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Working Party on Financial Aspects of Development Assistance

**FINANCIAL SYSTEMS FOR SUSTAINABLE RESOURCE MOBILISATION
IN LESS ADVANCED DEVELOPING COUNTRIES**

This document is submitted for CONSIDERATION at the meeting of the Working Party to be held on 21 January 2000.

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FINANCIAL SYSTEMS FOR SUSTAINABLE RESOURCE MOBILISATION IN LESS ADVANCED DEVELOPING COUNTRIES

I. Introduction

1. Strengthening financial systems in less advanced developing countries is very much a prerequisite for delivering broader economic growth and poverty reduction. For example, in the other areas addressed by recent workshops (enterprise development; infrastructure), improving financial systems are key. Access to equity investment and suitable forms of credit is essential to expanding the opportunities for enterprise development in an economy. Together with a greatly expanded role for the private sector, the development of new financial markets and instruments to facilitate investment in infrastructure at regional, national and local levels is essential to meeting the immense infrastructure needs foreseen in developing countries into the 21st century.

2. The main objective of the present work of the Working Party on development finance issues is to bringing together, for the December 2000 SLM, the three workshops on development finance themes so far addressed. The proposal to do this in the form of a “compendium” is set out in note DCD/DAC/FA(2000)1.

3. The present note sets out, in Annex 1, a paper prepared by Subhrendu Chatterji, with financial support from the United Kingdom. It is suggested that this paper could provide the basis for developing the proposed “compendium” chapter on financial systems. The analytical framework presented in Annex 1 may provide a good foundation for donors wishing to strengthen their programming in this sector. Its analysis highlights the key components of a country’s financial system and their interdependence. The framework highlights three important stages:

- *Assessment* of the requirements of the financial sectors’ various components for development and strengthening;
- Developing *strategic development objectives* for these components;
- *Implementing a co-ordinated strategy* to meet these objectives, shared by the developing country, multilateral and bilateral donors and the private sector.

4. Implementation issues examined include the need to improve access for the poor; better governance of financial institutions; a changed, supportive role for government in the financial sector; facilitating the entry of qualified foreign financial institutions; and examining regional solutions to the problems posed by small economies. It also addresses co-ordination issues, and identifies a number of essential elements for success -- developing country ownership of the process and the strategy; partnership of all stakeholders, including multilateral and bilateral donors, the private sector, civil society, and the informal sector; and effective donor co-ordination, which respects the different roles of multilateral and bilateral donors and what they can contribute.

5. Annex 2, prepared by the World Bank, provides an overview of the World Bank/IMF financial sector assessment programme (FSAP). This program began in May 1999, with a one-year pilot phase in

about 12 countries. An objective of the FSAP is to provide broader, more rigorous analysis of a country's financial system and to better utilise and co-ordinate support from the Fund and Bank. The FSAP is designed to identify financial system strengths and weaknesses, reduce the potential for future crises, and make recommendations on strengthening and developing financial sectors in client countries. This approach fits well with the kind of assessment of the financial sector called for in the analytical framework set out in Annex 1. At a later stage, information on the FSAP could be integrated into the "compendium" chapter on financial systems.

6. The FSAP raises important issues for bilateral donors.

- It will obviously address highly confidential issues regarding the short-term vulnerability of financial sectors. At the same time, it is important that the analysis and findings regarding medium- and long-term financial sector development are made available as a basis for a shared understanding of problems and needs.
- A number of delivery mechanisms are foreseen in the FSAP for follow-up technical assistance -- assistance provided directly by Bank and Fund staff; support provided through project lending; and technical assistance funded through trust funds financed by donors. To what extent could the FSAP offer a common platform to co-ordinate the delivery of technical assistance with bilateral donors, particularly in less advanced developing countries?
- It is envisaged that the FSAP will cover all members of the IMF over a timeframe of several years. Financial sector development strategies and co-ordinated capacity building programmes are needed in many less advanced countries more urgently than this timeframe may allow for. What can be done to help less advanced countries with financial sector development issues in a shorter timeframe.

II. Issues for discussion

7. Members are invited to comment on the following issues:

a) *General questions*

- **To what extent do Members share the methodology set out in Annex 1 for assessing financial systems needs, and its implications for donor strategies and policies?**
- **Do Members agree that Annex 1 could provide the basis for the "compendium" chapter on financial systems and be used as a "model" for the other thematic chapters (enterprise development; infrastructure)?**

b) *Specific questions -- implications for donor strategies, instruments and implementation*

8. Annex 1, together with the conclusions of the workshop on financial systems [see DCD/DAC(99)9] provides the following list of implications for donor activities in this area:

- It is difficult to overestimate the importance of co-ordinated, coherent, sector-wide approaches, led by developing countries themselves and involving the full range of relevant partners. This should be based on a thorough assessment and well-planned strategy which pays attention to inter-linkages and sequencing.

- Such an approach makes it possible to proceed effectively and simultaneously with activities at a number of levels (macro, meso, micro) in parallel, to meet a full range of needs identified in the area of financial sector strengthening.
- Donors should first of all be careful to “do no harm”, particularly by avoiding inappropriate subsidies and impeding privatisation and the commercialisation of credit.
- Assisting governments to engage in extensive local capacity building at many levels should be at the forefront of any well-formulated strategy and programming. Training is a crucial element in capacity building.
- Technical assistance to support financial liberalisation (market-determined interest rates, elimination of directed lending, entry of qualified new entrants), as well as developing new financial instruments, markets and products for new clients, should be a donor priority.
- Donor attention to microfinance is justified in that, if appropriately designed and implemented, it can reduce poverty by increasing income and investment.
- The operation of state-owned financial institutions, and helping define a new role for government, often deserve attention.
- Efforts to strengthen regulation and supervision are essential. New legislation is often required regarding the Central Bank, commercial banks, and non-banking institutions. Supervisory units often need to be built for implementing new legislation and regulations.
- The underlying infrastructure and enabling environment for financial sector strengthening (bankruptcy legislation, capacity of the judiciary, accounting and auditing, tax laws, credit and rating institutions, etc.) often requires attention.
- Moving towards a more reliable, efficient payments system may provide opportunities for developing countries to “leapfrog” technological stages in financial sector strengthening.
- Educating legislators, civil servants, journalists and the public at large may be a good way to increase transparency and develop a constituency for financial sector reform.
- Donors are in a good position to assist governments and the private sector in ensuring that the gender and social impacts of financial sector development are identified, discussed with stakeholders, and appropriately addressed.
- Regional solutions -- donors should look for the potential regional dimensions of financial sector work in order to multiply benefits, generate economies of scale and assist regional integration.

9. The above list should provide the key headings for the central part of the chapter on financial systems -- where and how can donors best support efforts to strengthen financial systems in less advanced developing countries.

