a drop in the measure of capital adequacy, even if nothing in the lending operations of the banks changed (see Box 10.2 for an example). In contrast, restructuring banks by taking NPLs off their books and recapitalizing them would obviously result in an immediate drop in the measure of NPLs and an increase in the 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.

From the 21 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 14 of the countries moved in the right direction in terms of decreasing NPLs, as a percentage 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 (the last year with available data) Yemen still had NPLs of 34 percent of assets (down from 40 percent), and by 2001, Brazil had decreased NPLs from 23 percent

Box 10.2: Financial Reforms Can Affect Banking Health in Both Directions: Tunisia

In Tunisia, reforms supported by Bank lending in the early 1990s caused most measures of banking health to worsen, and then in the late 1990s, further reforms supported by the Bank caused most measures to dramatically improve. In 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 practices (Basel 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 Economic Competitive Adjustment Loan II, the government agreed to restructure banks by replacing NPLs with zero-interest bonds. With this action, 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. During this period there was little change in the governance of commercial banks, and more recent data show that NPLs have increased again, to levels before Economic Competitive Adjustment Loan II.

(1995) to 11 percent. In most of these countries, the reduction in NPLs came from bank restructuring. Albania presented the most dramatic example by reducing bank NPLs from 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 1998 and 2003, for which 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 10.4).

In terms of capital adequacy, there was very little information for the whole period; for the few countries that had information, most increased their percentage levels 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 10.4). There was no significant trend in the profitability of banks in borrowing countries (or in nonborrowing countries) during the period.

Table 10.4: Measures of Banking Health in Borrowing versus Nonborrowing 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 did not 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 did not borrow from the Bank	19	14.2	14.9	0.7	10 improved 7 deteriorated 2 no change

Country-Level Impact: Financial Sector Depth and Stability

Overview

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 IEG/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 did not borrow during the period FY93–FY03. The caveats in the previous chapter related to these comparisons apply to the results in this chapter as well (see Box 10.1).

Financial Sector Depth: Positive Findings

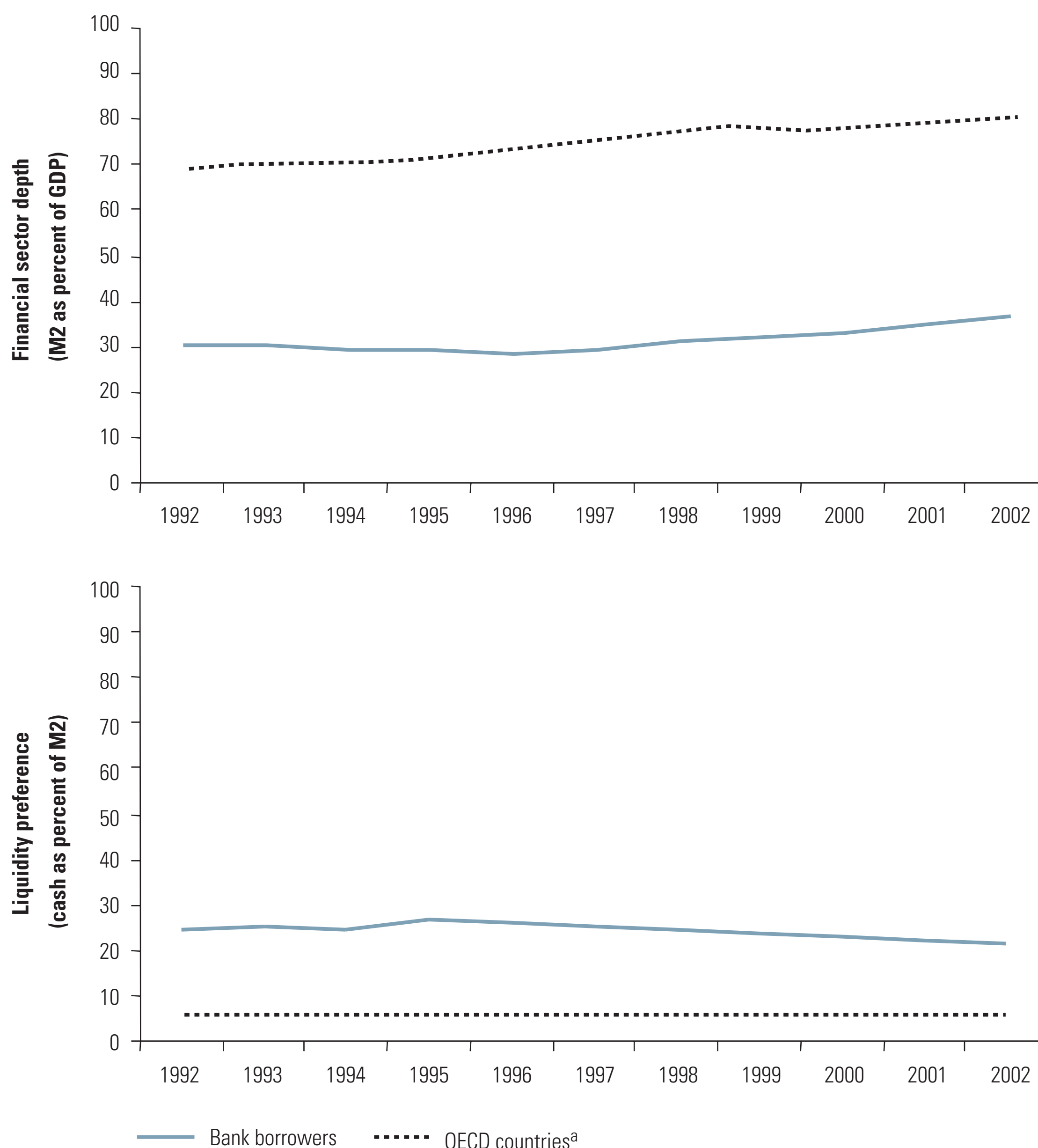
Two indicators are used to measure progress in financial sector depth: (i) M2/GDP [1] is a measure of the money supply relative to the size of the economy—a higher ratio indicates greater financial sector depth; and (ii) cash as a percent of M2 is a measure of liquidity preference—it declines when the public is willing to put more of its funds into the banking system, and is thus inversely related to public confidence in the system. A lower ratio of cash to M2 indicates a higher level of confidence.

During 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 11.1. Given the significant financial turmoil and subsequent restructuring that occurred during this period in many borrowing countries (Box 6.1), this increase in average financial sector depth can be viewed as reasonably good progress.

On the measure of liquidity preference, which should decline as confidence in the banking system increases, Figure 11.1 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.

The results of the IEG/DEC model are shown in Table 11.1. They show that in both the "with Bank lending" and "without Bank lending" categories of countries, financial sector depth, as measured by M2/GDP, grew by about 1.7

Figure 11.1: Financial Sector Depth and Liquidity Preference in Countries That Borrowed for Financial Reforms, 1992–2002



Source: World Bank, 2004b.

a. Excludes countries in the Euro zone.

percent per year. There was no significant difference between the two groups.

Preference for liquidity in the form of cash dropped by about 0.5 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 nonborrowing group showed a significantly lower increase in confidence. This could indicate that reforms undertaken with Bank support aimed at reducing the government's role and increasing competition may have also increased public

Table 11.1: Annual Growth Rates in Financial Sector Depth and Confidence in the Banking System

	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 the 1 percent level

confidence in the banks. One interesting finding on the changes in public confidence is that these 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 thus the public is responding to the banking problems by keeping their money in cash.

Systems Still Shallow in Many Countries

The results presented above do not show the wide variations among clients and the very shallow systems that still characterize many of the client countries. Figure 11.1 shows that M2/GDP is still, on average, only about one-half of the level of OECD countries. Table 11.2 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 and remained below 20 percent in 18 out of 62 countries. Public confidence actually fell in over one-third of the countries (in 19 out of 57 countries, the ratio increased, indicating a fall in term deposits).

