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World Bank

Report No: 70030

AN IEG COMPARATIVE REVIEW
BASED ON PROJECT PERFORMANCE ASSESSMENTS OF:

EGYPT
EGYPT FINANCIAL SECTOR DEVELOPMENT POLICY LOAN
(LOAN NO. IBRD-73910)

EGYPT SECOND FINANCIAL SECTOR DEVELOPMENT POLICY LOAN
(LOAN NO. IBRD-75280)

GUATEMALA
GUATEMALA FINANCIAL SECTOR ADJUSTMENT LOAN
(LOAN NO. IBRD-71300)

MOROCCO
MOROCCO FINANCIAL SECTOR DEVELOPMENT POLICY LOAN
(LOAN NO. IBRD-73500)

PAKISTAN
BANKING SECTOR RESTRUCTURING AND PRIVATIZATION
(LOAN NO. IDA-35710)

BANKING SECTOR DEVELOPMENT POLICY PROGRAM
(LOAN IDA-40310 FSLT-72700)

June 29, 2012

IEG Country, Corporate, and Global Evaluation
Independent Evaluation Group

Currency Equivalents (annual averages)

Egypt

Currency Unit = Egyptian Pound (EGP)

2005	US$1.00	5.79
2006	US$1.00	5.74
2007	US$1.00	5.64

Guatemala

Currency Unit = Guatemalan Quetzales (QSZ)

2002	US$1.00	7.82
2004	US$1.00	7.95
2005	US$1.00	7.64
2006	US$1.00	7.60
2007	US$1.00	7.67

Morocco

Currency Unit = Moroccan Dirham (MAD)

2004	US$1.00	8.88
2005	US$1.00	8.85
2006	US$1.00	8.80
2007	US$1.00	8.20
2008	US$1.00	7.74

Pakistan

Currency Unit = Pakistani Rupees (Rs)

2001	US$1.00	61.77
2002	US$1.00	59.62
2003	US$1.00	57.74
2004	US$1.00	58.34

Abbreviations and Acronyms

ADB	Asian Development Bank
AML	Anti-monetary laundering law
BGUAT	Central Bank of Guatemala
BNDE	Banque Nationale pour le Développement Economique
BRSP	Banking Sector Restructuring Program
BSDP	Banking Sector Development Program
CAM	Crédit Agricole du Maroc
CAR	Capital adequacy rate
CAS	Country Assistance Strategy
CBE	Central Bank of Egypt
CDG	Caisse des Dépôts and de Gestion
CFAA	Financial Accountability Assessment
CIH	Crédit Immobilier Hôtelier
CNCA	Caisse Nationale de Crédit Agricole
DPL	Development Policy Loan
DFI	Development financial institution
EFSA	Egyptian Financial Supervisory Authority
EU	European Union

FDIC Federal Deposit Insurance Corporation
FTAL Financial Technical Assistance Loan
FSAP Financial Sector Assessment Program
GDP Gross Domestic Product
HBL Habib Bank Limited
ICR Implementation Completion and Results Report
IEG Independent Evaluation Group
IMF International Monetary Fund
LCR Latin America, Caribbean and Pacific Region
MCB Muslim Commercial Bank
MNA Middle-East and North Africa Region
MOF Ministry of Finance
MTP Motor-third party liability
NBFI Non-bank financial institutions
NILEX Nile Stock Exchange
NPL Non Performing Loan
PPAR Project Performance Assessment Report
ROA Return on Assets
ROE Return on Equity
ROSC Report on the Observance of Standards and Codes
RTG Teal Time Gross Settlement System
SBP State Bank of Pakistan
SIB Superintendency of Banks
SME Small and medium-sized enterprise
SOE State-owned enterprise
UBL United Bank Limited
USAID United States Agency for International Development

Fiscal Year

Government of Egypt: July 1 – June 30

Government of Morocco: January 1 – December 31

Government of Pakistan: July 1 – June 30

Government of Guatemala: January 1 – December 31

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Contents

This report was prepared by Aristomene Varoudakis, James Hanson, James Lacey, Dimitry Vittas, and Tim de Vaan, who assessed the projects between December 2010 and June 2011. The report was peer reviewed by Anjali Kumar. Aimée Niane provided administrative and editorial support.

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IEG Mission: Improving World Bank Group development results through excellence in evaluation.

About this Report

The Independent Evaluation Group assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEG annually assesses 20 percent of the Bank's lending operations through field work. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons.

To prepare a Project Performance Assessment Report (PPAR), IEG staff examine project files and other documents, visit the borrowing country to discuss the operation with the government, and other in-country stakeholders, and interview Bank staff and other donor agency staff both at headquarters and in local offices as appropriate.

Each PPAR is subject to internal IEG peer review, Panel review, and management approval. Once cleared internally, the PPAR is commented on by the responsible Bank department. The PPAR is also sent to the borrower for review. IEG incorporates both Bank and borrower comments as appropriate, and the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

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IEG's use of multiple evaluation methods offers both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEG evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (additional information is available on the IEG website: http://worldbank.org/ieg).

Outcome: The extent to which the operation's major relevant objectives were achieved, or are expected to be achieved, efficiently. The rating has three dimensions: relevance, efficacy, and efficiency. *Relevance* includes relevance of objectives and relevance of design. Relevance of objectives is the extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). Relevance of design is the extent to which the project's design is consistent with the stated objectives. *Efficacy* is the extent to which the project's objectives were achieved, or are expected to be achieved, taking into account their relative importance. *Efficiency* is the extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. The efficiency dimension generally is not applied to adjustment operations. *Possible ratings for Outcome:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Risk to Development Outcome: The risk, at the time of evaluation, that development outcomes (or expected outcomes) will not be maintained (or realized). *Possible ratings for Risk to Development Outcome:* High, Significant, Moderate, Negligible to Low, Not Evaluable.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry of the operation and supported effective implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of supported activities after loan/credit closing, toward the achievement of development outcomes. The rating has two dimensions: quality at entry and quality of supervision. *Possible ratings for Bank Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower (including the government and implementing agency or agencies) ensured quality of preparation and implementation, and complied with covenants and agreements, toward the achievement of development outcomes. The rating has two dimensions: government performance and implementing agency(ies) performance. *Possible ratings for Borrower Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Preface

This is a multi-country Project Performance Assessment Report (PPAR) on six lending operations in the financial sector—five Development Policy Loans (DPLs) and one Investment Loan (IL)—in Egypt, Guatemala, Morocco, and Pakistan.

Egypt: The **First Financial Sector Development Policy Loan** (P088877) in the amount of US$ 500 million was approved on June 15, 2006 and made effective on April 30, 2007. It was disbursed in one tranche on May 16, 2007. The Loan was closed on June 30, 2007. The **Second Financial Sector Development Policy Loan** (P094551) in the amount of US$ 500 million was approved on May 29, 2008 and made effective on March 23, 2009. It was disbursed in one tranche on March 26, 2009. The Loan was closed on December 31, 2009.

Guatemala: The **Financial Sector Adjustment Loan** (P074530) in the amount of US$ 150 million was approved on June 25, 2002 and made effective on December 18, 2002. It was disbursed in 3 tranches of US$50 Million. The Loan was closed on March 30, 2007.

Morocco: The **Financial Sector Development Policy Loan** (P088243) in the amount of US$ 200 million was approved on December 15, 2005 and became effective one week later. It was disbursed in two tranches. The Loan was closed on June 30, 2007.

Pakistan: The **Banking Sector Restructuring and Privatization** (P055292) in the amount of US$ 300 million was approved on October 24, 2001 and became effective the same day. The Loan was closed on December 31, 2004. The **Banking Sector Development Policy Program** (P083079) in the amount of US$ 300 million was approved on January 13, 2005 and made effective one week later. The Loan was closed on July 31, 2005.

The IEG evaluation team wishes to express appreciation to World Bank staff; government officials; financial and non financial business sector representatives; as well as representatives of think tanks met in Egypt, Guatemala, Morocco, and Pakistan, for time, insights, and support extended to the team during the country visits.

This report was prepared by Aristomene Varoudakis (Task team Leader), James Hanson, James Lacey, Dmitri Vittas (consultants), and Tim de Vaan, who assessed the lending operations from December 2010 to June 2011, with country visits organized in December 2010 (Guatemala); January 2011 (Egypt and Morocco); and February 2011 (Pakistan). Erkin Yalcin provided research support and Aimée Niane administrative support.

The assessment was conducted with guidance from Ali Khadr and the report benefited from comments by Anjali Kumar (panel reviewer), Millard Long (external reviewer), Martha Ainsworth, and Mark Sundberg.

Following standard IEG procedures, copies of the draft PPAR have be sent to government officials and agencies for their review and comments. Comments have been taken into account in the finalized report and have been included as Annex E.