Members have requested that “guidance” should be less in the form of general principles and focus more on the co-ordination of the delivery of aid at the implementation level. At the same time, guidance should probably not be at the level of the “nuts and bolts” of implementing specific instruments at the field level. Members views and suggestions are, therefore, particularly solicited on how to frame the guidance in ways and at a level that best meets their needs.

- **How can we, therefore, develop the items listed in paragraph 8 above towards the “how to” of implementation.**
- **What are the main difficulties with co-ordinating donor approaches and how can/have these been overcome?**

Annex 1

**ANALYTICAL OVERVIEW OF POSSIBLE DONOR STRATEGIES IN DEVELOPING
COUNTRY FINANCIAL SECTORS**

by Subhrendu Chatterji

GBRW Limited

December 1999

*THIS PAPER HAS BEEN PRODUCED WITH THE FINANCIAL SUPPORT OF THE DEPARTMENT
FOR INTERNATIONAL DEPARTMENT. THE VIEWS EXPRESSED ARE THOSE OF THE AUTHOR
AND DO NOT NECESSARILY REPRESENT THOSE OF DFID.*

1. Executive summary

1. Effective financial sectors are the engines for delivering economic growth by efficiently allocating resources from savers to borrowers. In developing countries, however, financial sectors tend to be characterised by a number of shortcomings. These limitations impede the financial sector's ability to most effectively support economic growth and render them susceptible to financial crises. Developing countries and their development co-operation partners need to work closely together to develop and strengthen financial sectors if OECD DAC international development targets set for 2015 are to be met.

2. The scale of the task involved dictates close co-operation between multilateral institutions, bilateral donors and the private sector to share the responsibility for supporting recipient governments. Moreover, as the financial sector works as a system of inter-linked institutions, markets and supporting infrastructure, development activity aimed at a particular part of the sector may impact on, or be dependent upon, other areas. To be effective therefore, financial sector development and reform needs to be approached by local partners and donors on a co-ordinated basis. The objective of this paper is to highlight the need for co-ordination. It presents an approach which facilitates this by formulating specific development assistance programmes within the context of an overall strategy for a country's financial sector.

3. An analytical framework is used in the paper that works as a diagnostic template to highlight the key components of developing country financial sectors that tend to require development or strengthening. These include the financial structure, comprising a range of institutions and markets catering to different savings and financing needs; the market-distortive impact of government involvement in the financial sector; the effectiveness of governance over financial sector institutions and markets; the financial and operational strength of institutions; the adequacy of the financial sector regulatory and supervisory regime; and the robustness of the legal, information and other infrastructure on which the financial sector relies for its effective functioning. The analytical framework is used to highlight the three key stages involved in the approach suggested in this paper:

4. Financial sector assessments that identify the development and strengthening needs of various components of a financial sector.

5. Developing strategic development objectives for the various elements of the financial sector, based on the outcome of the assessment exercise.

6. Developing a co-ordinated strategy to meet these objectives and highlighting the key areas where recipient countries and their partners can work together on implementation.

7. Among other matters, the paper highlights the importance of improving the poor's access to financial products and services; developing appropriate mechanisms and incentives for stakeholders to exercise governance over financial institutions rather than relying primarily on regulation and supervision; the critical need to liberate financial sectors from government influence, but, at the same time, how government activity can stimulate the development of the financial sector; the positive impact qualified foreign financial institutions can play in bringing know how, financial resources, competition and good regulation from their home countries; and the need to explore regional solutions given many developing country economies are relatively small.

8. Finally, the paper stresses that the recipient country needs to take the lead in this exercise. Local stakeholders must be integrally involved in the various stages of the exercise and take ownership. The multilateral institutions need to play a key role in supporting local partners and ensuring donor activity is

effectively co-ordinated. Bilateral donors can support financial sector development and reform in a number of areas. Effectiveness of their work is maximised if they can respond quickly to needs and contribute to activities where they have a comparative advantage.

2. Introduction

9. An efficient and robust financial sector is the engine for delivering sustainable economic growth for developing countries. It does so by mobilising and allocating resources to their most productive uses. It lowers transaction costs of economic activity by providing efficient payments mechanisms, helps pool risk and, through maturity transformation, makes available long-term capital. Financial institutions and markets also play an important corporate governance role over other economic entities. They monitor the use of capital and where necessary, exert external pressure to improve its productivity, or reallocate it to more productive uses. A robust financial sector engenders confidence and facilitates the attraction of private sector capital from abroad. By making funds available for entrepreneurial activity and through its impact on economic efficiency and growth, a well-functioning financial sector also helps alleviate poverty both directly and indirectly.

10. Frequently however, developing country financial sectors do not perform at their optimum. They tend to suffer from a number of handicaps:

11. They are usually incomplete – they lack a full range of markets and institutions that meet all the financial needs of the economy. For instance, there is generally a lack of availability of long term finance for infrastructure and industry, finance for SME development and financial instruments that meet the needs of poor people.

12. They are often fragmented – lack of information and financial linkages between institutions and markets impairs efficiency in allocating resources. One result is the presence of informal financial organisations.

13. They tend to be distorted – rather than being market determined, financial sector activities tend to be influenced by the government and other non-commercial factors, for instance in pricing deposits and lending decisions.

14. The institutions and markets tend to be inefficient – lack of competition, inadequate access to technology and know how and diffused incentives render financial sector activity unduly expensive.

15. The financial systems tend to be fragile – weaknesses in governance and lack of appropriate regulation and supervision enhance their susceptibility to shocks.

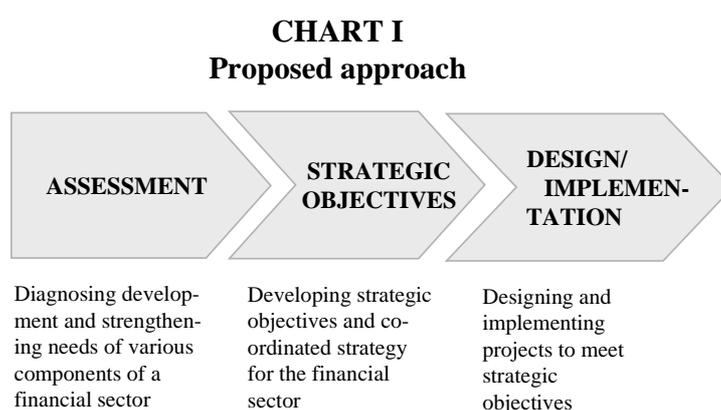
16. The impact of these shortcomings on wider economic activity is two-fold. They prevent economic potential to be realised. Additionally, financial sectors become susceptible to crises. As the continuing repercussions of the Asian crisis clearly highlight, the financial and human impact of such financial crises can be very severe and prolonged.

17. Strong financial sectors are necessary for developing countries to meet the OECD Development Assistance Committee international development targets set for 2015 for poverty reduction, human development and environmental sustainability and regeneration. The magnitude of the task required to develop and reform developing country financial systems is considerable, and requires both technical and financial assistance from donors. Such resources can only be mobilised by a partnership of the recipient country, donors (both multilateral and bilateral) and the private sector, working in co-ordination to maximise the development impact of their work.