Credit to the Private Sector

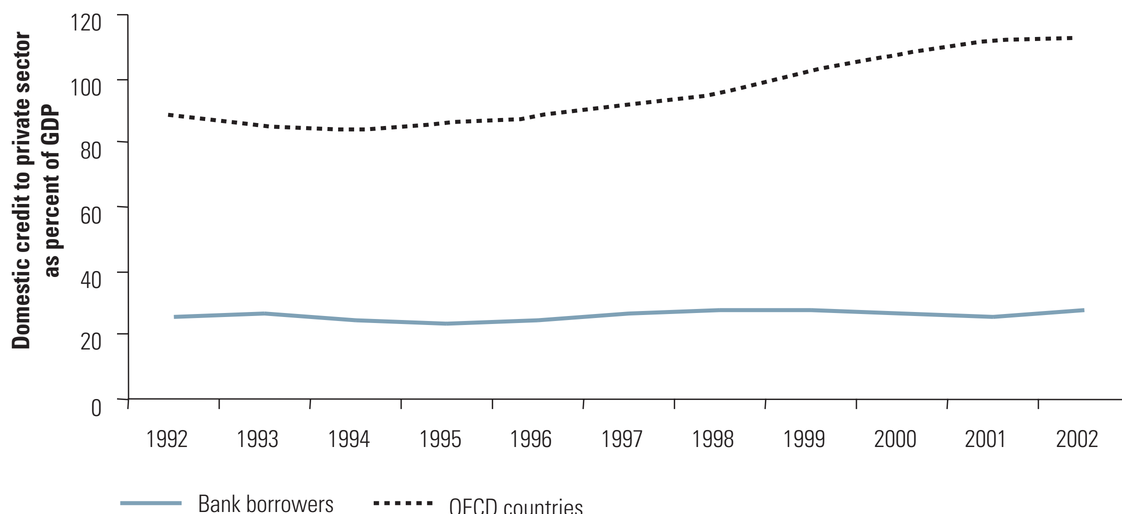
Credit to the private sector, measured by claims on the private sector by the banking system as a percent of GDP, is considered one of the keys for economic growth. It is the main objective of a banking system's mobilization of resources. Credit to the private sector during the period 1992–2002 in countries that borrowed from the Bank for financial sector reforms is shown in Figure 11.2, and shows a small increase during the period (25.2 to 27.5 percent of GDP).

The results of the IEG/DEC model show that credit to the private sector as a share of GDP increased in both borrowing and nonborrow-

Table 11.2: Distribution of Changes in Measures of Financial Sector Depth in Borrowing Countries

	Change in indicator between 1992–94 and 2001–02					
Percentage point change in M2/GDP	>20	10–19.99	5–9.99	0–4.99	<0	Total
	Number of countries					
	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					
	19	17	13	6	2	57

Figure 11.2: Credit to the Private Sector in Countries That Borrowed for Financial Reforms, 1992–2002



Source: International FinanceCorporation; World Bank, 2004b.

ing countries (Table 11.3), but here the growth rate is larger in nonborrowing countries: 1.7 percent per year in nonborrowing countries versus 0.4 percent 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 11.3: Annual Growth Rates for Credit to the Private Sector

	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 the 10 percent level.

** significantly different from zero at the 1 percent level.

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. Credit to the private sector 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 11.4). By the end of 2002, credit to the private sector remained at a very low 10 percent of GDP in 16 out of 60 countries.[2]

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

IEG also examined, in a separate review, experiences with more microeconomic approaches to increasing access to credit such as financing LOC through financial intermediaries (IEG, 2006). During a decade (FY93–FY03), much of the financing remained unused (cancellations rates averaged about 40 percent of original commitments) and outcomes of the projects were satisfactory in only about half of the projects. Thus, more

Table 11.4: Distribution of Changes in Access to Credit in 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

direct attempts to expand access to credit have had high success rates.

The reasons for the low level of financial intermediation include macroeconomic influences (Chapter 2). Private access to credit can be crowded out by the government's need for financing, which, in turn, is related to fiscal deficits (World Bank, 2004a), and institutional and environmental factors such as collateral laws, creditors' rights, strength of the judicial system and the enabling environment for private investment may play critical roles in the willingness of banks to extend credit.

However, more work may be required with respect to the banks' capacities to lend and to manage risks. After ownership and market structure are changed, interest rates liberalized, and prudential regulations and banking supervision strengthened, if the banking staff and managers have little experience in banking, then more microeconomic approaches may be needed. For example, 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

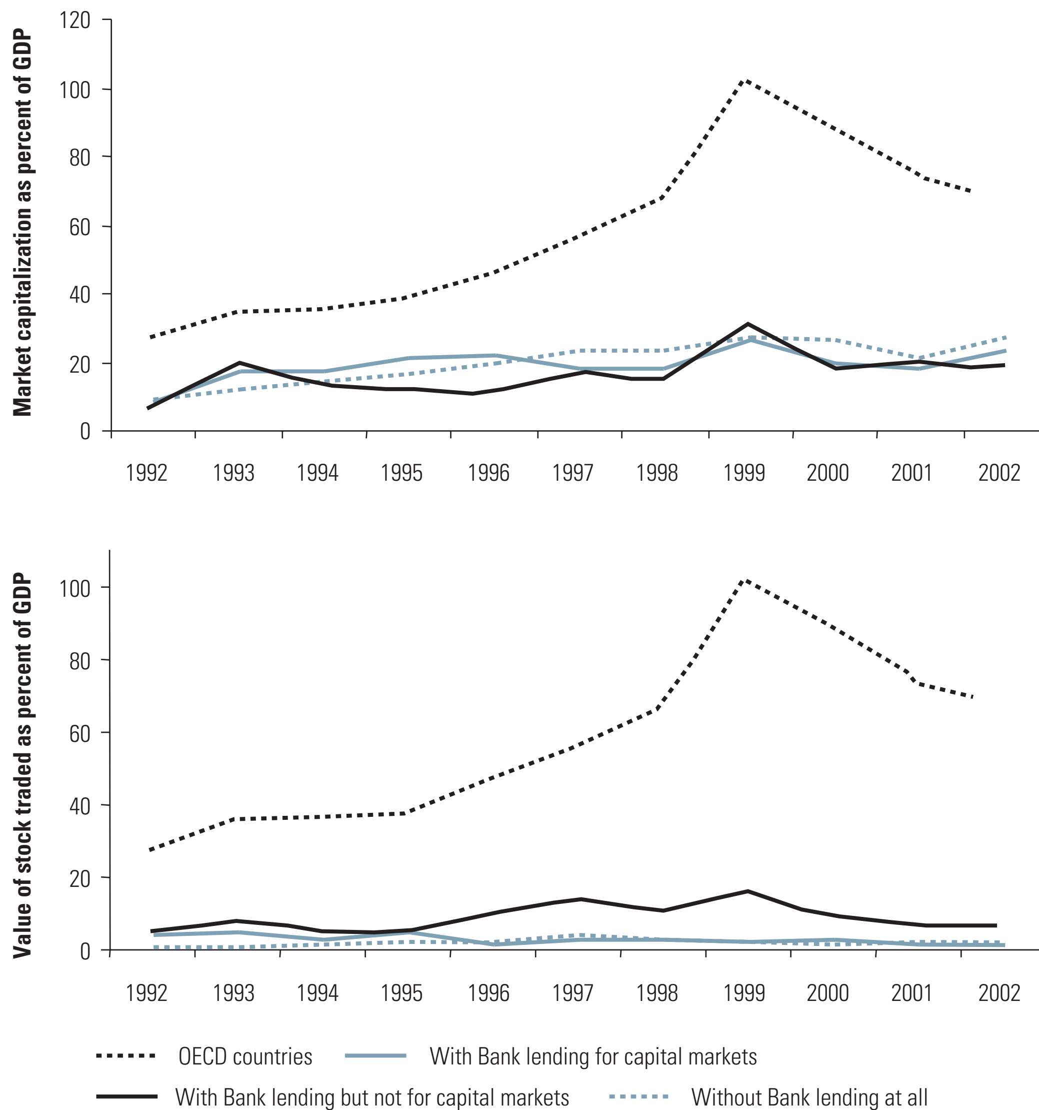
This section reviews the evolution of capital markets in the countries that borrowed for capital market improvements, using changes in market capitalization and market turnover (value of stock traded), both as a percentage of GDP. Thirty countries borrowed from the Bank for capital market reforms but information was available for only 15 of them, predominantly Latin American countries.[3]

Figure 11.3 below shows some increase in market capitalization in borrowing countries, but it remained relatively low, on average, and market turnover decreased during the period, as a percent of GDP. In addition, the distribution of the changes in these indicators (Table 11.5) shows that about 40 percent (six out of 15 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 during 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 11.3. The results show little difference between borrowing countries and nonborrowing countries.