Summary

Following the comprehensive assessment of the effectiveness of Bank assistance for financial sector reform conducted by the IEG in 2006, this Project Performance Assessment Report (PPAR) reviews the effectiveness of Bank assistance in financial sector reform through a cluster of **six lending operations** in four countries—**Egypt, Guatemala, Morocco, and Pakistan**—over a period spanning from 2001 (first operation in Pakistan) to 2008 (second operation in Egypt).

Although the country context differed across the focus countries, a common development objective of the operations was to strengthen the enabling legal and institutional environment for financial intermediation and financial risk management and to increase the role and participation of the private sector in the provision of financial services. The PPAR reviews the effectiveness of the reforms supported by the Bank's operations in achieving these objectives. Moreover, financial sectors around the world were placed under stress by the 2008-09 global economic crisis. The PPAR reviews the impact of the global economic crisis on the financial sectors of the focus countries and, to the extent possible, traces the effectiveness of the reforms supported by the Bank in making the financial sectors of the focus countries more shock-resistant.

The **size of the banking system**—as measured by the domestic deposits in proportion to GDP—grew through 2007 in Morocco, and less so in Guatemala, while remaining approximately stable in Egypt and Pakistan. The financial crisis of 2008-2009 lowered deposits in Egypt and Pakistan and capped deposit growth in Morocco, although deposits continued to grow in Guatemala. At the same time, the structure of the banking system has evolved. **Bank privatization** and reduction of the role of state-owned capital in private banks was vigorously pursued in all four countries that received Bank assistance, although the presence of state-owned banks varies. In Egypt, which was the country with the largest share of state-owned banks among the four focus countries, around 50 percent of bank assets were still held by state-owned banks, but this share was drastically reduced from 80 percent in 2004 and state-owned banks' shareholdings in private banks (joint ventures) were eliminated.

The **soundness of the banking system** has generally improved, though with varying results across the four countries and throughout the 2000s. In Guatemala and Morocco Non Performing Loans (NPLs) were much lower compared to Egypt and Pakistan. In all four countries, NPLs followed a downward trend, from very high initial levels in Egypt and Pakistan. Morocco stands out for fairly consistent reduction in NPLs, outperforming the Middle East and North Africa Region averages. Solid pre-crisis growth, settlement of NPLs in state-owned banks, and tighter prudential regulation and supervision have favored this outcome in the four countries. In Pakistan the improving trends in NPLs and provisioning were not sustained during 2008-09 as a result of multiple shocks, including natural disasters. Provisioning of NPLs has considerably improved throughout the decade and is comparatively higher in Egypt and in Guatemala. In all countries an effort to build bank capital buffers was evident throughout the decade. The capital ratio was maintained at high levels, around 15 percent in Egypt, Guatemala, and Pakistan, and close to 12 percent in Morocco.

The volume of **credit allocated to the private sector** (in proportion to GDP) was relatively high in Morocco and Egypt at the beginning of the period. It experienced strong growth in Morocco but suffered a significant decline in Egypt in the ensuing years. In contrast, credit to private sector was considerably lower and remained fairly flat throughout the 2000s in Guatemala and Pakistan. The fall in outstanding loans to the private sector in Egypt partly reflected the settlement of NPLs of state-owned enterprises and an increase in bank holdings of government securities. In the four countries, the banking system holds a sizeable portfolio of government securities and it remains involved in providing credit to state-owned enterprises. In Pakistan and Guatemala credits to government and State-owned enterprises represent almost half of the credit provided to the private sector. The Egyptian banking system stands out for being the most heavily engaged in lending to the state and its enterprises, almost at par with lending to the private sector. Although loans to State-owned enterprises declined compared to the pre-reform period, bank holdings of government securities increased in 2008-09, with an almost commensurate decrease in private sector lending, as banks bought government bonds sold by foreign investors and took a cautious lending stance to businesses as a result of the crisis.

Overall, the evaluation finds that the reforms supported by the Bank's operations strengthened the financial sectors of the four focus countries and helped them resist the impact of the financial crisis of 2008-2009. In all the countries the financial systems are still bank-oriented but the banking sector is much stronger and generally in a better position to respond to the financing needs of the private sector. Yet, risks remain, as credit growth is often concentrated, credit risk management systems need further strengthening, and, in some cases, credit to state-owned enterprises is not entirely based on market criteria. Moreover, in most of the focus countries, growth in private sector credit has not reached the levels anticipated or desired.

In parallel with the specific conclusions reached in the PPARs of the individual operations, a number of lessons can be drawn from findings common to the four countries. Even though the measures supported by these operations were not necessarily representative of financial sector reform efforts around the world, lessons drawn from the comparison of experiences may be useful to the governments in question, in addition to expanding the knowledge base regarding the design of these types of operations as well as the approaches they took and the results achieved. These "stylized lessons" can be summarized as follows:

i) The quality of prior analytical work is crucial for the success of policy-based operations in the financial sector. In three of the four countries (Egypt, Guatemala, Morocco), the policy content of the operations was closely based on the findings of recently completed Financial Sector Assessment Programs and further technical analysis conducted during preparation. The high quality of the technical analysis (FSAPs; Accounting and Auditing Reports on the Observance of Standards and Codes) provided the basis for policy dialogue and technical discussions during the preparation and implementation of the operations, and underpinned the cooperation between the authorities and the Bank teams during project implementation.

(ii) Effectiveness of implementation support is a key condition for results because financial sector reforms are easy to design but difficult to implement. This was most evident in Guatemala, where high quality technical analysis and advice was provided as part of implementation support of the Bank's Financial Sector Adjustment Loan (FSAL), not only through the supervision of the operation but also through the technical assistance operation. However, the needed resources are not always available to Bank teams if, contrary to the case of Guatemala, there is no parallel technical assistance loan. Although grants for technical assistance may be available from other development partners, the coordination with Bank operations can be too slow and complex when problems must be addressed promptly to achieve the best results for the country. In parallel with technical assistance, enhancing the transparency of the reform program, through the regular publication of comprehensive data and assessments, can play a key role in strengthening program implementation. Egypt (absence of comprehensive reports) and Morocco (ample availability of data and analysis) offer contrasting examples where the information available determines the rigor of monitoring and evaluation of the reform program.

(iii) Multi-tranched financial sector adjustment operations are effective instruments to support major financial sector reforms. The success of the Guatemala FSAL and the Morocco Financial Sector Development Policy Loan shows that a multi-tranched adjustment operation can be very effective in cases of major financial sector reforms that involve the enactment of new basic legislation and the institutional strengthening of the agencies in charge of implementing the reforms. A multi-tranched adjustment operation can support the process of reform at different stages and help lock in the credibility of a government reform program over time. By contrast, the stand-alone, single-tranched Banking Sector Development Policy Credit (BSDP) for Pakistan did not have a material impact on privatization of state-owned banks, which was concluded prior to this operation. The BSDP provided the government with financing for recapitalization costs incurred earlier, reflecting the Bank's policy in Pakistan which linked recapitalization support to successful bank privatization. The BSDP also focused on institution-building issues and further strengthening the State Bank of Pakistan, where sustained progress is difficult to achieve with a stand-alone, single-tranche operation, with no follow up and no associated technical assistance. Similarly to multi-tranched operations, programmatic loans are also potentially effective in supporting reform programs, but may require more focused efforts to obtain the best results from major reform processes. The slippages observed in the outcomes of the Second Financial Sector Development Policy Loan in Egypt, compared with the first one, illustrate this point, although the two operations were not formally part of a programmatic series.

(iv) A strengthened regulatory and banking supervision framework enhances credit risk management and helps withstand shocks but does not eliminate the risk of overextension of credit and deterioration of the quality of bank portfolios. Reflecting tighter supervision and the adoption of improved risk management practices, but also other factors, such as the limited development of their financial markets, the commercial banks in all four countries that received Bank assistance did not suffer large losses from the global financial crisis because they did not rely on wholesale funds to support their lending, did not have significant foreign exposures, and were not active in trading or investing in derivatives and other off balance sheet type instruments. **Pakistan** offers a good illustration of the effectiveness of these reforms, as the banking system was able to withstand the impact of the global financial crisis as well as the various bouts of domestic turbulence both political and due to the 2010 flooding. However, as illustrated by the case of **Morocco**, banks can still expand at a very rapid pace their financing of specific sectors, especially of housing, thus facing the risk of growing NPLs resulting from the abrupt fall of sales of housing units targeted to nonresident buyers.