3. Objective of the analytical overview

18. The financial sector is critically dependent on a range of constituent institutions and markets to meet its objectives. Such financial institutions and markets must operate efficiently themselves. They must additionally fulfil effectively their function as components of the country's financial system. This requires a competitive environment, which encourages innovation and lowers transaction costs, whilst at the same time nurturing good corporate governance. The financial sector must work as a co-ordinated system of institutions and markets linked with channels of financial and information flows. It also needs an effective regulatory and supervisory regime to be in place. A supportive enabling environment, including effective legal and accounting frameworks, is another prerequisite.

19. The financial sector therefore acts as a system of inter-linked institutions, markets and supporting infrastructure, drawing on its enabling environment for strength. To be effective, measures to develop new institutions and markets, or strengthen existing ones, must take into account these systemic interdependencies. This is best achieved by formulating specific development assistance programmes within the context of an overall strategy for a country's financial sector. Three broad steps are required:



20. A prerequisite for developing a sound financial sector reform strategy is a detailed understanding of its development needs. Comprehensive financial sector assessment exercises are a critical foundation for this approach. Such assessments are considered in more detail later in the paper. Another key need is for recipient country and donor-co-ordination to ensure that a coherent strategy is implemented efficiently.

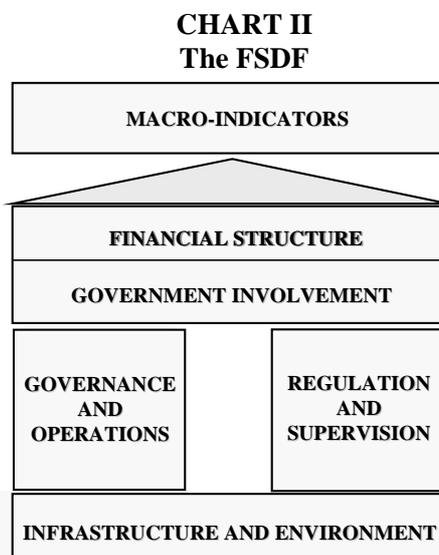
21. The objective of this paper is to illustrate this approach by using an analytical framework, the Financial Sector Diagnostic Framework (FSDF), which can be used as a guide to the development and strengthening needs of developing country financial sectors.

22. The next Section introduces the FSDF and highlights the main elements of the financial sector that should be considered in any diagnostic exercise. It then draws on these components to outline key development and reform objectives in the sector in Section 5. Section 6 subsequently explores specific areas in developing country financial sectors where donors can work with local partners to meet these strategic objectives. Finally, options for recipient country and donor roles and co-ordination in implementing assistance programmes are explored in Section 7.

4. The FSDF and assessing financial sectors

23. The FSDF categorises the various components of a financial sector and the factors affecting it into five broad groupings, or parameters. As the Chart opposite illustrates, these can be arranged as a building, for ease of conceptualisation. The foundation is made up of the financial sector's supporting Infrastructure and its enabling environment. It rests on two pillars: Governance and operations and Regulation and supervision. The two pillars support the Financial structure and Government involvement parameter. Finally, at the top is the output of the structure – this is measured by various macro-indicators.

24. The Framework is used in this Section to highlight the key areas that would warrant scrutiny in any developing country financial sector assessment exercise.



Macro-indicators

25. Macro-indicators are measures of the macroeconomic impact of a financial sector's efforts in allocating resources. They comprise economic measures such as an economy's propensity to save and invest; monetary depth; level of intermediation of financial sector, particularly to the private sector; security market outstanding in relation to GDP; and productivity of resources (measured by, for instance, return on capital). The Macro-indicators parameter, as presented in the FSDF, is not an integral component of the financial system per se. The aim of financial sector development and reform is to work on the other parameters of the Framework to improve these measures.

Financial structure and Government involvement

26. Components of the financial sector grouped under the Financial structure and Government involvement parameter provide a guide to the development and efficiency of various financial institutions and markets and the extent to which a country's government influences the activities of the sector. In this area, financial sector strategy development requires an assessment of:

The range of institutions in:

- the banking sector (comprising commercial banks and other deposit taking institutions);
- the banking system (central bank and other banking institutions); and
- the financial sector (banking institutions and non-bank financial institutions (NBFIs) and markets, including those in the informal sector);

and the extent to which they can meet the country's savings and investment mobilisation needs. The banking system, which often accounts for over 80 per cent. of financial sector assets in developing countries, requires particular attention.

- The structure of in particular the banking, but also the NBFIs industries, with particular reference to competition within and among the various segments of the financial sector.
- The efficiency of the various financial institutions and markets.
- The level of, and barriers to, participation of qualified foreign financial institutions.
- The nature of the informal financial sector, causes of fragmentation and barriers between the formal and informal parts of the financial sector.
- Whether a country's economy has the critical mass to support, by itself, all the institutions and markets required for an efficient financial system.
- The distortive influence of government in the financial sector through, for example: ownership of banks and NBFIs; disproportionately high share of bank credit and other financial sector assets; and other regulatory and non-regulatory restrictions.

Governance and operations

27. Financial intermediaries are particularly susceptible to weaknesses in governance (broadly defined as exercise of control). This is caused by barriers to information access for all stakeholders and lack of appropriate incentives for them to exercise oversight. Together with shortcomings in other areas, this contributes to poor operating performance. Strong governance and operations is therefore one of the key pillars on which the financial structure rests. In this area, any strategy aimed at developing a robust financial sector requires an assessment of:

- How ownership of a country's key financial institutions, particularly by the government, but also by some private sector shareholders such as industrial holding companies, can risk weaknesses in governance.
- The level of government or political interference in financial institution activities. This may include directed lending, explicit and implicit government guarantees on loans and weak exit policies.
- The extent to which stakeholders and markets exercise discipline on financial institutions and the principal barriers to it.
- The nature of incentives and penalties on managers.
- The operating performance of financial institutions and specific institutional development needs.
- The financial condition and operating performance of institutions, in particular the largest banks.

Regulation and supervision

28. Regulation and supervision is the second pillar of the financial sector under the FSDF. Strong regulatory provisions relating to entry, conduct and exit of financial institutions are necessary to ensure stability and reinforce good governance. Financial markets require regulations to protect the interests of

investors, maximise transparency and generally garner confidence in them. Even more important is the need to enforce regulations. Diagnostics should extend to issues such as:

- The nature, scope and extent of co-ordination among agencies within the regulatory and supervisory framework, including overall adherence to international standards.
- The status of the central bank, its autonomy and reputation, and its effectiveness in discharging its macro-economic (price stability) and micro-economic (financial sector stability and, in many developing countries, financial sector development) responsibilities.
- Existence and appropriateness of licensing, capital adequacy, connected lending, portfolio concentration, deposit insurance and exit-related regulation for the banking sector.
- Appropriate regulation for transparent operation of and protection of investors' interests in financial markets and industries such as mutual funds, insurance, pensions and leasing.
- Independence, capacity and work practices of the supervisory agencies, both for banking and non-bank financial institutions and markets.