Did Bank Borrowing Improve Stability?

As a proxy for measuring stability, IEG examined whether borrowing countries had fewer instances of systemic bank insolvency[4] 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

Figure 11.3: Market Capitalization and Value of Stocks Traded in Countries, 1992–2002



Source: World Bank, 2004b.

Table 11.5: Distribution of 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 percent of GDP	5	4	6	15
Value of stocks traded as percent of GDP	2	3	9	14

Source: World Bank, 2004b.

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 cannot be assumed that countries not included in this list had necessarily robust banking systems. Therefore, the sample of countries falls at the lower end of the spectrum in terms of measured health of their banking systems.

Table 11.6 summarizes the results and the list of countries in each category is in Appendix F, Table F.1. No clear pattern emerges. Out of the 58 countries that borrowed from the Bank for financial sector reforms and for which information was available, 18 were not characterized by banking insolvency at the time that they borrowed, and did not experience insolvency afterward, while 15 of them borrowed during insolvency and later improved. An additional 23 also borrowed during insolvency and did not pull out of it in the years following the loan(s). Among the 58 Bank borrowers, only two borrowed during a period when there was no systemic insolvency (Jamaica and the Ukraine), but later experienced a banking crisis. Among the 22 countries that did not borrow from the Bank for financial reforms during this period and for which information was available, more than half experienced systemic bank insolvencies. 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 53 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 11.6: 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 the Bank for financial sector reforms	58	18	40 (out of which 15 borrowed during insolvency and improved; 23 borrowed during insolvency but did not improve; and 2 borrowed and insolvency followed)
Total number	80	27	53

Source: World Bank.

Findings and Recommendations

Findings

After well over a decade of borrowing from the World Bank for financial sector reforms, most of the 96 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 about US$56 billion dollars in lending, or 24 percent of the Bank's total commitments.

The support targeted 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.

Most of the lending for financial sector reforms was embedded in components of multisector loans. Out of 385 loans containing some support for financial reforms, only 36 percent (137 loans) were for the financial sector. The remainder of the support were components of adjustment and technical assistance loans and LOC for other sectors. During the period FY93–FY03, lending for financial sector reforms declined, mainly because of the sharp drop in LOC. Apart from LOC, support for financial sector reforms through adjustment and technical assistance lending declined only slightly, with a more noticeable drop in (formal) nonlending assistance.

This IEG review finds that the objectives of financial sector lending followed good practices in the areas of (i) reducing government ownership of financial intermediaries, (ii) improving prudential regulations to be consistent with international norms, and (iii) strengthening banking supervision to adhere more closely to international principles. This review also finds, however, that consistency within a country and, especially, coherence of the Bank's approach to financial sector reforms across countries should be improved, particularly with respect to the priority of Bank support for payments systems, deposit insurance schemes, and capital market development. The combination of ongoing debates within the Bank (e.g., whether and how to support deposit insurance schemes), absence of "good policy" notes, and

Most Bank lending for financial sector reforms has been embedded in components of multisector loans, but outcomes of these components are significantly lower than outcomes of loans under the Financial Sector Network.

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.

Excluding LOC, which are analyzed in a separate IEG review, outcomes of all lending for financial sector reforms (adjustment plus TA loans) averages 75 percent satisfactory, slightly below the 79 percent average for all (adjustment and TA) lending, excluding the financial sector. However, the outcomes of loans classified under the financial sector board were significantly better than outcomes of financial sector components of multisector loans. This 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 multisector loans have strong support from financial sector officials in the client country.

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 do not. 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.

At a country level, IEG examined whether Bank borrowing could be associated with changes in outputs, outcomes, and impacts. 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 nonperforming loans.

At a country level, IEG examined whether Bank borrowing could be associated with changes in outputs, outcomes, and impacts.

Finally, impacts were defined as: (i) financial sector depth in banking, as measured by the money supply as a percentage of GDP, and the preference for cash as an indicator of the lack of confidence in the banking system; (ii) size of the capital markets, as measured by capitalization and turnover as a percentage 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. IEG also tested whether the results were different for countries that borrowed from those that did not borrow for financial sector reforms during 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 do not borrow, the results of the econometric analysis show an association of Bank borrowing with outcomes, rather than causality.

Outputs 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 nonbank financial intermediaries that do substantial lending. Thus, reducing the government's role in financial intermediation remains a challenge.

Although the Bank often and appropriately supported financial restructuring prior to the privatization of banks, Bank support did not consistently focus on the quality of the new owners, and this contributed to poor results. In addition, the Bank supported financial restructuring of banks in the absence of governments' commitments to change their ownership, and this also led to poor results (reappearance of poor loan portfolios and insolvency).

Improvements in laws and regulations governing the financial sector were 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 nonborrowing 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 nonborrowing 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 being in compliance with Basel core principles.

Outcomes at the Country Level

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

Although government ownership has decreased dramatically in borrowing countries, reducing government's role in financial intermediation still remains a challenge.

Impacts at the Country Level

The positive results on outcomes discussed above do not translate into equally positive findings on impact during the last decade, although developments have been in the right direction. Financial sectors deepened in countries that borrowed for financial sector reforms during the period, although not significantly more than in nonborrowing countries. Borrowing countries remained, on average, relatively shallow. For example, M2/GDP was below 40 percent in the Bank borrowers in 2002 (as a comparison, it was 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 nonborrowing countries), which could be the result of the reforms aimed at downsizing, restructuring, and privatizing banks and proactive efforts by governments to regulate and supervise them.

Credit to the private sector (as a percent of GDP) grew at an annual rate of 0.4 percent per year in countries that borrowed from the Bank for financial sector reforms, less than in countries that did not borrow from the Bank (where credit to the private sector 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. Therefore, though the growth is slower than in nonborrowing countries, it may be more prudent

Improvements in laws and regulations governing the financial sector were uneven, and there was little information on the critical aspect of their implementation.

Financial sector depth and access to credit have both grown during the period, but starting from very low bases, both remain shallow in borrowing countries.

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, IEG found no pattern in terms of improved stability of the financial system in countries that borrowed from the Bank relative to those that did not.

The findings on financial sector depth and credit to the private sector suggest that the reforms supported by Bank lending during 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.

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

IEG found that the Bank was ill-prepared to respond quickly in Mexico in 1994, and in Thailand, Korea, and Indonesia in 1997; and better prepared in Argentina, Russia, and Turkey. Even in countries where it recognized signs of vulnerability (e.g., Indonesia and Turkey), official Bank documents gave optimistic assessments of the 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 31 closed operations (US$18 billion) were lower by about 15 percentage points than outcomes of noncrisis lending. This is a somewhat surprising finding given the high relevance of the objectives and the fact that crises often induce or strengthen the commitments of governments to address the problems. The ratings are likely the result of the need to state overly ambitious objectives to justify the large loans that are necessary to fulfill the preannounced assistance package (Chapter 10).

The reforms supported by the Bank during the 1993–2003 period have led to improvements in financial systems in client countries, but have been insufficient to bring about well-developed systems.

Collaboration with the IMF in these crisis countries 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 division of responsibilities 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, IEG found that prior recommendations for the Bank to prepare guidelines on the triggers for actions in crisis situations and clear divisions of responsibility have not been implemented and remain valid today.

Recommendations

- The Bank's FSB should provide guidance for Bank staff and client countries, and the Financial Sector Network should become more proactive in the quality control of financial sector components in multisector 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); AMCs (if, when, and how); privatization of banks; promotion of capital markets (if, when, and how, and in conjunction with the 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) the 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, and 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 a crisis:
  (i) The Bank should develop a rating system, in partnership with other relevant institutions, for vulnerability to crises, 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.
  (ii) The Bank should make internal arrangements to respond better to crises by developing guidelines, which should include the possibility, if circumstances warrant, of lending liquidity support to countries experiencing a crisis without stipulating ambitious reforms (which may not get realized) as justification for the loan.
  (iii) 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 the division of responsibilities among themselves.