(v) Restructuring of state-owned banks without privatization requires strong safeguards to prevent retrogression into unsound practices. In Pakistan and Morocco, where financial and operational restructuring of state-owned banks was actively pursued with Bank support, transfer of bank ownership to the private sector was considered a key prerequisite for improved financial intermediation. In Egypt the reform program covered the privatization of the fourth largest state-owned commercial bank (the Bank of Alexandria) and the sale of participations in joint-venture banks but did not include the privatization of the two largest commercial banks nor the large insurance companies. Many measures have been taken to improve the management of these institutions, which were akin to an effective "privatization of management" rather than "privatization of ownership". However, the safeguards that have been created to prevent retrogression into unsound practices do not appear to be sufficiently strong since state bank lending to SOEs on a long-term basis with thin margins has been resumed.

(vi) Better access to credit for the private sector requires a broader set of reforms than bank restructuring and privatization, including a favorable macroeconomic framework. Bank financial restructuring, privatization, and strengthening of the prudential framework and supervision of banks lay the groundwork for an increase in credit to the private sector on a sound basis but do not necessarily entail an increase in lending volumes in the short term. As a result of cleaning up the balance sheets of banks and writing down provisioned NPLs or NPLs settled by the government, the volume of outstanding bank credit to the private sector may even decline. Depending on country circumstances, a broader array of reforms may need to complement banking sector reform to help achieve a visible improvement in access to credit. Legal and institutional reforms to strengthen the insolvency regime, improve collateral security, and enhance borrower quality information are most prominent.

Egypt offers an example where two, still unaddressed, shortcomings of the legal framework impede the rapid and sound expansion of credit to the private sector. The absence of a modern bankruptcy law and insolvency regime and the lack of an efficient registry of collateral security on movable assets. In **Pakistan**, high inflation has resulted in very high interest rates that limit sound credit demand. In both **Pakistan** and **Egypt** state borrowing from the banking system crowds out the private sector as banks are in a position to generate very attractive margins from investing in government bonds, with little incentive to pursue lending to small and medium-sized enterprises and consumers which is risky and carries a higher administrative cost. Maintaining macroeconomic stability and limiting fiscal deficits thus appear necessary complements to banking sector reform in order to achieve viable growth in private sector access to credit.

Caroline Heider
Director-General, Evaluation

1. Introduction and Context

1.1 This section introduces the key question(s) to be assessed across the countries, the context, the projects, and any analytic framework, including factors beyond the government's control that could affect outcomes. Each of the main questions becomes a chapter.

1.2 The financial sector encompasses banks, non-bank financial institutions, such as insurance companies and pension funds, and money and capital markets. It plays a key role in fostering sustained economic development. It ensures an efficient payment system; mobilizes savings; channels them to productive investments in growing sectors; and helps people manage risks. At the same time, the financial sector often acts as a conduit for the transmission of crises to the economy, and in the context of growing exposure to global capital flows it may exacerbate, rather than tame, the impact of domestic or external shocks. A well-diversified, robust, and tightly supervised financial sector can improve the resilience of the economy to shocks, by providing credit buffers to sound companies; preventing abrupt swings in asset prices; ensuring adequate liquidity when needed; and bolstering confidence in the economy. Conversely, a mismanaged, vulnerable, and poorly regulated financial sector is likely to misallocate resources, thus dampening a country's potential for growth, in addition to making the economy more prone to volatility and crises.

1.3 Cognizant of the importance of finance for growth, the World Bank has a long-standing engagement in assisting client countries reform their financial sectors and bolster regulators, in particular in banking, but also in capital markets, insurance, and pensions. The IEG conducted, in 2006, a comprehensive review of the effectiveness of Bank assistance for financial sector reform between 1993 and 2003. This Project Performance Assessment Review (PPAR) has a more limited ambition, as it reviews the effectiveness of Bank assistance in financial sector reform through a cluster of **six selected lending operations** in four countries—**Egypt**, **Guatemala**, **Morocco**, and **Pakistan**—over a period spanning from 2001 (first operation in Pakistan) to 2008 (second operation in Egypt).

1.4 The review examines outcomes of the selected operations with due hindsight, two to six years after their completion. Outcomes of financial sector reforms, which typically include strengthening of regulators; overhaul of prudential regulations; improvement of supervision, and restructuring of financial institutions, often take relatively long to materialize, so that the assessment can be conducted on a more solid basis with the benefit of time. Moreover, financial sectors around the world were placed under stress by the 2008-09 global economic crisis. In the aftermath of the crisis, it is relevant to evaluate the resilience of the financial systems to shocks of such magnitude. The four countries covered by this PPAR share similar characteristics regarding the level of economic development; comparable openness of their financial systems to foreign investors and banks; and degree of freedom of international capital movements. The degree of their potential exposure to the global financial crisis was thus broadly similar. They all faced similar challenges in financial sector modernization, although at different stages of reform and with different urgency from a financial system stability perspective:

1.5 **Morocco** was at a more advanced stage in the financial sector reform agenda and had a more diversified, dynamic, and sophisticated financial system compared to the other three countries covered by this evaluation. **Egypt** was about to initiate a long-delayed but ambitious reform program, to fill important regulatory gaps, especially in the non-bank sector, and revitalize a relatively large banking sector that was distorted by the overwhelming presence of state banks. In neither Morocco nor Egypt were the reforms supported by the Bank implemented at a time of financial instability or crisis. By contrast, in Pakistan and Guatemala the Bank provided assistance at a time of financial instability. The banking system in **Pakistan** was on the verge of a major crisis in the mid-1990s, with predominance of state-owned banks and poor governance. The Bank assisted Pakistan in strengthening governance and financial discipline in the banking sector to avert an open crisis. In **Guatemala**, the Bank's assistance in the early 2000s came in the wake of a banking crisis in the late 1990s.

1.6 Although the context differed across the focus countries, a common development objective of the operations was to strengthen the enabling legal and institutional environment for financial intermediation and financial risk management and to increase the role and participation of the private sector in the provision of financial services. The PPAR reviews the effectiveness of the reforms supported by the Bank's operations in achieving these objectives. It also reviews the impact of the global economic crisis on the financial sectors of the focus countries and, to the extent possible, traces the effectiveness of the reforms supported by the Bank in making the financial sectors of the focus countries more shock-resistant. Therefore, some key questions, common across countries, addressed by the PPAR include the following:

- Did the Bank's operations contribute to a sustained improvement of bank soundness, by reducing the level of non-performing loans (NPLs); improving provisioning; and maintaining adequate capital and liquidity buffers? What have been the most effective measures to prevent a new build up of NPLs and are there instances where safeguards have been insufficient?

- Did the Bank's operations lead to more robust bank credit-risk management practices and tighter supervision and prudential norms? Have these reforms proven effective in safeguarding the soundness of the focus countries' banking system during the global financial crisis and in the face of other domestic shocks?

- Have the reforms supported by the Bank's operations fostered sound growth of credit to the private sector? Is there anything that could have been done differently to tackle bottlenecks to access to credit that may remain unaddressed?

1.7 The PPAR is organized as follows: The first part reviews the context of the Bank's operations and the post-reform performance of the financial sector in the four countries from a comparative perspective. The second part presents the evaluation findings from the review of the specific operations, with the results presented in more detail in the four country annexes to the synthesis report. The third part summarizes IEG's assessment of the performance of the six lending operations. The fourth part summarizes the conclusions and lessons drawn by the PPAR. Drawing lessons from the Bank's assistance for financial sector reform is of policy relevance for the future, in view of the continuing fragility of global financial markets and the potential vulnerability of developing countries to recurring financial crises.

2. Country context

1.8 The first section presents in more detail the context of the Bank's assistance for financial sector reform in the four countries. The second section reviews key financial sector performance indicators post-reform and also looks at the performance of the financial systems of the four countries in the aftermath of the 2008-09 global financial crisis.

CONTEXT OF FINANCIAL SECTOR REFORM AND BANK ASSISTANCE

1.9 The financial sector of **Morocco** is better balanced than those of the other countries covered by this evaluation. Insurance companies and pension funds are well established and have accumulated substantial assets. However, despite the relatively strong presence of institutional investors, the financial system continues to be dominated by the commercial banks. Morocco has always had large private banks that are prudently managed and operate with adequate capitalization and high profitability. These are universal banks with extensive interests in asset management and insurance. A downside of the prudent and conservative management of private commercial banks has been their neglect of financial inclusion and the limited access to financial services by low-income groups. In contrast to the private banks, public sector banks have tended to be specialized in particular economic sectors and have suffered from high levels of NPLs, large losses and inadequate capital.

1.10 The Moroccan authorities have taken a long series of measures to reform the structure and functioning of the financial system. Reform measures were supported by the 2005 FS DPL —a two-tranche operation for an amount equivalent to US$ 200 million. The operation was based on the findings of the 2002 FSAP and supported the government's program with the aim of: implementing an effective and modern legal, regulatory and supervisory framework; restructuring weak public financial institutions; and developing as needed the financial sector infrastructure. Another Financial Sector DPL was designed in 2009 to continue supporting the remaining agenda, with a particular focus on promoting sustainable access to finance.