Infrastructure and environment

29. Infrastructure and environment, comprising the wider economic, legal and social background, provides the foundation to the financial sector under the Framework. Weak legal and information infrastructures impair the ability of financial institutions and markets to operate effectively and generally restrict the level of transparency. There is a two-way interaction between the financial sector and the real economy and weaknesses in the latter can damage the financial sector, although a deep and stable financial system is better able to withstand environmental shocks. Finally, issues within the wider social climate (for instance, levels of corruption) and political stability can also influence the functioning of the sector. Of particular importance in this connection is an understanding of:

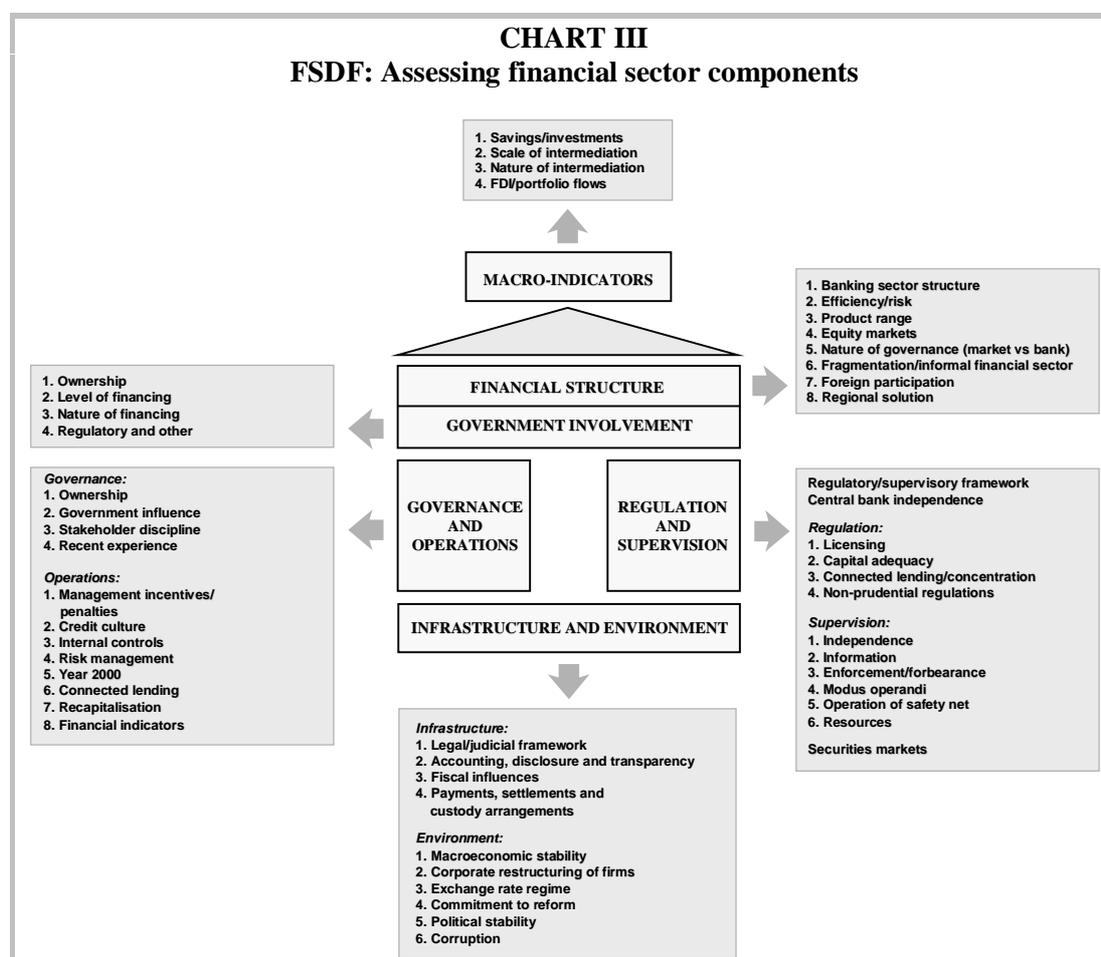
- The general market friendliness of the legal framework and in particular the adequacy of corporate, contract, bankruptcy and property law.
- The existence of defined fiduciary responsibilities and liabilities of financial agents and managers.
- The extent to which existing laws conflict with, or do not adequately provide for the introduction of new financial products and restructuring.
- Whether a judiciary exists which is appropriately resourced, trained and willing to enforce legislation.
- The existence of internationally consistent generally accepted accounting standards enforced by a strong regulatory body of professional accountants
- The availability of independent credit-rating or credit-information facilities.
- The nature and impact of fiscal influences on provisioning, interest accrual and other taxes affecting the operation of the financial sector.
- The extent of development of payments, settlements and custody-related systems.

Interdependence between the parameters

30. The various components of the financial sector have been grouped under five parameters and presented separately in this Section. In practice, there is considerable interdependence between the parameters. For instance, a strong legislative and accounting infrastructure is essential for the development and strengthening of all financial institutions and markets in the financial structure. Similarly, reliance on regulation and supervision, in the absence of appropriate incentives for good governance of financial institutions, is likely to render the sector fragile in the long run.

31. As highlighted previously, these interdependencies have important implications for financial sector strategies. To develop effective aid programmes, recipient countries and donors must take into account the state of development of other related components of the financial sector.

32. Chart III below summarises the key components of the FSDF, many of which have been highlighted in this Section.



5. Strategic donor objectives in the financial sector

33. The ultimate objective of a developing country and its development co-operation partners is to enable financial institutions and markets, and the financial system in its entirety, to be robust and play a pro-active role in economic development and poverty alleviation.

34. Their core strategic aims can be broken down into more specific objectives for different components of the financial sector. Specific objectives will vary between developing countries, depending on the needs of their financial sectors and the wider economy. Also, focus will evolve over time, as the need to meet objectives at an early stage of reform are satisfied and activities next in the sequence are targeted.

35. The analytical framework of the FSDF is used in this Section to explore some possible donor objectives for the various components of the financial sector. Selected assistance programmes to achieve these objectives are outlined in the next Section, which relates to their design and implementation.