APPENDIXES

APPENDIX A: DATA ON TRENDS IN LENDING AND NONLENDING

Table A.1: Lending by Region, Including and Excluding LOC, FY93–FY03

Region	Lending amount including LOC $(millions)	Percent of Region lending	Lending amount excluding LOC $(millions)	Percent of Region lending
Africa	806.6	3	630.6	2
East Asia and Pacific	6,764.0	12	6,357.0	11
Europe and Central Asia	6,386.4	14	5,257.2	11
Latin America and Caribbean	8,145.8	14	7,499.8	13
Middle East and North Africa	990.5	8	845.5	7
South Asia	1,711.7	5	659.8	2
Total	24,805.1	11	21,249.9	9

Table A.2: Bank Lending for Capital Market Reform, Number of Projects, by Region

Region	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Total
Africa	2	1		2			1	2				8
East Asia and Pacific			1			1	2	1				5
Europe and Central Asia				4		3	3		1		2	13
Latin America and Caribbean	1	3		2	2	2	2	1	1	1	1	16
Middle East and North Africa				2	1	1	2					6
South Asia												0
Total	3	4	1	10	3	6	10	4	2	1	3	48

Figure A.1: Finance Lending, Including LOC, by Region

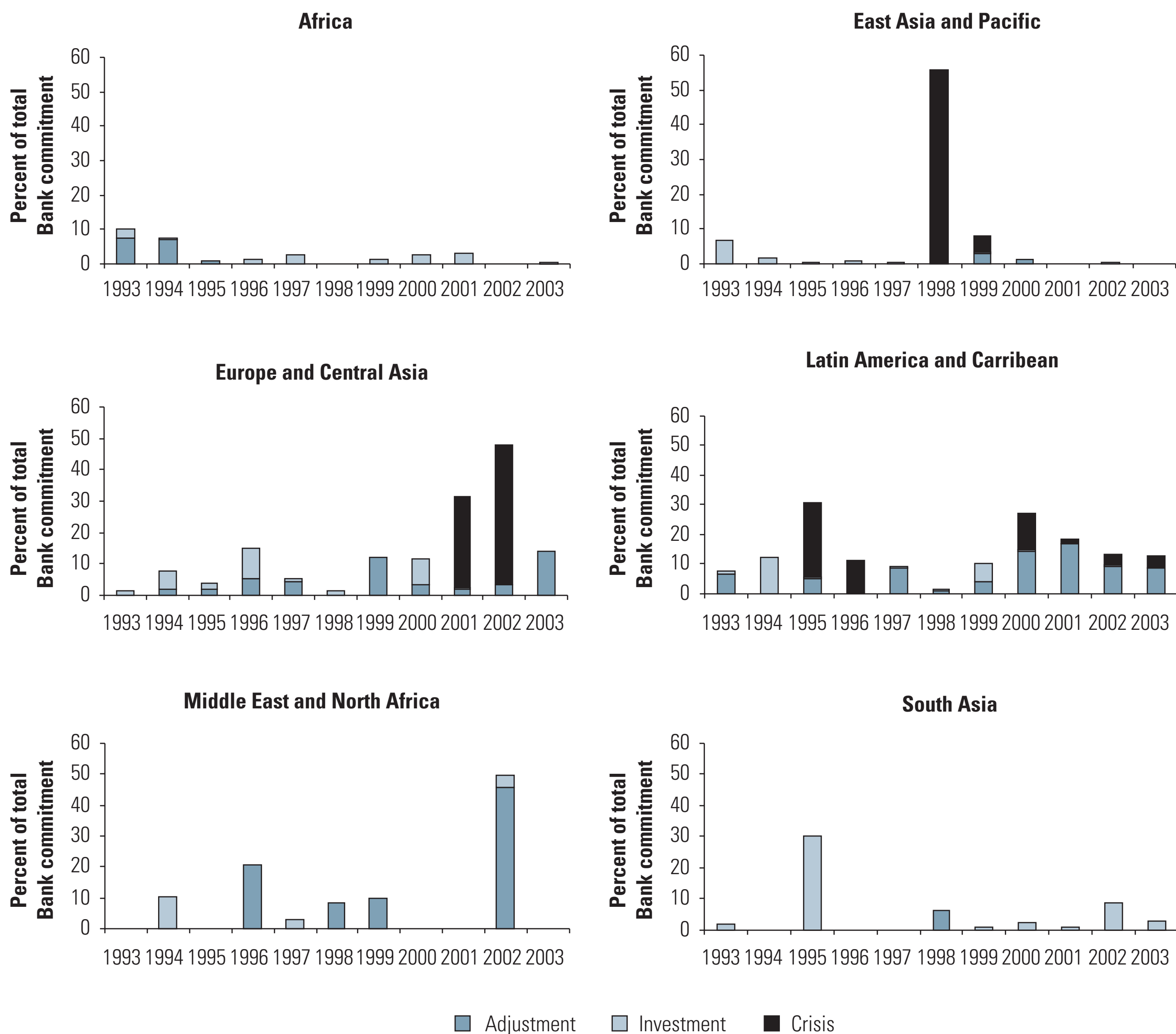


Figure A.2: Finance Lending, Excluding LOC, by Region

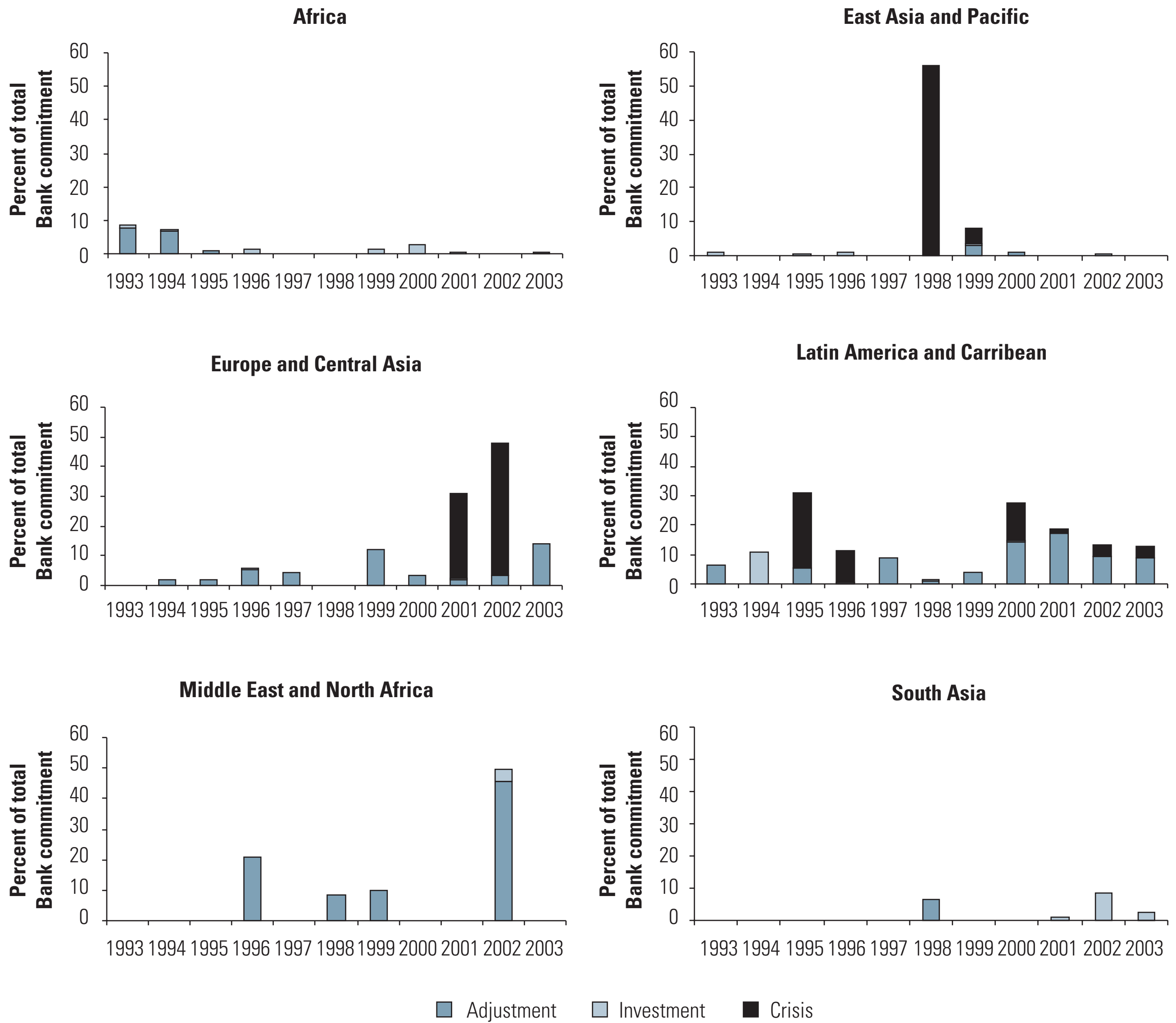
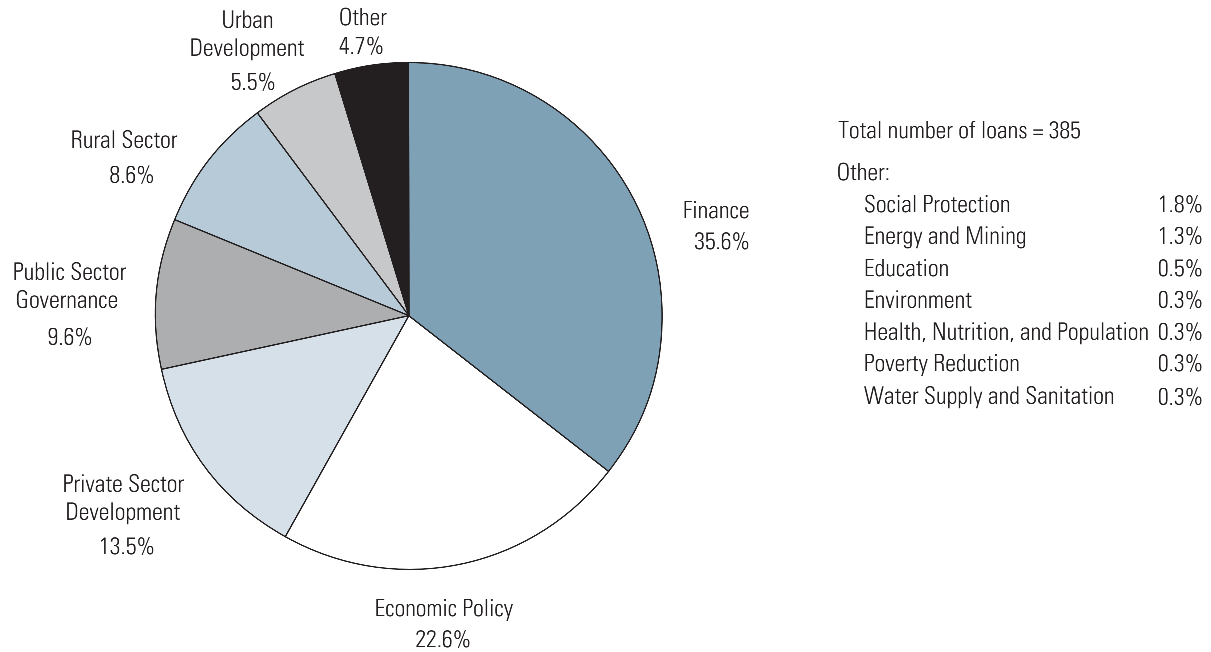