1.11 In **Egypt**, the financial sector faced important challenges given low levels of competition, relatively high intermediation costs, limited innovation, and dominance of state owned banks. The banking system was burdened by high levels of non-performing loans, while the non-bank segment was characterized by underdeveloped bond, insurance, and mortgage markets, thin trading in equities, weak corporate governance, and weak infrastructure for effective payment and credit information systems. In 2004 the government began an extensive reform of the financial sector, influenced by recommendations from a 2002 FSAP.

1.12 The Financial Sector Development Policy Loans I and II were single-tranche loans of US$ 500 million each. They supported the government's financial sector reform program, the basic objective of which was the creation of a resilient and competitive financial system with sound banking and insurance sectors that would, in the medium-term, provide modern and efficient financial services. In addition to the two DPLs that are reviewed in this PPAR, the Bank supported two Mortgage Finance Projects in 2006 and 2009. The Financial Sector DPL III that was approved in May 2010 continued supporting the reforms of the first two DPLs but also focused on financial inclusion and expanding access to financial services by both households and SMEs. In parallel, a Financial Intermediary Loan to Enhance Access to Finance for Micro and Small Enterprises (US$ 300 million) was initiated in 2010.

1.13 Aided by the 1997 Bank Sector Adjustment loan, **Pakistan**'s "Home Grown Bank Reform Program" helped stem a pending financial crisis related to a high level of non-performing loans and significant liquidity issues in the financial system. By the end of the 1990s, when the program concluded, the banking sector had recorded significant improvements by most benchmarks, but the agenda for reforms was far from complete. To assist the government with the next stages of the reform program the Bank prepared a Bank Sector Restructuring and Privatization Project (BSRP) in 2001. BSRP was an investment loan that planned to help the government with the second stage of the operational restructuring of the Nationalized Commercial Banks (NCBs) in preparation for their privatization as well as for improving corporate governance of the partially privatized banks and strengthening the regulation of the banking system. The reform measures in this phase were also supported by the Bank's 2004 Banking Sector Development Policy Program (BSDP).

1.14 In the early 2000s, **Guatemala** experienced a crisis that had been brewing in the country's weak financial system since 1998. The crisis was brought to a head by macroeconomic imbalances; a deterioration of export prices; and a severe hurricane. The authorities resolved some small, weak banks, at substantial cost to the Central Bank of Guatemala (BGUAT). However, a financial reform was necessary to address the underlying problems. The 2002 Guatemala FSAL was a US$150 million loan, disbursed in three tranches, aimed at strengthening the financial sector to withstand shocks and increase prudent lending, in line with the financial reform program initiated by the Guatemalan government and the recommendations of the 2000 FSAP. The loan was accompanied by a US$5 million Bank financial technical assistance loan (FTAL).

1.15 The content of the six operations covered by this evaluation is summarized in Table 1. Strengthening bank regulation and supervision, together with bank restructuring and privatization, were common areas of bank assistance in all four countries. Securities market reform, with particular focus on insurance, was pursued in Egypt and Morocco. Payment system modernization and transparency was a common focus area in all countries.

Table 1: Financial Sector Reform PPAR: Policy content of selected operations

	Egypt First Financial Sector DPL	Egypt Second Financial Sector DPL	Morocco Financial Sector DPL	Pakistan Banking Sector Restructuring and Privatization Project	Pakistan Banking Sector Development Policy Program	Guatemala Financial Sector Adjustment Loan
Strengthening Bank Regulation and Supervision						
Central bank autonomy and bank supervision	√	√	√		√	√
Bank regulation	√	√	√	√		√
Restructuring and Privatization of State-Owned Banks						
Bank resolution and consolidation	√		√			√
Bank financial restructuring	√	√	√	√		
Bank operational restructuring	√	√	√	√		
Bank privatization	√	√	√	√	√	
Reform of Capital Markets and Non-bank Financial Institutions						
Securities Market regulation and supervision	√	√	√			
Insurance sector regulation	√	√	√			
Restructuring of insurance companies	√	√				
Financial Sector Infrastructure and Integrity						
Payment system and transparency		√	√		√	√
Corporate Financial Reporting	√		√			
Other						
Public Financial Management	√					

Source: IEG Staff Review

1.16 In three of the four focus countries (**Egypt**, **Guatemala**, and **Morocco**) the Bank used the DPL instrument to support broad ranging regulatory reforms in the banking sector and capital markets, as well as bank restructuring and privatization, in accordance with similar practice in other countries. The use of the fast-disbursing DPL instrument is well-adapted to the strong policy content and the cross-cutting themes of reform programs in the financial sector, but also the high cost of some measures associated with this reform agenda (such as bank recapitalization and settlement of non-performing loans). **Pakistan** is a somewhat atypical case where this reform agenda was supported through an Investment Loan (IL) operation (Banking Sector Restructuring and Privatization project—BSRP). This was achieved through a design that aligned disbursements to the progress in the implementation of bank restructuring and the policy measures included in the operation. BSRP was, however, an exception, as “first-generation” financial sector reforms in Pakistan were supported in the 1990s through a Structural Adjustment Loan and the 2001 BSRP was itself followed by another DPL in 2004 (Banking Sector Development Policy Program—reviewed by the PPAR). Technical Assistance Loans to help the implementation of the reforms supported by the DPLs were provided in three of the four focus countries (**Guatemala**, **Morocco**, and **Pakistan**). The Bank’s assistance in the financial sector in **Egypt** was also provided through Financial Intermediary Loans (FILs), as credit lines to financial institutions, to promote mortgage finance and micro and SME finance. The policy reform agenda in mortgage finance in Egypt was furthered through a 2010 DPL that followed the 2007 FIL in this area.

POST-REFORM FINANCIAL SECTOR PERFORMANCE

A. FINANCIAL SECTOR DEPTH AND SOUNDNESS

1.17 The **size of the banking system**—as measured by the domestic deposits in proportion to GDP—stands out as fairly large in Morocco and Egypt, even above the average for the MENA region during most of the 2000s (Figure 1; other, complementary, indicators of size and soundness are presented below). Financial intermediation through the banking system is considerably smaller in Pakistan and Guatemala—in the case of the latter noticeably below the regional average for LCR. Bank deposits grew through 2007 in Morocco, and less so in Guatemala, while remaining approximately stable in Egypt and Pakistan. The financial crisis of 2008-2009 lowered deposits in Egypt and Pakistan and capped deposit growth in Morocco, although deposits continued to grow in Guatemala. The crisis also impacted the banking systems through a decrease in credit to the private sector, but also through lower capital inflows, especially remittances (see below).

Figure 1: Domestic deposits (as a percentage of GDP)

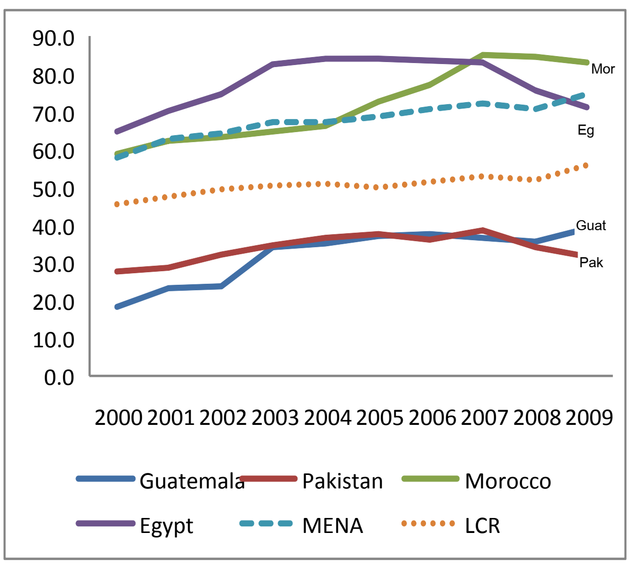
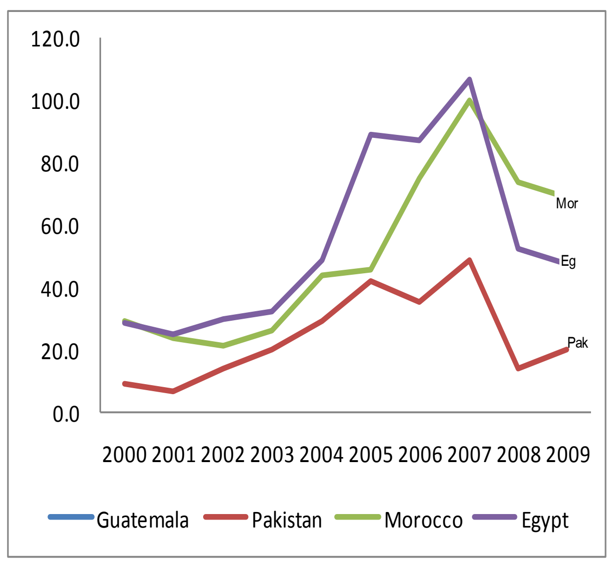


Figure 2: Stock market capitalization (as a percentage of GDP)



Source: World Bank, FinStats

1.18 **Capital markets** have been volatile and remain an unreliable source of private sector financing. Morocco, Egypt, and Pakistan started in the early 2000s with fairly small stock markets—as measured by their capitalization—Guatemala has no stock market (Figure 2). During the decade, the stock markets in Morocco and Egypt boomed, following similar trends for the MENA region as a whole, but market capitalization remained low in Pakistan. However, in all cases the size of the stock market was strongly influenced by economic cycles and shocks. The upward trend lasted until 2007, when the financial crisis impacted the stock markets in a similar fashion—with a particularly sharp drop in Pakistan and Egypt. The number of listed companies still remains small, and SMEs remain distant from capital markets, although Egypt started an SME market (NILEX) in 2010.