Financial sector and government involvement

36. The key strategic objective under this parameter is to develop a full range of financial institutions and markets that function efficiently. Specific objectives might include:

- Promoting a methodical and appropriately sequenced approach for the establishment of new institutions and markets to meet the outstanding financial needs of the economy.
- Encouraging the promotion and sustenance of competition in the financial sector, including the introduction of qualified foreign financial institutions, which in addition to competition bring know how, capital and best regulatory practices.
- Promoting information and funds flows between the various segments of the financial sector.
- Improving financial sector access to the poor, including nurturing the informal and semi-formal financial sectors and removing barriers to their effective operation.
- Supporting the development of regional financial institutions and markets where appropriate.
- Reducing or reorienting the influence of government to minimise market distortion, address market failures effectively and stimulate orderly development of new market-oriented financial institutions and markets.

Governance and operations

37. The principal objective under this parameter would be to develop strong institutions and markets and provide for their good governance. Specific objectives might include:

- Promoting private sector ownership of financial institutions and reduction of political influence, whilst ensuring that appropriate regulatory and supervisory safeguards are in place.
- Developing more market-oriented financial and industrial policies, which promote commercial incentives in, and competition among, financial institutions.

- Improving the ability and incentives for stakeholders to exercise discipline on financial institutions.
- Financially and institutionally strengthening existing banks and other financial institutions with commercial potential, whilst enabling the controlled exit of non-viable institutions.

Regulation and supervision

38. The principal objective of regulation and supervision should be to reinforce good governance, rather than be seen as its substitute. Specific strategic objectives in this area might include:

- Promoting a comprehensive, co-ordinated regulatory framework for the financial system as a whole, with the ultimate aim of meeting international standards.
- More specifically, strengthening the effectiveness of the central bank in discharging its macro- and micro-economic responsibilities.
- Strengthening regulatory and supervisory capability relating to non-bank financial institutions and markets.
- Ensuring banking and other regulations facilitate the effective and market friendly functioning of the financial sector. At the same time, taking care to avoid excessive regulation.
- Promoting appropriately structured regulation of selected informal sector organisations.
- Ensuring regulation promotes other strategic objectives, such as encouraging competition and stakeholder discipline.

Infrastructure and environment

39. As stated earlier, the infrastructure and environment of the financial sector provides its foundation. Many of the objectives for strengthening this parameter would be part of recipient country and donor activities focused on other development needs, such as those relating to development of a judiciary and legal profession, accounting profession, macro-economic policies, anti-corruption initiatives, external debt management and capital account policies. Some matters, such as political stability and commitment to reform are, however, beyond the direct influence of donors.

40. Financial sector strategy can nevertheless aim to achieve the following:

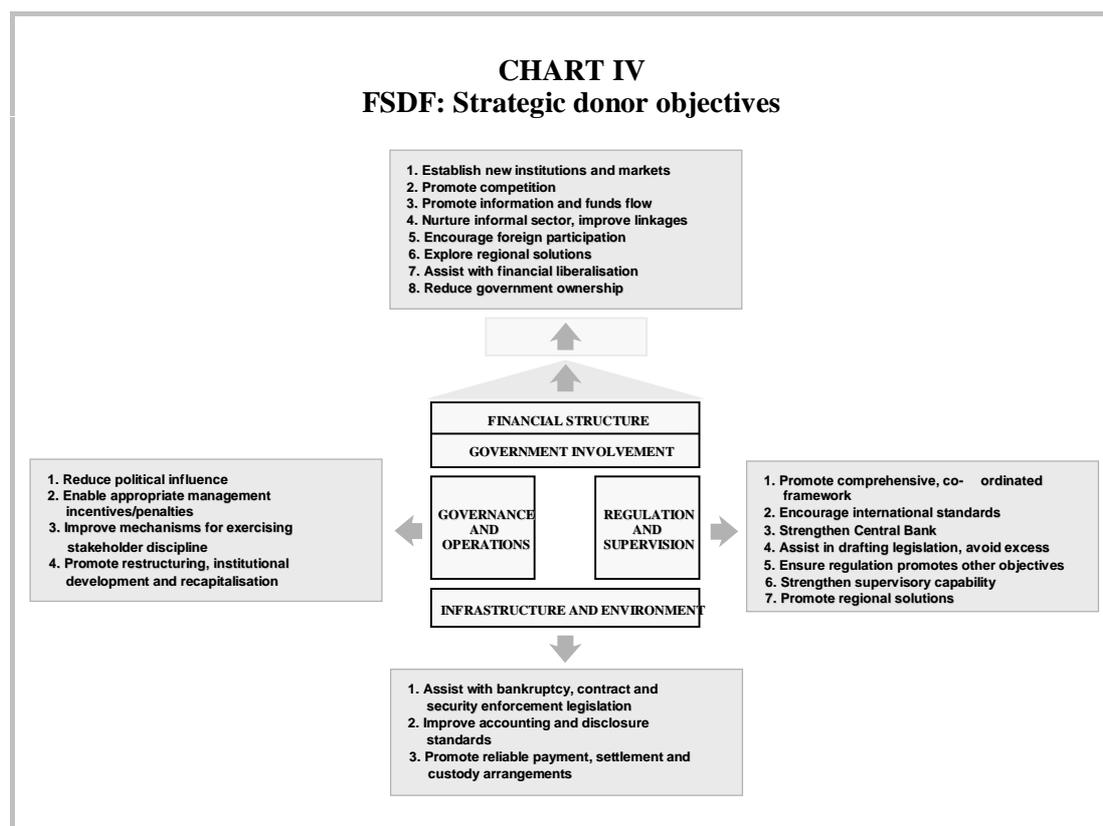
- Developing an infrastructure that enables effective exit of non-viable financial institutions and their clients. This is a crucial prerequisite for allowing the financial sector to reallocate resources away from non-productive uses. Weak bankruptcy legislation is a major contributor to economic crises as well as being a significant impediment to financial sector efficiency.
- Ensuring legal, accounting and other infrastructure supports the effective functioning of existing and proposed new financial institutions and markets.
- Promoting the transparency of operation of financial institutions and markets, including the production and reliability of financial statistics.

- Ensuring the country’s judiciary and other enforcement bodies have the capacity to discharge their roles effectively.
- Developing the necessary payment and other infrastructure to support the conduct of transactions and generate the confidence of market participants.
- Encouraging education of the key stakeholders, including the press and the wider public, on the role of the financial sector, the institutions within it and in particular the central bank.

Local stakeholder ownership of objectives

41. It is important that donor objectives are shared by all groups of affected stakeholders in host countries. Achieving ownership should therefore be a key overarching objective in itself for donors when formulating their development co-operation strategies for the various components of the financial sector. This may require a joint strategy among donors which reaches beyond traditional stakeholders to such parties such as small institutions, business and professional associations and elements of the civil society. This matter is considered further in Section 7, dealing with co-ordination.

42. Chart IV below summarises the key strategic donor objectives in the financial sector.



6. Developing and implementing financial sector strategy

43. This paper has already stressed that to maximise effectiveness, financial sector projects need to be undertaken as part of a comprehensive development and reform strategy. The inter-linkages between the various components of the financial sector and the systemic nature of its functioning warrant this approach. Moreover, a strategic approach also enables host country stakeholders and donors to work together proactively to achieve development goals, rather than react to specific problems.