Figure A.3: Breakdown of Operations with Financial Sector Components, by Sector Board (Including LOC)



Note: Percentages do not add up to 100 owing to rounding of numbers.

Figure A.4: Number of Sector Loans, Including Multisector Loans and LOC, as Percent of Region's Loans

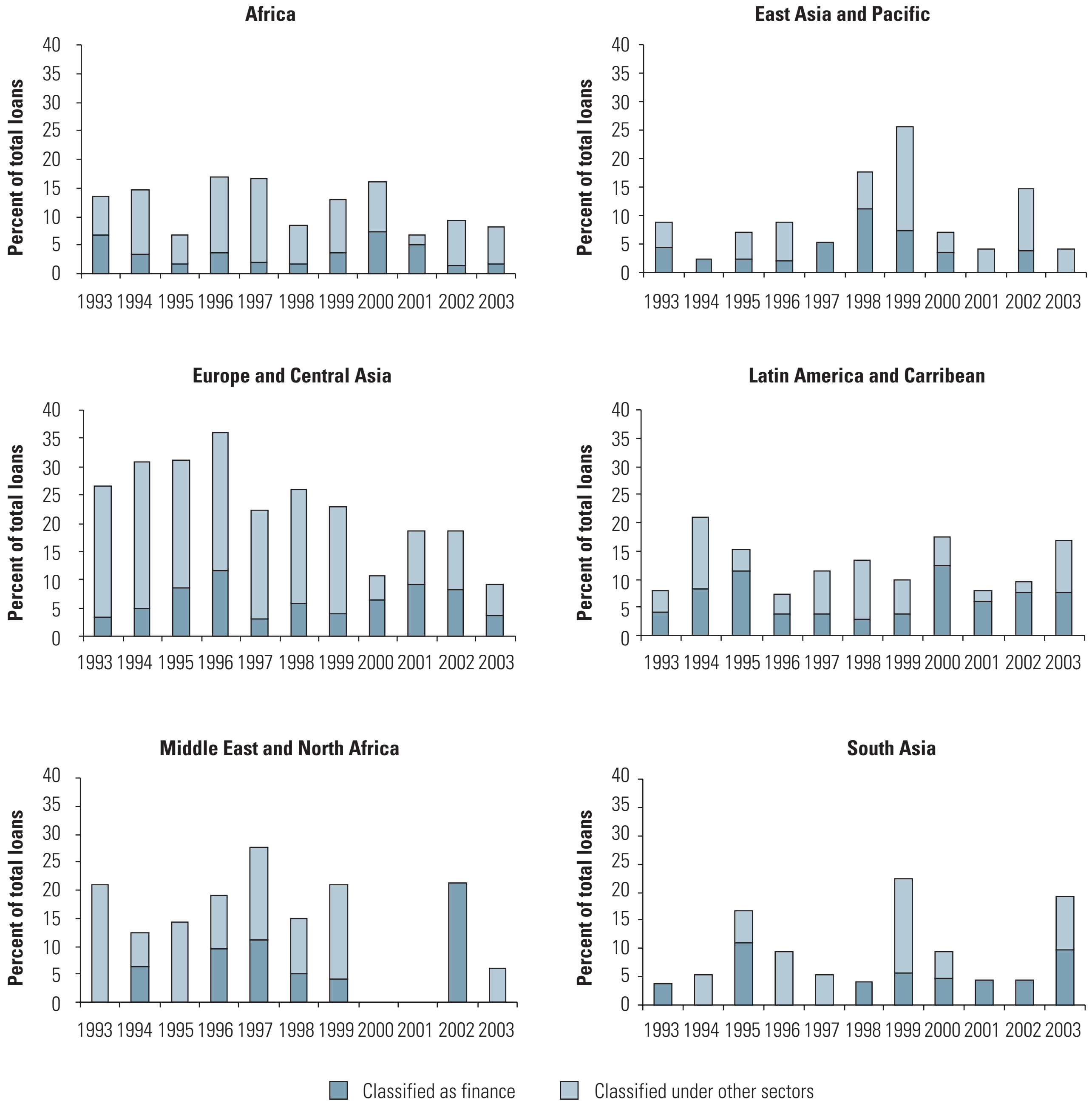


Figure A.5: Trends in Lending in Support of Specific Financial Sector Reforms, by Year