1.19 The structure of the banking system has evolved. **Bank privatization** and **reduction of state control in banking** were vigorously pursued in all four countries. However, the presence of state-owned banks varies across them. In Egypt state-owned banks still hold around 50 percent of bank assets, although this was drastically reduced from 80 percent in 2004, following the privatization of one of the state-owned commercial banks and the sale of public bank shareholdings in joint venture banks. In Morocco, the initial share of assets in state-owned banks was much lower and fell slightly, at less than 24 percent in 2008, down from 26 percent in 2004—including the banking assets owned by the *"Caisse de Dépôt et de Gestion"* and the postal bank. In Pakistan, the share of public banks was reduced to 18.6 percent of bank assets in 2008, from a predominant position when the reform program was initiated in the late 1990s. In Guatemala the banking system is mostly private, with only one big bank still in the public sector.

1.20 Mirroring the size of the deposit base, the volume of **credit allocated to the private sector** (in proportion to GDP) was high in Morocco and Egypt at the beginning of the period under review but was considerably lower in Guatemala and Pakistan (Figure 3). In these last two countries, the trend throughout the 2000s remained fairly flat. However, credit to the private sector experienced strong growth in Morocco while it suffered a significant decline in Egypt in the ensuing years. The fall in outstanding loans to the private sector in Egypt partly reflected the writing off of NPLs further to the settlement by the state of NPLs of state-owned enterprises and the full provisioning of other, private sector, NPLs (see part II), and partly a parallel increase in bank holdings of government securities. In the four countries, the banking system holds a sizeable portfolio of government securities and it remains involved in providing credit to state-owned enterprises (Figure 4). In Pakistan and Guatemala credits to government and SOEs represent almost half of the credit provided to the private sector. The Egyptian banking system stands out for being the most heavily engaged in lending to the state and its enterprises, almost at par with lending to the private sector. Although loans to SOEs declined compared to the pre-reform period, bank holdings of government securities increased in 2008-09, with an almost commensurate decrease in private sector lending, reflecting sales of government bonds by foreign investors and cautious lending to businesses as a result of the crisis. In Guatemala, the increase of the banking system's balance sheet (as measured by deposits in proportion to GDP), coupled with fairly stable lending to the private sector and an increase in lending to the government and SOEs, suggests that the banking system's extra lending space was mostly channeled to the public sector.

Figure 3. Private sector credit/GDP

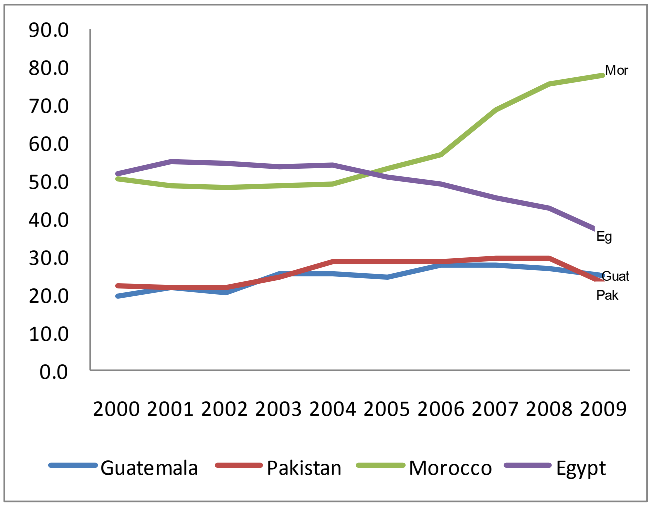
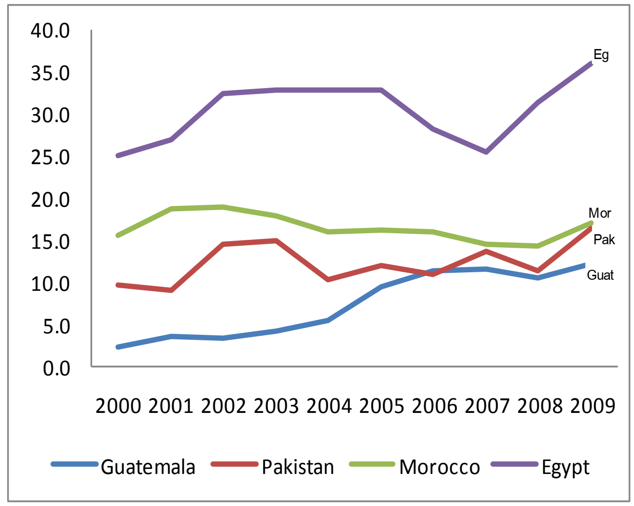


Figure 4. Credit to Government and SOEs



Source: World Bank, FinStats

1.21 Indicators of the **soundness of the banking system** show a general improvement, though with varying results across the four countries and throughout the 2000s (Table 2). In Guatemala and Morocco NPLs were much lower compared to Egypt and Pakistan. In all four countries, however, NPLs followed a downward trend, from very high initial levels in Egypt, Pakistan, and Morocco. Morocco stands out for fairly consistent improvements in NPLs, outperforming the MENA averages. The Egyptian banking system suffered from a high level of NPLs in the early 2000s, but managed to cut these by half (as a percentage of total gross loans) by 2009, while provisioning and regulatory capital improved beyond the respective regional averages. Solid pre-crisis growth; settlement of NPLs in state-owned banks; and tighter prudential regulation and supervision, have favored this outcome in the four countries. In Pakistan the improving trends in NPLs and provisioning were not sustained during 2008-09 as a result of multiple shocks, including natural disasters. Provisioning of NPLs has considerably improved throughout the decade and is comparatively higher in Egypt and in Guatemala. The capital ratio was maintained at high levels, around 15 percent in Egypt, Guatemala, and Pakistan, and close to 12 percent in Morocco. In all countries an effort to build bank capital buffers was evident throughout the decade. However, in Egypt, the regulatory capital of banks is overstated by the large holdings of zero-weighted government securities.

Table 2 Bank soundness indicators

NPLs to Total Gross Loans (%)							
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Guatemala	6.5	7.1	4.2	4.6	5.8	2.4	2.7
Pakistan	17.0	11.6	8.3	6.9	7.6	10.5	12.6
Morocco	18.7	19.4	15.7	10.9	7.9	6.0	5.5
Egypt	24.2	23.6	26.5	18.2	19.3	14.8	13.4
Provisions to NPLs (%)							
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Guatemala			43.2	40.0	42.7	73.2	89.3
Pakistan	63.9	71.6	76.7	77.8	86.1	69.6	69.9
Morocco	54.9	59.3	67.1	71.2	75.2	75.3	74.1
Egypt	57.0	60.2	51.0	76.2	74.6	92.1	100.4
Regulatory Capital to Risk-Weighted Assets (%)							
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Guatemala	15.6	14.5	13.7	13.6	13.8	13.5	15.4
Pakistan	8.5	10.5	11.3	12.7	12.3	12.2	14.0
Morocco	9.6	10.5	11.5	12.3	10.6	11.2	11.8
Egypt	11.1	11.4	13.7	14.7	14.8	14.7	15.1

Source: World Bank, FinStats

1.22 **Bank profitability** was generally improving prior to the 2008-09 crisis—with the exception of Egypt (Figures 5 and 6). The financial crisis depressed results at least somewhat in each of the four countries. Indicators of bank profitability were comparatively higher in Guatemala toward the end of the decade. In Guatemala, bank profitability had dipped during the country's crisis in the early 2000s, but showed subsequent improving trends as a result of the resolution of unsound banks. Starting from low levels, bank profitability in Pakistan surpassed the other three countries pre-crisis but dropped more prominently in 2007-09. This can be linked to domestic shocks, which compounded the impact of the global crisis, and an increase in provisioning for NPLs during that time period. Bank profitability in Morocco improved throughout most of the 2000s, and was close to the regional averages for the indicators in MENA. ROE and ROA in the Egyptian banking system point at lower profitability than in the other 3 countries, and are below the regional averages.