44. A comprehensive financial sector strategy has the advantage of co-ordinating and implementing programs in their proper sequence. If financial sector liberalisation and reform is improperly sequenced, the sector becomes vulnerable to expensive crises. The process needs to be implemented as a co-ordinated package of initiatives, many moving in parallel, but with due consideration to progress in other related areas. For example, there is considerable risk in liberalising entry into the financial sector without putting adequate safeguards, in the form of regulation and supervision, in place. Certain exogenous factors, such as macro-economic and fiscal stability, are also important inputs in the sequencing decision.

45. The starting point for developing a comprehensive financial sector strategy is an understanding of the strengths, weaknesses and reform needs of a country's financial sector. The key diagnostic areas were highlighted earlier in the paper, by using the FSDF as a tool. The output of financial sector assessment exercises would then be used to formulate strategic objectives. This interim stage between diagnosis and implementation is important as strategic objectives can be achieved through activity in a number of areas. For instance, competition can be enhanced through privatisation, encouraging new institutions and markets and appropriate market entry regulation.

46. Having reviewed the diagnostic and objective-setting stages with the aid of the FSDF, possible areas where recipient countries and donors can work together to meet strategic objectives are now highlighted in the context of the Framework. Chart V on page 15 summarises these.

Financial structure and government involvement

47. Strategic objectives for this parameter are achieved through broadly two groups of often-interdependent activities:

- Financial liberalisation.
- Developing new financial institutions, markets and products.

48. Financial liberalisation strategy-related activities centre around developing policies on interest rate liberalisation, withdrawal of lending directives as well as moving to more indirect monetary policy instruments and market-oriented fiscal management. Privatisation of existing financial institutions can also be loosely grouped into this category as it entails removal of direct government influence. Liberalisation of the financial sector to facilitate entry of new institutions, including appropriately qualified ones from more developed economies, is a further issue.

49. The building of new financial institutions, markets and products, both in the formal and informal financial sectors, is one of the key development assistance needs in recipient countries. As Chart III highlights, the need is for a range of institutions and markets serving different segments of the financial system. In addition to deepening the financial sector, this has the advantage of facilitating financial liberalisation by widening options for government financial activities. At the same time, a move to more market-based central and local government financing policies stimulates the development of these institutions and markets. New institutions and markets needed in developing countries often include money markets, debt and equity capital markets (including stock exchanges) and institutions such as pension and

insurance funds. Additionally, the development of intermediaries such as securities brokers require support.

50. Donors can also support local partners in developing new financial products. This includes new debt and equity instruments as well as specialist credit products in, for example, longer-term finance (including infrastructure-related), SME finance, trade and agricultural finance. Products such as leasing are particularly suited to the underdeveloped legal infrastructure in developing countries. In addition to technical expertise, financial assistance through participation in equity funds, credit guarantee funds and credit lines can stimulate these activities and can be beneficial provided they are designed to achieve long-term self-sustainability and minimise market distortions.

51. Microfinance is of considerable importance as it can, appropriately designed and implemented, directly alleviate poverty by increasing income and investment. Focus should be on strengthening indigenous organisations and products, extending reach and encouraging the adoption of best practice from other parts of the world tailored to the local environment. The development of semi-formal organisations, including those that are NGO-led, and their evolution into more formal institutions where appropriate also requires support. Informal finance should be seen as an integral component of the financial sector to ensure linkages are developed between formal, semi-formal and informal financial institutions that enable funds to flow into microfinance activities.

Governance and operations

52. Many of the governance-related objectives can be met through activities in other areas, for example: by developing a range of institutions and markets and tailoring licensing requirements to stimulate competition; and improving legal and information infrastructures as well as designing appropriate deposit protection systems to enhance stakeholder discipline.

53. Much of the potential work in this area relates to improving the operations of state owned commercial banks and development finance institutions. The key objective is to identify viable institutions and restructure them, whilst finding a politically acceptable solution for those which are unlikely to be sustainable in a market-based system. As highlighted earlier, given banks often account for over 80 percent. of financial sector assets in less advanced developing countries, this is a crucial area of assistance from donors. Institution building support through transfer of technology and know how may be required by local partners especially in areas such as credit analysis and management information systems, often for considerable periods. Where large incidences of non-performing loans exist, assistance in resolving them is also a critical need.

54. Technical and financial support may be required to recapitalise banks that are being restructured. Additionally, support to privatise banks is often an important need, although particular care must be taken to ensure appropriate checks and balances exist for the institutions to operate effectively after privatisation. In cases where immediate privatisation is not possible, appropriate commercially-oriented governance structures can be established as an interim measure.

Regulation and supervision

55. The most immediate need in this area is usually in the drafting or strengthening of legislation for the regulation and functioning of central banking, commercial banking and non-banking institutions and markets such as those affecting insurance companies, pension funds, mutual funds and insider dealing. International standards such as the Basle Core Principles for banking supervision and International Organisation of Securities Commissions (IOSCO) principles and frameworks should be aimed at. The

challenge is to draft regulations that are market-friendly and encourage competition, including from foreign institutions, whilst enhancing transparency, protecting depositors, investors and other participants and preventing crises. Designing appropriate regulation for microfinance and other semi-formal and informal organisations can also benefit from recipient country and donor co-operation.

56. In terms of resource commitment, however, the more enduring need in developing countries is for assistance in building institutions that can effectively supervise financial sector institutions and markets and enforce regulations. This requires transfer of know how on supervisory practices as well as access to technology to develop appropriate systems and procedures to discharge monitoring-related responsibilities. Additionally, central bankers and finance ministry officials may need donor co-operation in developing capacity to discharge their monetary, fiscal and external finance related responsibilities.

Infrastructure and environment

57. Assistance with drafting and enacting bankruptcy-related legislation is often needed, along with support for capacity-building in the judiciary to enforce these and other laws. In addition, frequently, enabling legislation needs to be enacted, or existing laws amended, to ensure that new products such as leasing, housing finance and new financial instruments can be introduced. Accounting regulations for banking and other financial institutions generally need strengthening, as does the auditing profession and its practices. New financial instruments and new practices such as mergers and acquisitions can also require new accounting standards and amendments to corporate legislation. Existing tax laws often conflict with the efficient operation of the developing financial sector and need to be addressed. In a wider context, support for developing more market-friendly commercial and labour laws and general accounting principles is also necessary, for example to enable corporate restructuring. Rating agencies and credit bureaux providing information on loans and pledges also require setting up.

58. A reliable payments system is critical for the efficient functioning of the financial system and the wider economy and transfer of know how and technology can help many developing countries 'leap frog' in areas such as use of payment cards and, assuming the necessary infrastructure exists, e-commerce. Efficient settlements and custody systems are another prerequisite for developing confidence in and encouraging domestic and foreign participation in financial markets.