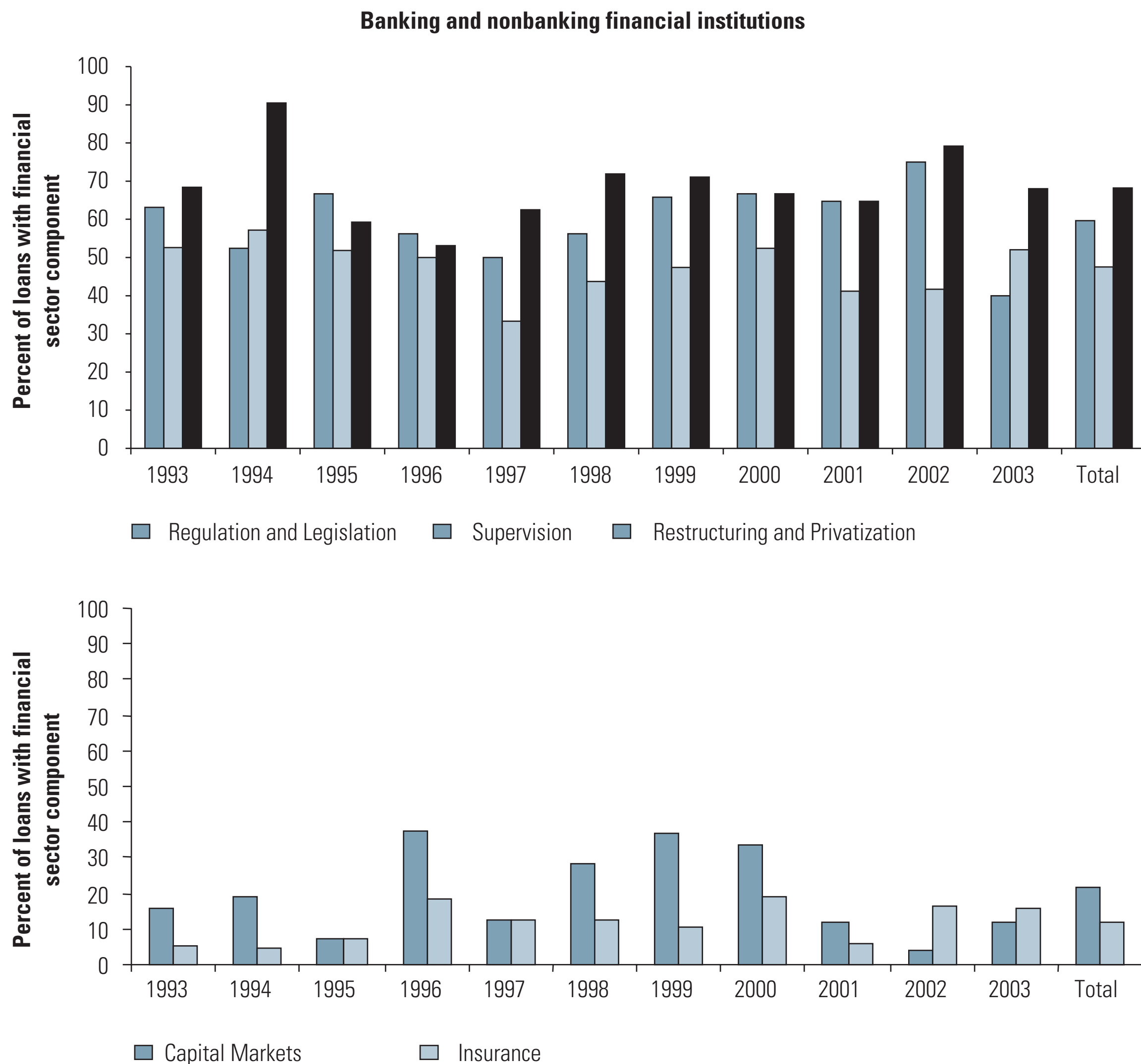
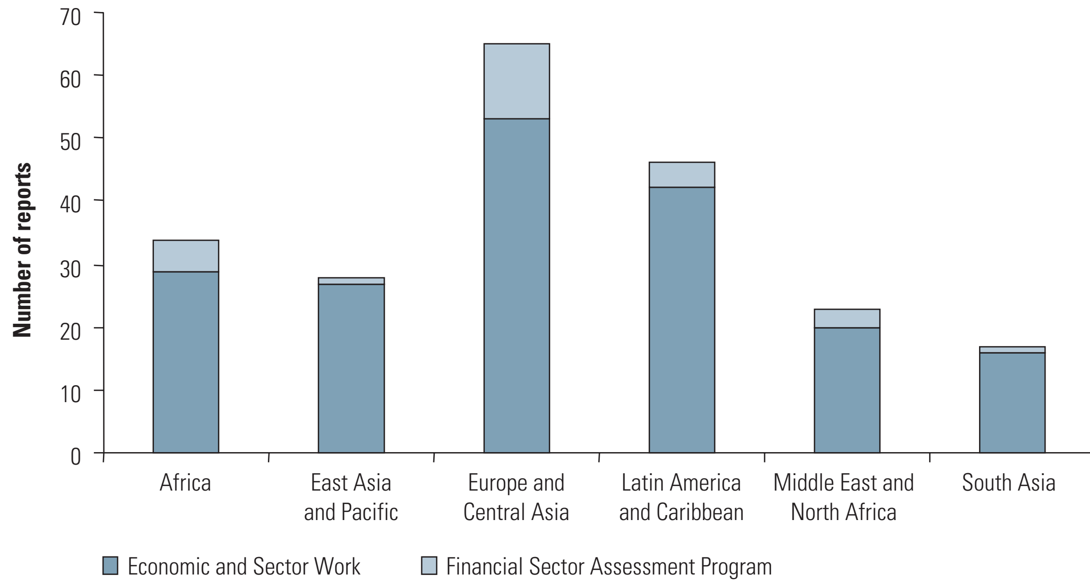


Figure A.6: Number of ESW, by Region, FY93–FY03



APPENDIX B: OUTCOME RATINGS OF BANK LOANS

See Chapter 6 for further information.

Table B.1: Changes in Ratings of Financial Sector Components of Multisector Loans

	IEG				
Source of rating	Performance assessment reports	Desk review	Total IEG	Implementation completion report validated by IEG	Grand total
	27	60	87	12	99
Upgraded	1	8	9	1	10
Downgraded	4	7	11	2	13
Disconnect	(3)	1	(2)	(1)	(3)

Note: Numbers in parentheses indicate more downgrades than upgrades. Upgrade and downgrade refer to changes in outcome ratings between the overall project rating and the component rating.

Table B.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 multisector loans	142	106	75
All adjustment loans (excluding financial sector)	243	192	79
Financial sector TA loans plus financial sector components of multisector 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 multisector adjustment loans	99	68	69*
Financial sector TA loans	17	14	82
Financial components of multisector TA loans	32	24	75
Sector classification and 2003 CPIA rating			
Financial sector loans, low-CPIA rating (CPIA between 1.0 and 3.5)	17	15	88*
Components of multisector loans, low-CPIA rating (CPIA between 1.0 and 3.5)	51	34	67*
Financial sector loans, high-CPIA rating (above 3.5)	43	37	86*
Components of multisector 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 multisector loans, low income	54	37	69
Financial sector loans, middle income	42	39	93*
Components of multisector loans, middle income	77	55	71*

* significantly different at the 5 percent confidence level.

Table B.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[a]			
1996 ratings			
Loans in low-CPIA (1.0–3.5) countries	127	94	74
Loans in high-CPIA (3.6–6.0) countries	53	41	77
2003 ratings			
Loans in low-CPIA (1.0–3.5) 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 (1.0–3.5) 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

a. 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 ranges for 1996 CPIA ratings (1.0–3.0; 3.1–6.0) with similar results. For 2003, there were too few observations in the CPIA rating 1.0–3.0 to be meaningful.

* significant at the 10 percent confidence level.

** significant at the 5 percent confidence level.

Table B.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 components			
Loans with associated TA loans	48	36	75
Loans without associated TA loans	94	70	74
Income level and TA[a]			
Low-income countries: loans with TA	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[a]			
Low-CPIA countries, loans with TA	11	10	91*
Low-CPIA countries, loans without TA	16	9	56*
High-CPIA countries, loans with TA	17	9	53
High-CPIA countries, loans without TA	40	31	78
Transition countries			
Transition countries: loans with TA	19	16	84
Transition countries: loans without TA	35	27	77

a. Excluding transition countries.

* significantly different at the 5 percent confidence level.

APPENDIX C: COUNTRY-LEVEL OUTPUTS

Table C.1: Capital Adequacy in 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 foreign exchange losses	6	6		13	12	

Table C.2: Comparison of Loan Classification, by Average Number of Days

	1998			2003			Number of countries with changes
	Substandard	Doubtful	Loss	Substandard	Doubtful	Loss	
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 C.3: Indicators on Strength of Financial Regulations for Banking in Transition Countries

With Bank lending	1998	2002	Change	Without Bank lending	1998	2002	Change
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
Macedonia, FYR	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**

Source: EBRD Transition Report, various years.

Note: The EBRD indicator for each country is a composite measure, scaled from 1 to 4, with pluses and minuses; an increase from 2– to 2 was counted as an increase of 0.33; from a 2 to a 2+ was 0.33, etc.

Table C.4: Indicators on Strength of Regulations for Securities Markets and Nonbank Financial Institutions in Transition Countries

With Bank lending	1997	2002	Change	Without Bank lending	1997	2002	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	Hungary	3+	4–	0.33
				Kazakhstan	2	2+	0.33
				Latvia	2+	3	0.67
				Lithuania	2+	3	0.67
				Macedonia, FTR	1	2–	0.66
				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**

Source: EBRD Transition Report, various years.