Figure 5: Bank profitability, return on equity

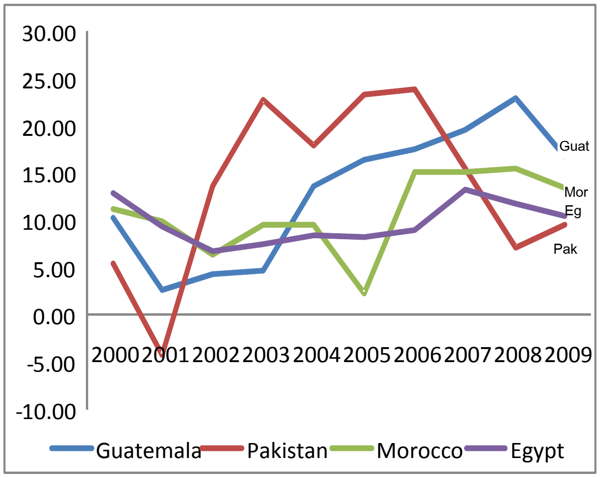


Figure 6: Bank profitability, return on assets

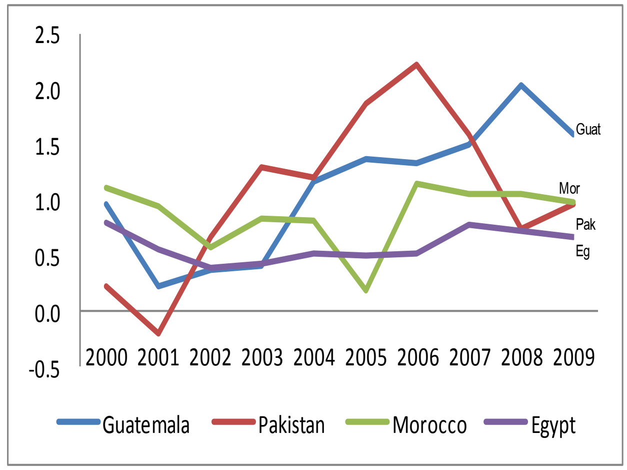


Figure 7: Insurance markets, Life premiums (in % of GDP)

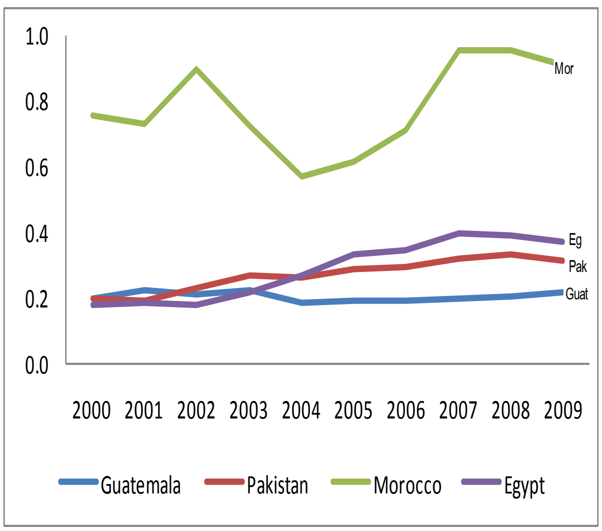
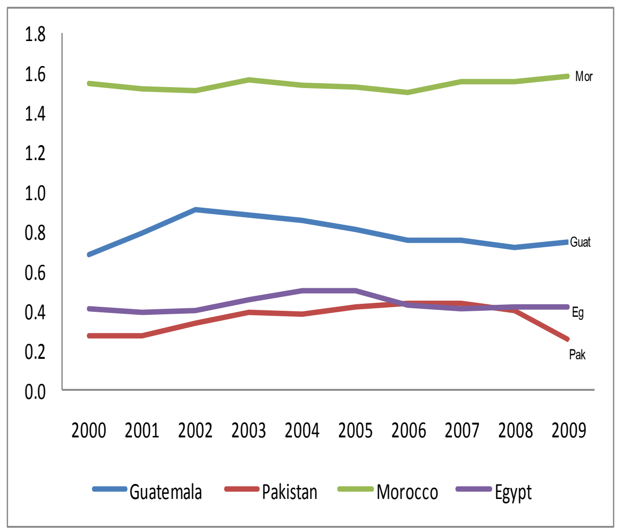


Figure 8 Insurance markets, Non-life premiums (in % of GDP)



Source: World Bank, FinStats

1.23 **Insurance markets** in the four countries remained underdeveloped, as measured by premiums (over GDP) for life and non-life insurance (Figures 9 and 10). They are more developed in Morocco, compared to the other three countries, and stand out for outpacing the MENA averages. In Guatemala non-life insurance is relatively more developed, but still lags behind the LCR average. An upward trend in life insurance premiums is noted in Egypt and Pakistan, although from very low levels.

B. The impact of the 2008-09 global financial crisis

1.24 In all four countries covered by this evaluation the negative impact of the global financial crisis was transmitted through external accounts; declines in exports; remittances;

FDI; or capital flows, with varying damage to government fiscal positions and their external financing. In Pakistan the financial crisis was exacerbated by political turbulence and the 2010 flooding. The commercial banks in all four countries were generally unscathed from the global financial crisis because they did not hold toxic assets and did not rely on wholesale funds to support their lending. They did not suffer from either maturity or currency mismatching, while neither bank leverage nor credit expansion were excessively high. Tighter prudential rules and the adoption of improved risk management practices contributed to this favorable outcome.

1.25 In **Guatemala**, the international financial crisis did not directly affect the financial system, as banks had little or no exposure to complex financial instruments, mortgages were in their infancy, the banks' liquidity was high, and foreign banks had only a limited role. However, Guatemala experienced a precursor to the crisis in 2007 when one of its largest banks went bankrupt, in part because the holder of its U.S. assets went bankrupt; it was resolved using institutions set up under the DPL. The 2008-2009 international crisis had two important, indirect, effects: First, the contraction in the industrial countries reduced Guatemala's exports and remittances and led to a drop in GDP growth. However, so far, reported NPLs have not increased much and, on average, are reported to be fully provisioned. Second, the decline in foreign credit lines to Guatemalan banks, may have contributed somewhat to the reduction in credit growth. However, banks' net foreign borrowing had traditionally been small relative to domestic deposits as a source of credit. Credit growth declined after 2007 not only because of risk aversion by the banks but because of the slowdown of the economy, which led to a corresponding decline in demand for credit. In 2009 and 2010, reported average bank capital remained about 15 percent of risk weighted assets, well above the 10 percent required minimum. Reported NPLs in 2009 and 2010 were less than 3 percent with much higher provisioning than in the past because of strengthened regulations on provisions.

1.26 In **Pakistan**, the banking sector withstood international and local crisis much better than expected—including the impact of the uncertain political environment in its region as well as the severe shocks, especially from the flooding in 2010. The Pakistan banking sector was not overly exposed to the fallout from the global financial crisis. Banking in Pakistan is conducted mainly in local currency and the banks were not actively involved in any of the complex financial instruments. The business is predominantly a deposit taking business and on the asset side of the balance sheet the main assets are loans and government securities. This is largely due to the regulations of the SBP and also to a conservative management approach by the main banks. The recently privatized banks (see next section) continued to be managed and controlled effectively, maintaining strong balance sheets with a solid capital position, good levels of liquidity and a high level of provisions against non performing loans.

1.27 In **Morocco,** the economy suffered from the retrenchment of capital flows and the decline of receipts from exports, tourism and remittances. However, thanks to a strong performance of agricultural production, Morocco was able to offset part of the adverse effects of the global financial crisis and to preserve a reasonable growth performance. The authorities adopted several stimulus packages to support the incomes of different groups and stimulate public investment, resulting in a sharp deterioration of public finances. With inflationary pressures low, the central bank lowered its key policy rate and gradually reduced reserve requirements from 15 percent in December 2008 to 8 percent in October 2009.