59. From a broader perspective, there may be a general need to educate legislators and civil servants to facilitate change.

Training

60. Training is a critical component for all the institutional and capacity building activities donors undertake in the financial sector and should be an integral part of every project. It is most effective when it is tailored to support specific programmes. Assistance in developing indigenous capacity in this area, for example through professional training institutes and formal qualifications, should also be considered.

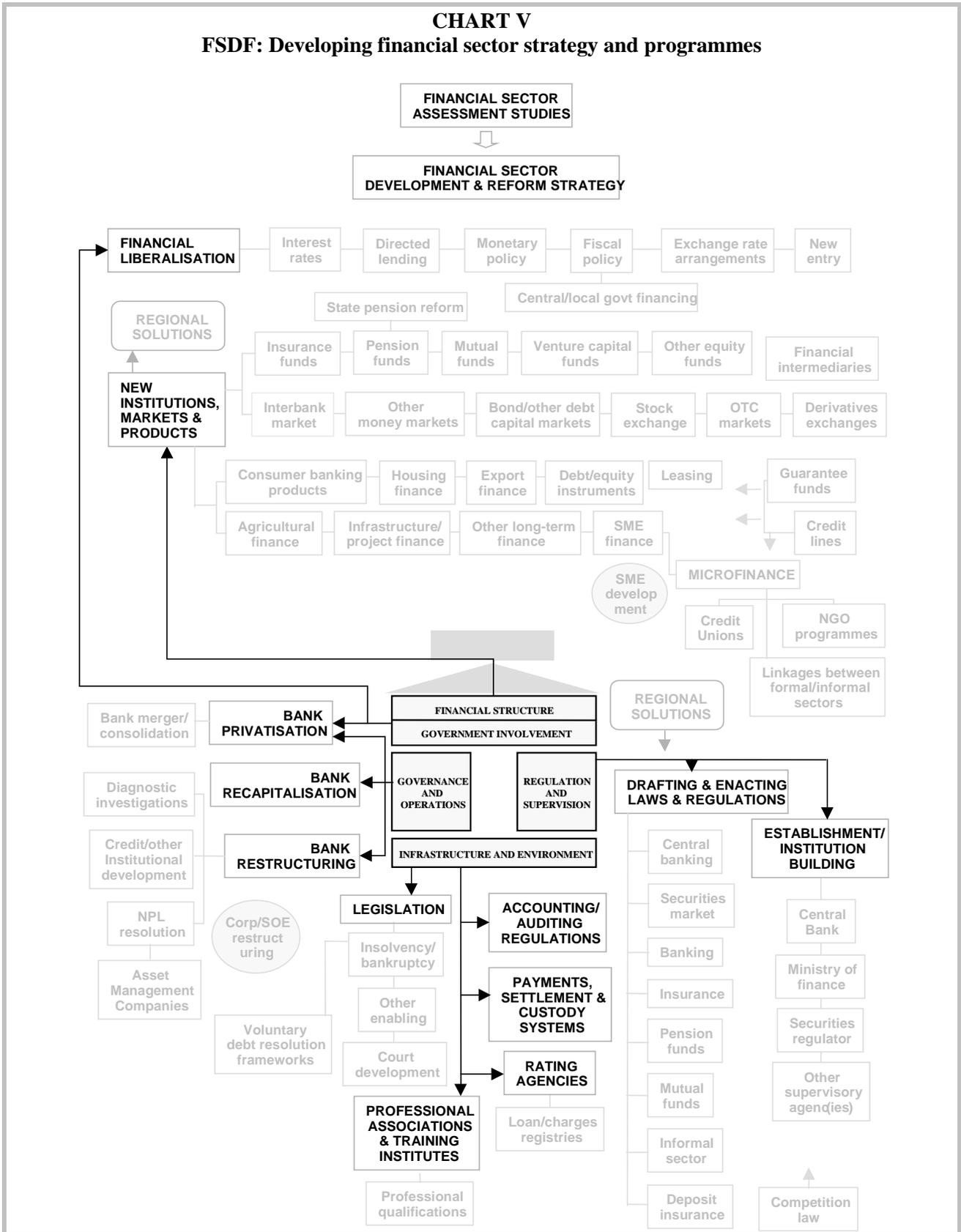
Regional solutions

61. The entire financial sector of many developing countries is smaller than the largest banks in more advanced industrialised countries. It is doubtful if they can be sustainable, or at best, function optimally, on a stand-alone basis. Donors should support regional institutions and markets, such as stock exchanges, central banks, insurance markets and credit rating agencies where they provide a superior solution. In such cases parallel supra-national regulatory and supervisory frameworks would also need to be established.

Interlinkage with non-financial sector projects

62. Given the nature of the financial sector, there is often considerable scope for co-ordinating financial sector aid programmes with those aimed at developing other sectors of the economy. For instance, bank non-performing loan restructuring is critically interdependent on the industrial restructuring of state owned enterprises and other corporate borrowers. Similarly, the effectiveness of projects focused on financing SMEs can potentially be substantially enhanced if they are co-ordinated with those aimed at SME development, for example through advice centres. This suggests the desirability of co-operation, not only for financial sector programmes, but also with those aimed at other sectors.

CHART V
FSDF: Developing financial sector strategy and programmes



7. Co-ordination with recipient country and among donors

63. The nature of the financial sector, its impact on wider economic activity and social infrastructure and the scale of the task facing the development community strongly dictates an approach based on partnership and co-ordination. The objective of this section is to sketch possible roles for the various parties involved in the process.

The recipient country partners

64. The critical need for local ownership has already been highlighted in this paper. Partners in recipient countries need to take the lead and be integrally involved throughout the various stages of development of financial sector assistance programmes outlined in this paper (which will be linked with their overall economic development plans). This includes consultation and involvement during the assessment process; taking responsibility for developing a financial sector development and reform strategy based on the results of the assessment, with support from donors where necessary; and working with multilateral and bilateral donors to ensure that assistance resources are efficiently deployed. In many cases, this will require the building of appropriate co-ordination capacity in partner countries, with donor assistance if appropriate. Recipient governments can additionally play a more direct role in developing their financial sectors by stimulating the growth of markets and institutions by their financing activities.

The multilateral institutions

65. Multilateral institutions will be expected to play a key leadership role in this process. The joint World Bank-IMF Financial Sector Assessment Program (FSAP), which is eventually expected to assess the vulnerability and development needs of all IMF member countries as part of the Article IV consultations, can provide a valuable foundation on which financial sector development strategies can be built. Other multilateral banks, such as the Asian Development Bank, are also commissioning financial sector assessment studies of their developing member countries.