Note: The EBRD indicator for each country is a composite measure, scaled from 1 to 4, with pluses and minuses; an increase from 2– to 2 was counted as an increase of 0.33; from a 2 to a 2+ was 0.33, etc.

Table C.5: Changes in Government Ownership of Banks

With Bank lending for privatization		Without Bank lending for privatization
Albania	Macedonia, FYR	Bangladesh
Argentina	Madagascar	Benin
Armenia	Malawi	Chile
Azerbaijan	Mali	Congo, Rep. of
Brazil	Mongolia	Costa Rica
Bulgaria	Morocco	Czech Republic
Burkina Faso	Mozambique	Dominican Republic
Cameroon	Nicaragua	Egypt, Arab Rep. of
Chad	Pakistan	Ethiopia
Colombia	Philippines	India
Côte 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. of	Peru
		Sri Lanka
		Venezuela, R. B. de
		Zambia

Table C.6: OECD Member Countries as of 1993, Excluding Bank Borrowers

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

APPENDIX D: REFERENCE TABLES

Table D.1: Countries for Desk Studies and Value of Operations, by Region

	Value of Loans, $m		Value of Loans, $m
Africa		**Latin America and Caribbean**	
Burkina Faso	25	Brazil	808
Cameroon	545	El Salvador	50
Chad	85	Nicaragua	150
Côte d'Ivoire	200	Peru	400
Ghana	340	**Total**	**1,408**
Guinea	23	As percent of regional lending	28%
Madagascar	221		
Mozambique	420	**Middle East and North Africa**	
Tanzania	134	Algeria	750
Togo[a]	—	Morocco	600
Uganda	226	Tunisia	412
Zambia	262	Yemen, Rep. of	82
Total	**2,482**	**Total**	**1,844**
As percent of regional lending	74%	As percent of regional lending	85%
East Asia and Pacific		**South Asia**	
Lao PDR	57	Pakistan	850
Mongolia	42	**Total**	**850**
Philippines	500	As percent of regional lending	74%
Vietnam	500		
Total	**1,099**		
As percent of regional lending	78%		
Europe and Central Asia			
Albania	100		
Armenia	285		
Georgia	195		
Hungary	225		
Kazakhstan	540		
Lithuania	179		
Macedonia, FYR	215		
Moldova	120		
Poland	450		
Romania	1,230		
Slovak Republic	257		
Ukraine	1,410		
Total	**5,206**		
As percent of regional lending	61%		
Total number of case countries	37		
Total value of loans in case countries, $m	12,888		
As percent of all countries borrowing for financial reforms[b]	54%		
As percent of total Bank lending for finance[b]	59%		

a. Togo had a TA operation that was to be followed by an adjustment credit, which did not materialize. It is included here because the TA operation was a substantial part of the Bank program in the sector.
b. Excluding crisis countries.

APPENDIX E: COUNTRY-LEVEL OUTCOMES

Measures of Contestability, 1998–2003

Table E.1: Entry Requirements: Average Number of Licenses

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

Note: Scale: no = 0; yes = 1.

Table E.2: Average Change in Minimum Capital Requirements

	Change between 1998–2003
With Bank borrowing	1.04
Without Bank borrowing	1.00

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

Table E.3: Number of Countries That Changed Minimum Capital Requirements between 1998 and 2003

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

Table E.4: Restrictions on Activities

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

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

Table E.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
Côte d'Ivoire	Korea, Rep. of
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, R. B. de
Togo	Zambia
Turkey	Zimbabwe
Uganda	

Table E.6: Countries Studied with Select Variables

Variables: Concentration, interest rate spread, financial sector depth, liquidity preference, and credit to the private sector[a]

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 Herzegovina	Mauritania	Costa Rica
Brazil	México	Czech Republic
Bulgaria	Moldova	Dominican Republic
Burkina Faso	Mongolia	Egypt, Arab Rep. of
Cameroon	Morocco	Estonia
Central African Republic	Mozambique	Ethiopia
Chad	Nicaragua	Gabon
Colombia	Niger	Gambia, The
Congo, Dem. Rep. of	Pakistan	India
Côte d'Ivoire	Peru	Iran, Islamic Rep. of
Croatia	Philippines	Kenya
Ecuador	Poland	Lebanon
El Salvador	Romania	Lesotho
Georgia	Russian Federation	Mauritius
Ghana	Slovak Republic	Nepal
Guatemala	Slovenia	Nigeria
Guinea	Tanzania	Oman
Honduras	Thailand	Panama
Hungary	Tunisia	Papua New Guinea
Indonesia	Turkey	Paraguay
Jamaica	Uganda	Senegal
Jordan	Ukraine	South Africa
Kazakhstan	Uruguay	Sri Lanka
Korea, Rep. of	Vietnam	Swaziland
Kyrgyz Republic	Yemen, Rep. of	Syrian Arab Republic
Lao PDR	Zambia	Togo
Latvia		Trinidad and Tobago
		Venezuela, R. B. de
		Zimbabwe

a. Definitions and sources of information for these variables are in Appendix F.

Table E.7: Capital Markets

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

APPENDIX F: DEFINITIONS AND SOURCES FOR IEG/DEC MODEL

Table F.1: Financial Instability[a] and Bank Borrowing for Financial Sector Reforms, 1995–2002

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

a. 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.

IEG/DEC Model
Definitions and sources of information

Table F.2: Indicators Used to Measure Outputs, Outcomes, and Impacts 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. (2003): EBRD (various years); Barth et al. (2001a); Mozes (2003); Kiguel and Dujovne (2003)	Definitions vary slightly by source, for example, in Laporta et al. (2002), the definition is the 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. (2001a,b,c); 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	Statistical Information Management and Analysis	
Financial sector depth	M2/GDP	Statistical Information Management and Analysis	
Liquidity preference	Cash/M2	IMF *International Financial Statistics*	Lines (34+35) – Lines (24+25)
Credit to private sector	Banking claims on private sector/GDP	Statistical Information Management and Analysis	

IEG/DEC Model

The basic model tested was:

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

where:

Y_{it}	= M2/GDP, Private Credit/GDP, Cash/M2, Interest Rate Spreads, or Concentration in country i, year t (1…12)
α	= country-specific fixed effect
wb	= World Bank lending for financial sector reforms between FY93 and FY01
no-wb	= no World Bank lending for financial sector reforms between FY93 and FY01
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:

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

where the macro/institutional controls were excluded;

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

where the macro/institutional controls were included, and

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

APPENDIX G: MANAGEMENT RESPONSE

Introduction

Management welcomes IEG'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 IEG Review. It then sets forth Management's comments on the analysis, conclusions, and recommendations. The Management Action Record is attached.

Summary of IEG's Findings and Recommendations

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 multisector 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. IEG 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.

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, AMCs, 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 multisector 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 pres-

ent 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.

Management Comments

Impact

The IEG 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.

The Lagged Impact of Financial Sector Reforms. The Bank's recent work "Economic Growth in the 1990s: Learning from a Decade of Reform,"[1] 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 IEG. 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.[2]

Macroeconomic Considerations. The IEG 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, 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.[3] 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

Knowledge and Learning Activities. The Review recognizes (Chapter 2, footnote 9) 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.

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 IEG'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, FYR Macedonia (Stopanska), Bosnia, and Romania. The review cites some of these privatizations (FYR Macedonia and Tanzania), but does not mention IFC's involvement and contribution to a successful outcome.

Analysis of Bank Support for Crisis Countries. IEG 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.

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-term 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.

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); AMCs (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 multisector loans.*

The IEG 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.[4] Management nevertheless recognizes the need for operational guidance to staff that will distill in a comprehensive way best practice principles to reforming a particular policy and set of institutions. Against this background, and in view of IEG'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.

Multisector Operations with Financial Components. The review concludes that outcomes of financial components in multisector 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 multisector 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 multisectoral 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 multisector 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 nonspecialists 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.*

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[5] 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: 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:*

(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.

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 IEG'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.[6] 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.

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.

The IEG 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.

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.

(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.

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.

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

Management Action Record

IEG Recommendation	Management Response
The financial sector anchor should also be more pro-active in quality control, especially for financial sector components of multisector 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 AMCs; 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 multisector 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 reach quick agreement at the outset of the crisis, on the division of responsibilities.	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 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.