1.28 Moroccan banks did not hold “toxic” assets, did not rely on wholesale funds to support their lending, and did not suffer from exposure to maturity and currency mismatching. However, the banks had expanded their financing of infrastructure, housing and SMEs, while microfinance institutions engaged at the same time in a rapid increase of microcredit that was funded by borrowings from banks. Growing difficulties emerged in two of these areas: microcredit suffered from high levels of nonperforming loans, rising from less than 2 percent before 2007 to 12 percent in 2009, while the real estate sector experienced an abrupt fall of sales of housing units targeted to nonresident, mainly European, buyers. The central bank took steps to ensure the resiliency of the banking system by raising the minimum capital adequacy ratio from 8 to 10 percent of risk-weighted assets in 2008, encouraging mergers of microfinance institutions, introducing a regional real estate price index, and indicating its intent to raise the CAR to 12 percent for institutions with significant risk concentrations in real estate or other sectors. Bank credit experienced a significant slowdown, with its growth rate falling from nearly 30 percent in 2008 to less than 18 percent in 2009. This was a welcome correction to the very rapid growth of preceding years.

1.29 As in the other countries, the **Egyptian** banking sector was not directly impacted by the global financial crisis. The banking sector did not have any exposure to complex financial products and leverage was not excessive. But it did suffer some withdrawal of deposits. Both the government debt market and the stock market experienced a sharp deterioration as a result of the sudden selloff of government debt by external holders and outflows of foreign portfolio investment. Low overall credit was reflected in a low loan-to-deposit ratio of 52 percent for all banks, a source of strength in the crisis but also a sign of shallow financial markets and crowding-out by increased bank holdings of high-yielding government securities when foreign demand for them declined. In addition, consolidation of the banking sector, with support from the DPLs, and the increase in minimum capital requirements strengthened the capital buffers of the banking system in the face of the crisis. Public anxiety from the global crisis was connected to the deteriorating growth and employment prospects rather than to concerns about bank soundness.

1.30 The real sector suffered from a slowing aggregate external demand and the retrenchment of foreign direct and especially foreign portfolio investment. In response to the global crisis, the authorities adopted fiscal and monetary stimulus measures by accelerating infrastructure investment projects, increasing export subsidies, and lowering import tariffs on intermediate and capital goods. The central bank eased monetary policy by lowering interest rates and waiving the 14 percent reserve requirement on deposits that fund commercial bank loans to SMEs.

1.31 The ultimate impact of the global crisis on growth was not as large as originally feared. Prior to the political turbulence, in early 2011, growth was projected to exceed 5 percent in 2011 and capital inflows, foreign exchange reserves and the exchange rate had resumed their pre-crisis levels. However, the political turmoil is likely to dent economic growth, which is now projected at 1 percent in 2011, down from 5.1 percent in 2010. This will put to test the quality of bank lending portfolios, especially in state-owned banks, while the authorities will continue facing the challenge of managing a large fiscal deficit and a sizeable public debt stock in an uncertain global environment and with a still-underdeveloped domestic capital market.

3. Evaluation Findings

1.32 This part summarizes the evaluation findings from the review of the six operations in the four focus countries. The findings are presented in four themes, based on the policy content of the operations, as summarized in Table 1 above: (i) achievement of objectives in strengthening bank regulation and supervision; (ii) effectiveness of restructuring and privatization of state-owned banks; (iii) achievements in reform of capital markets and Non-Bank Financial Institutions (NBFIs); and, (iv) results in modernizing financial sector infrastructure and improving integrity.

STRENGTHENING BANK REGULATION AND SUPERVISION

1.33 In all four countries Bank operations placed strong emphasis on strengthening the legal, regulatory, and supervisory framework of banking, cognizant of the risk that restructuring and privatization of state-owned banks may not lead to desirable outcomes unless bank regulation and supervision are put on a sound footing. The reform agenda was broad and ambitious, encompassing some common building blocks, although with variations depending on country priorities: (i) delineation of central bank operations and strengthening its independence; (ii) expansion of the scope of bank supervision; (iii) building central bank supervisory capacity; (iv) tightening prudential regulations; (v) removing constraints to efficient bank intermediation; (vi) strengthening bank resolution procedures and exit mechanisms.

A. CENTRAL BANK AUTONOMY AND BANK SUPERVISION

1.34 All four countries have enacted new central banking acts or amendments to the central bank bylaws that have sought to bolster their independence, promote price stability, formalize lender-of-last resort facilities, sharpen prudential regulation and supervision, and strengthen the authority of central banks to intervene in troubled banks. Central banks in all countries have adopted multi-year comprehensive programs of capacity building and institutional development, with a view to eventually moving from the traditional compliance-based approach to a modern risk-based supervision.

1.35 Bank supervision has been promoted by creating new capabilities in such areas as bank rating systems and stress testing, and adopting a framework for prompt corrective action in problem banks. Monitoring of macro prudential risks, and in the case of Morocco even macro prudential simulation exercises, have been adopted to improve the responsiveness of the authorities to emerging systemic risks. The new framework has aimed to introduce consolidated supervision of banking institutions and adopt the Basel II approach to capital standards and risk-based banking supervision.

1.36 Central bank modernization has entailed extensive organizational restructuring, the creation of new departments, and the adoption of new methods and tools in both off-site surveillance and on-site inspections. New staff with extensive banking experience and specialized skills has been hired, while training programs have been expanded. Increasing emphasis is now placed on evaluating internal control and risk management systems, while inspection reports are prepared with greater promptness and are extensively discussed with the banks concerned to ensure that methodical corrective action is taken to address shortcomings and gaps in bank management.

1.37 The quality of monitoring and evaluation of these reforms has varied across countries. In **Guatemala**, there are various indicators of the improvement in supervision. Data are now available on offshore as well as onshore banks and conglomerates. The FSAP Update of 2005 noted an improvement in supervision, but that substantial further improvement was needed. In **Pakistan**, the SBP has put in place a clear and consolidated instruction on financial disclosure with the aim of improving transparency and compliance with regulations. In addition the SBP publishes a quarterly banking system review and also has developed a five year plan for the sector which is published and widely discussed. In **Morocco**, both the Ministry of Economy and Finance and the Bank Al Maghrib regularly publish extensive economic and financial data, including a detailed annual report on banking supervision and bank performance. These have permitted a comprehensive assessment of the pace and achievements of the reform program. By contrast, in **Egypt** anecdotal evidence from commercial banks suggests that central bank inspections have become more thorough but, well-documented, written evidence on the impact of these changes is scant. The CBE highlights in its annual reports the objectives and broad outlines of the capacity building program. However, the reports contain little detailed information on the changes that have taken place or an assessment of the impact of the new approach on bank solvency and efficiency. There is no clear indication of the success of the new approach in enhancing supervision of complex operations of modern banking groups and in redressing the regulatory forbearance that had long characterized its relations with the large state-owned banks. Neither the EU nor the Bank teams have prepared a detailed report on this crucial aspect of bank supervision.

B. COMMERCIAL BANK REGULATION, PRUDENTIAL RULES, AND RESOLUTION MECHANISMS

1.38 Several measures have been taken in all four countries to sharpen bank regulation and prudential rules and streamline resolution mechanisms. These have included increases in the required capital adequacy ratios and significant tightening of provisioning rules for nonperforming loans. Branch expansion policies have been liberalized, especially for banks that operate with capital solidity, while higher capital requirements have been imposed on excessive risk concentrations, such as large exposures to housing.

1.39 In **Morocco**, the banking operations of CDG have been brought under central bank supervision while the restructured former specialized institutions have been required to comply with the same prudential requirements as the commercial banks. The minimum capital adequacy ratio was raised from 8 to 10 percent of risk-weighted assets and the central bank indicated its intent to raise the CAR further to 12 percent for institutions with significant risk concentrations in real estate or other sectors.

1.40 In **Egypt**, the minimum bank capital requirement was increased to LE500 million in order to encourage greater consolidation of the banking system through merger or exit of small and weak banks. The capital adequacy ratio had already been raised to 10 percent prior to the start of the reform program, while the central bank applied higher risk weights on loans with higher LTV ratios. Provisioning and workout rules on nonperforming loans were significantly tightened. The NPLs of state-owned banks were settled partly in cash and partly through a land swap, but loan provisioning by state-owned banks continued to be linked to their profitability and the realization of large financial gains.

1.41 In **Pakistan**, the minimum bank capital levels were increased in order to encourage the exit of weak banks and strengthen the soundness of the banking system. The opening of bank branches was liberalized. Banks with a good CAMEL rating are free to expand their branch network while banks with weaker ratings have to meet more stringent requirements. The National Savings Scheme (NSS), which was benefiting from tax exemptions and had previously been a cause of wide scale disintermediation in the market, was reformed and the interest rates lowered and linked to market rates, thus enabling the banking sector to increase its deposit base. The tax rate on banks was gradually reduced to come into line with the corporate tax rate, thus removing a distortion that had made banking less attractive to investors than other sectors of the economy.