66. Primary responsibility for advising recipient partners on matters such as development of financial sector liberalisation and reform strategies is expected to reside with the multilateral institutions, who may undertake these tasks as part of structural adjustment programs. They will also be well-placed to co-ordinate bilateral donor assistance in areas where they take the lead, such as regulatory and supervisory reform and banking system restructuring. It is likely that the multilateral institutions and bilateral donors will share the responsibility for assisting recipient partners in other areas of the financial sector. Multilateral institutions are also expected to be the key partner in providing financial assistance to recipient countries, although bilateral donors may also be involved in this activity selectively.

Bilateral donors

67. Bilateral donors can provide development assistance to their partner countries in almost the entire spectrum of activities aimed at strengthening financial sector. Their focus may depend on their respective geographic or industry segment specialisation, or their decision to participate in projects may be based on the size of commitment. It is particularly advantageous if donor participation is based on any comparative advantage they can bring to the exercise.

68. It is important that bilateral donors develop specific country and financial sector assistance strategies with due consideration to the overall framework for financial sector reform in that country and in

light of other initiatives being taken by the recipient partner and other donors. Effectiveness is also enhanced if donors ensure a strong field presence and flexible programming mechanisms in order to be able to absorb and quickly react to local developments in recipient countries.

The private sector and NGOs

69. The private sector can play an important role in restructuring and privatising existing institutions as well as developing new institutions, markets and products. In addition to capital, suitable foreign and, sometimes, domestic institutions can contribute up to date technology and know how. Wherever possible, partner government and donor activity should be aimed at encouraging foreign and domestic private sector participation, including those of organisations such as chambers of commerce and consultative groups. Additionally, NGOs can play a critical role, particularly in developing effective microfinance and other semi formal institutions.

Annex 2

The Financial Sector Assessment Program of the IMF and World Bank A note for the information of the OECD DAC

Nature and Purpose of the FSAP program

1. Recent experience has highlighted for all countries the importance of strong domestic financial systems to ensure systemic stability in the face of intensified globalisation, financial market integration, and capital account liberalisation. In recognition of the importance of a sound financial sector to both macroeconomic stability and economic development, the management of the World Bank and the International Monetary Fund initiated the Financial Sector Assessment Program (FSAP) in May 1999. Approved on a pilot basis by the Boards of the two institutions, the joint program:

- assesses the condition of a country's financial sector, including identification of vulnerability and risks, and observance of financial sector standards and
- recommends policies and technical assistance programs to reduce vulnerabilities and promote financial sector development, thereby positioning the sector to contribute more effectively to economic growth and the reduction of poverty.

2. Twelve assessments will be carried out during the pilot year. Countries selected for the pilot have different levels of financial sector development and face a range of macroeconomic challenges. Based on the experience of the pilot, the management of the Bank and the Fund will decide whether to propose to their respective Boards that the FSAP should be extended to cover the full membership of the institutions.

3. The Financial Sector Assessment Program draws heavily on financial sector work and experience in the Bank and the Fund and, at the same time, provides better co-ordination between the two institutions' financial sector work. Following on the decisions last spring of the Executive Board and the Interim Committee, Fund staff has been asked to increase its attention to financial and banking sector issues in the context of Article IV Consultations. The Fund's involvement has focused especially on the linkages between the soundness and operations of the financial sector and macroeconomic performance and the support of policies that avoid or lessen the likelihood and severity of financial system crises. The Executive Board of the World Bank, pursuant to the Bank's ongoing mandate to help foster the development of financial systems to ensure their capacity to contribute to long-term growth, has also identified a need for intensified assessment of the robustness of financial institutions and policies. The Bank's focus has been on the importance of the financial sector to development and the alleviation of poverty.

4. Countries will benefit from participation in the FSAP through broader coverage and more consistent and rigorous analysis of their financial systems based on a better utilisation of limited expert resources and closer collaboration between, and follow-up from, the two institutions. It is expected that the program will help countries reduce financial sector vulnerabilities and provide national authorities with a strategic framework within which to undertake the strengthening of their financial systems and services.

Written products

5. The FSAP mission produces an aide-mémoire, which is the property of the government. This report assesses the strengths and weaknesses of a country's financial system and vulnerabilities to

macroeconomic shocks; the country's compliance with international standards on regulation, supervision and transparency, and the contribution of the financial system to growth and development. The analysis serves as the basis for a financial sector development strategy and associated programs of technical assistance for the Bank and the Fund, and sector investment financing from the Bank, where appropriate.

6. The findings and recommendations from the FSAP are used by Bank and Fund staff in their individual institution's work. Following the completion of the final FSAP report, Fund staff will produce a Financial Sector Stability Assessment (FSSA) Report that is a streamlined version of the main issues arising from the FSAP and is included in the documentation for the Article IV Consultation. This report highlights the linkages between financial system developments and macroeconomic outcomes. The World Bank staff would use the FSAP report to identify key policy and developmental issues for the financial sector that supports the ongoing dialogue with a country, informs the Bank's Country Assistance Strategy, and serves as a basis –should the government wish—for technical assistance or other suitable Bank operations.

7. All information received in the course of the FSAP (other than information which is in the public domain) and all documents produced by or entrusted to the staff of the Bank and the Fund in connection with the FSAP, are classified and handled in a manner consistent with the understandings and agreements under which it was provided.

Follow-up technical assistance

8. The FSAP reports provide a basis on which to develop, in co-operation with country authorities, the financial sector technical assistance programs of the Bank and the Fund. The two institutions co-ordinate in providing technical assistance that follows the recommendations of an FSAP report. This assistance can come in several different forms:

Technical assistance directly provided by Bank or Fund staff. In many instances, the expertise required to assist national financial authorities can be found within the institutions, and it may be efficient for staff who have helped identify assistance needs to carry out the follow-up work. Funding for these activities from the institution's budget. In the Bank's case, country budgets could be usefully supplemented by trust funds, if raised, or funded as non-lending services, where appropriate.

Technical assistance provided through lending. The Bank can arrange expert assistance from private and official sources through technical assistance lending, either in conjunction with an FSAL or independently. TA loans have been used extensively in financing technical assistance to the Asian countries in crisis. More extensive use of TA loans will depend on borrowers' determination that financial sector reforms warrant sufficiently high priority to justify borrowing.

Technical assistance provided through trust funds. Trust funds provided by donors specifically for financial sector advisory services are potentially an important modality for financing TA to implement the recommendations of FSAPs. Therefore, to support the ability to deliver technical assistance, the Bank will seek trust fund support specifically for the FSAP program. Such funds can provide assistance to complement, or substitute for, technical assistance loans.

Donor Assistance

9. The FSAP program offers an appropriate vehicle for achieving co-ordinated and well-targeted technical assistance in the financial sector. To capitalise on this potential, the Bank will need to supplement

its resources for carrying out follow-up work of helping countries implement the FSAP recommendations. If the FSAP is extended to cover the full membership, the Bank plans to approach bilateral donors to seek trust fund resources to ensure that adequate funding is available to meet priority financial sector technical assistance needs in the Bank's client countries.

World Bank
10 December 1999