APPENDIX H: CHAIRMAN'S SUMMARY COMMITTEE ON DEVELOPMENT EFFECTIVENESS (CODE)

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

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 multisector loans. Over the period, lending for financial sector reform (FSR) declined, due mainly to the sharp drop in lines of credit (LOC). CODE discussed IEG review on LOC on October 13, 2004. The earlier 1998 IEG review of Bank support for financial sector reform presented several recommendations that management gave prominence in the financial sector strategy of 2001.

IEG Finding and Recommendations. The IEG review examined the Bank assistance to financial sector reform over the decade. The IEG 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 macroeconomic situation, and partly because further reforms were needed.

IEG recommended that the Bank should (i) provide more guidance to Bank staff and client countries, in areas such as restructuring of banks, AMCs, 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. IEG found in the current review that a prior management recommendation for the Bank to prepare guidelines for crisis situations has not been implemented and continues to remain valid.

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 multisector 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.

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.

Members supported recommendations for improving Bank's operational consistency and policy coherence as well as coordination with the IMF. They were concerned with IEG'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 IEG and management on policy implications going forward. The committee endorsed the IEG report and the MR.

The main issues raised during the meeting were the following:

Coverage of the Report. Many members and speakers noted the report's 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, and corporate governance could be important contributory factors. Some members also felt that a discussion of FSAPs and ROSCs 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. *IEG concurred that the macroeconomic situation could partially explain the weak impacts. IEG 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. *IEG responded that it will conduct an evaluation on judicial reforms, which will cover extra-judicial issues, such as out-of-court resolution of nonperforming 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.*

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 IEG's recommendations. Management indicated that second generation reform is the most critical issue shaping the financial sector strategy update because of their multisector dimension, cross-sectoral nature and high visibility, as well as need for strong country ownership.

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 noncrisis 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.

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 Settlements.* 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.*

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 noncrisis 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

ENDNOTES

Chapter 1

1. Pension reform was, until 2002, under the purview of the Financial Sector Board.

2. IEG (2006).

Chapter 2

1. In the United States, for example, *privately owned* central banks were established twice (in the late 18th and early 19th centuries), but their existence was controversial and challenged in the U.S. Supreme Court, and their charters were allowed to lapse. The country had no central bank for most of the 19th century.

2. 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; and in Switzerland, 14 percent (Clarke, Cull, and Shirley, 2004).

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

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

5. 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: privatization per se does not lead to good outcomes.

6. 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.

7. 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." (World Bank, 1992, paragraph 45).

8. The 1997 Strategic Compact declared the Bank's intention to work with the IMF on financial sector issues, but this did not constitute an internal Bank guideline.

9. These include seminars and conferences on topical issues, as well as papers and Web site 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 IEG did not carry out specific tracer studies to assess this. It could be an interesting area for self evaluation for DEC.

10. It could also be argued that one of the objectives of a financial system is to intermediate *efficiently*, and thus financial sector efficiency and profitability should be considered as impacts. This review, however, follows recent literature, which uses financial sector depth and stability as measures of financial sector performance (see, for example, Barth, Caprio, and Levine, 2001a and 2000b; and Cull, Senbet, and Sorge, forthcoming), and, accordingly, as the definition of "impact."

Chapter 3

1. See the World Bank's 1989 *World Development Report*, devoted to the financial sector.

2. For a detailed discussion of lines of credit, their trends, designs, outcomes, and issues, see IEG (2006).

3. The definition of "banks" varies by country. Development finance companies, savings and loan associations, and even specialized banks are often considered nonbank financial institutions. For the analysis in this report, reforms aimed at bank-like institutions are categorized under banking reforms.

4. Many loans are classified under more than one category of reforms.

5. In addition, pension reform would account for about 38 percent of total loans if they were included.

6. Very few TA loans were approved because planned adjustment loans did not materialize (e.g., Togo, Uzbekistan). China was the exception (Box 4.2).

7. Since FY02, anti-money laundering and combating terrorist financing activities have taken on increasing prominence in the Bank's nonlending financial assistance and have been incorporated as components in lending assistance in several Regions.

Chapter 4

1. 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 funding available for the project was not used.

2. See background paper by Mozes (2003) on Bank lending for financial sector reforms in Africa.

Chapter 5

1. The country case studies were selected to capture the bulk of the (noncrisis) lending and to represent all Regions (see Appendix D for the list of countries and amounts of lending reviewed).

2. The 1998 IEG 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 becoming 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.

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

4. 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, financial and procurement management assessments (Country Financial Accountability Assessments and Country Procurement Assessment Reports) are also somewhat standardized ESW products, so IEG analyzed the results both with and without these products and found the same results in both cases.

5. 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 country condition analysis, what other donors are doing, and a consistent view of the critical elements needed for an efficient, effective financial system.

6. 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." 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.

7. 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.

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

9. The Bank's research department is the Development Economics Unit and it has been active in exploring a number of subjects and producing articles on different elements of a financial system, or of reforms (e.g., 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 board.

Chapter 6

1. This chapter excludes outcomes of LOC, which are analyzed in IEG, 2006. It also excludes loans fo-

cused solely on pension reform, which are the subject of an ongoing IEG review.

2. Of the 99 component ratings, 12 came from implementation completion reports, validated by an internal IEG review; 27 came from IEG's assessment reports. Of the remaining 60 rated by an IEG desk review, outcomes of 9 components were rated better than the overall project outcome rating and 11 were rated 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 Appendix B, Table B.1.

3. The CPIA 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.

4. IEG examined the period prior to FY93 for adjustment loans addressing financial sector reforms; investment loans with reforms were not captured in this analysis.

Chapter 7

1. This chapter is based on the background paper by Millard Long (2003b) and IEG project assessments.

2. 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 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.

3. Venezuela had a crisis, but no Bank lending, and is not discussed here.

4. These figures exclude LOC.

5. 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.

6. A 2003 analysis by the United States General Accounting Office concluded much the same about the IMF's ability to anticipate crises.

7. Internal documents are the most frank, documents to the Board of Executive Directors are the least frank, and sector work falls somewhere in between the other two. The degree of candor may depend on whether the documents are disclosed to the public.

8. The President's report of the FSAL had an underlined section that noted the risk of a banking crisis if weaknesses were not addressed.

9. See, for example, Kenen (2002).

10. 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 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.

11. Out of the 32 closed and rated operations (including TA loans), 12 had assessment reports.

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

13. IMF (2001, 2002a, and 2002b).

14. Scott (1999).

Chapter 8

1. Defined as banks in which the government owns at least 50 percent of the capital.

2. 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.

3. 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.

4. In Cameroon, the "risk-free" asset proved to be high risk: the government was unable to service its bonds, which 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.

5. The countries were Albania, Cameroon, Romania, and the Slovak Republic, as well as the crisis countries, Indonesia, Korea, and Thailand. The support from adjustment lending was mostly through conditionality, which specified the transfer of NPLs to

the AMC or recovery targets. TA loans provided more specific assistance.

6. 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.

Chapter 9

1. The Core Principles for Effective Banking Supervision were issued in September 1997, which is about halfway through the period under review; even prior to their issuance, however, Bank loans supported many of these principles.

2. 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. IEG 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.

3. Theoretically, one set of measures would be the changes in capital adequacy ratios and nonperforming 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.

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

5. 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.

Chapter 10

1. 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-study countries (list is in Appendix D).

2. 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).

3. OECD countries are shown for comparison only and not as a target or benchmark.

4. 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.

5. 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.

Chapter 11

1. M2 is the combination of cash, demand deposits, and time deposits (IMF *International Financial Statistics*, lines 34 and 35).

2. At the high end for M2/GDP were Morocco (87 percent) and the Slovak Republic (64 percent). Countries with high measures of access to credit were Tunisia (69 percent) and Morocco (54 percent).

3. Of the 15 countries for which information was available, seven were from the LAC Region, two from the ECA Region, three from the MNA Region, two from the EAP Region, and one from the AFR Region.

4. Financial instability, as defined in Caprio and Klingebiel (2003), is characterized by 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.

Appendix G

1. World Bank (2005).

2. 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-Saharan 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.

3. For example, in the 25 developing and transition countries with the largest banking systems, the aver-

age 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 (2003).

4. IEG recognizes in Chapter 5, footnote 5 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.

5. http://worldbank.org/research/projects/bank_regulation.htm

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

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