1.42 In **Guatemala**, the Banking and Financial Groups Law, passed in April 2002, in addition to strengthening supervision, set norms for bank licensing and established a stronger bank regulatory framework including capital rules. The law also established a framework for better bank governance, with disclosure and dissemination of information by the banks and the financial conglomerates, as well as a framework for moving to international accounting standards.

1.43 In addition, the Law set-up bank resolution procedures and exit mechanisms, as well as a Fund for Protection of Savers (FOPA), which provided for moderate deposit insurance, and a fund to support bank resolution, for example takeovers of weak banks by stronger banks. The law also set-up the basis for the credit information system that can be used by banks to assess clients and for risk management and exposures to related parties by supervisors; a system that is now fully functioning. The Bank’s TA loan (FTAL) played an important support role to this sub-objective, in particular in the drafting and set-up of the deposit insurance system, the bank resolution system, and the credit information system. The bank resolution framework and the deposit insurance scheme were used in the exit of two banks in 2007.

RESTRUCTURING AND PRIVATIZATION OF STATE-OWNED BANKS

1.44 Several reform measures have been taken in all four countries to improve the structure of the banking system to promote greater competition and enhance efficiency. These have aimed at greater bank consolidation, financial and operational restructuring of state-owned institutions, and bank privatization programs.

A. BANK CONSOLIDATION

1.45 Bank consolidation, by removing small and weak banks, was promoted in Egypt and Guatemala. It was a key reform objective in **Egypt**, with the aim of increasing the banking sector's robustness and stimulating sound competition. This objective was achieved by raising the minimum capital of banks to EGP 500 million (nearly US$ 100 million) and encouraging the merger of small and weak banks or their absorption by stronger institutions. The number of banks fell from 57 in 2004 to 43 in June 2006 at the time of effectiveness of DPL I and 39 in June 2008. The increased capital base of banks and the absorption of small and weak banks has increased the solidity of the banking sector and has created better conditions for intense but sound competition.

1.46 The first DPL also supported assistance by an investment bank in the implementation of the merger of Banque Misr with Banque du Caire. Some confusion exists regarding the legal status of Banque du Caire. Its merger into Banque Misr was initially indicated but in May 2007 its ownership was transferred to Banque Misr with Banque du Caire continuing to operate as a separate entity. The intention to privatize Banque du Caire through the sale of 67 percent of its capital to a strategic investor was announced by the government in July 2007. The bank's balance sheet was cleaned by the transfer of its NPLs to Banque Misr. The offer for sale through a competitive bidding process was begun in 2008 but the transaction was thwarted by the global financial crisis.

1.47 Consolidation of the banking system was also actively pursued in **Guatemala,** where the weakness of the banking system prior to 2002 reflected in part the large number of banks (31), many of which were small. The decline in the number of banks since then has reflected closures and, in the last three years, exits of banks by takeovers. The creation of the bank resolution and deposit insurance funds contributed to the streamlining of the resolution process.

B. FINANCIAL RESTRUCTURING OF STATE-OWNED BANKS

1.48 Financial restructuring of state-owned banks was pursued in Egypt, Morocco, and Pakistan, involving various combinations of bank recapitalization and removal of NPLs. In Morocco and Pakistan the aim of financial restructuring was to privatize the intervened banks (see section D), while this objective was pursued in Egypt only in the case of one bank (*Bank of Alexandria*). In addition, Egyptian state-owned banks sold off their holdings of capital in joint-venture banks. This increased competition in the financial system, but also helped raise funds to strengthen the capital of the state-owned banks. Financial restructuring went in tandem with operational restructuring in most cases (see next section). In all countries commitment of public financial resources to state owned banks was accompanied by significant strengthening of bank supervision.

1.49 **Egypt** implemented an ambitious 4-year program of financial, institutional, and operational restructuring of two state-owned banks (*National Bank of Egypt* and *Bank Misr/Banque du Caire*) with support from the DPL series. The financial restructuring entailed the resolution of the large volume of NPLs with both state-owned enterprises (SOEs) and private sector borrowers. However, although the risk was acknowledged by the Bank's operations, safeguards appear to have been put in place to prevent the accumulation of new bad loans to SOEs by the state banks. Some safeguards have been introduced as part of the Government's reform program, although these measures were not included in the DPLs. For example, the Ministry of Finance issued a policy forbidding state guarantees for SOEs. According to the authorities, loans to SOEs are being granted on full assessment of borrower and project viability with full-fledged analysis of cash flow repayment capacity with pricing at market norms. Although lending to SOEs is still a minor fraction of the portfolio of banks, findings of the IEG mission suggest that the state-owned banks continue to provide loans to SOEs at very long maturities and fixed rates, with small margins compared to the cost of their resources (for, example, long-term loans by the NBE to the Electricity Company). Profitable SOEs obtain financial services from competing private banks since they represent attractive risks but SOEs that depend on public subsidies for their commercial viability may not have this option, especially at times when the budget may come under strong pressure. Project documents emphasized the importance of transparency and close monitoring but neither was in evidence at the time of this evaluation.

1.50 Like nearly all other banks, the state-owned commercial banks not only exceeded by a large margin the CAR of 10 percent required by the prudential rules but were also able to increase their CAR levels in recent years. However, this achievement was made easier by the substantial decline of lending to the private sector and the corresponding increase of holdings of government bonds. In fact, because of the different risk weights attached to these asset classes, the CAR could have been increased even with a reduction in regulatory capital.

1.51 The overall financial performance of the state-owned commercial banks continued to lag considerably behind that of the more successful and efficient private banks. Only in the last couple of years have the results of the NBE seemed to come closer to those of the private banks. This could represent a landmark achievement by the NBE, although the decline in economic growth caused by the political uprising is likely to affect adversely the financial results of the next few years.

1.52 In **Morocco**, institutional and financial restructuring covered three formerly specialized public financial institutions: the *Banque Nationale pour le Développement Economique* (BNDE), the *Crédit Immobilier et Hôtelier* (CIH), and the *Crédit Agricole du Maroc* (CAM) - successor to the *Caisse Nationale de Crédit Agricole* (CNCA). These institutions had been exempted from prudential requirements and had suffered from large NPLs. The Bank's FSDPL directly supported, through tranche conditions, only the restructuring of CIH, which was successful despite remaining challenges, but the Government was committed to move ahead with all three institutions. The restructuring of CIH entailed the recognition of large losses from non-recoverable NPLs, a substantial recovery of debts from connected borrowers, a recapitalization from existing shareholders, and a transfer of public sector shareholdings to CDG, while a strategic investor entered the bank's capital. The restructuring resulted in a new strategy that defined CIH as a family bank in direct competition with commercial banks in the offer of deposit facilities and other financial services and the granting of consumer and especially housing loans. CIH has been able to comply with prudential requirements since the end of 2006 and operates with a high CAR that reflects both the recovery of bad debts and the profitability of current operations. However, CIH still suffers from large volumes of NPLs, the resolution of which continues to face difficulties, although they are covered by substantial provisions. Another weakness is its continuing high exposure to the real estate sector.

1.53 In **Pakistan**, the interventions undertaken by the government in the first two phases of the bank reform program were estimated to have cost about US$2 billion or 2.8 percent of GDP. These costs included capital injections for the banks, voluntary retirement programs, branch closures and also other costs involved in restructuring the banks in advance of privatization. Financial restructuring of state-owned banks was not explicitly supported through disbursement conditions by the Bank's BSRP and BSDP operations. However, the Bank's operations provided *de facto* financing for the restructuring operations undertaken by the government.

C. OPERATIONAL RESTRUCTURING OF BANKS

1.54 In **Egypt**, the operational restructuring of state-owned banks entailed a major upgrading of the management of financial and operational risks, human resources and automation systems. The banks were advised by international consultants funded by EU financial support. There is ample anecdotal, and in some cases written, evidence that significant progress has been made by both banks but as in the case of banking supervision by the CBE, no comprehensive report appears to have been prepared by either of the two state-owned banks, the CBE Bank Reform Unit, or the EU and Bank teams. (If such a report exists, it has not been made known to the PPAR team.)

1.55 Some aspects of the technical restructuring of the state-owned banks are well documented in their annual reports. The NBE reports highlight both the adoption of management information systems, the gradual expansion of automation and the linkage of a growing proportion of its branch network to modern on-line systems. In the area of human resources, both banks have expanded the recruitment of young graduates as well as experienced senior professionals with specialized skills, and have adopted promotion systems based on performance rather than seniority. The hiring of new staff was offset by voluntary retirement programs that encouraged the departure of older staff. Both banks substantially increased their training budgets and the number of staff training hours.

1.56 In **Pakistan**, a key objective of the BSRP project was to help the government with the second stage of the operational restructuring of the NCBs in preparation for their privatization as well as for improving corporate governance of the partially privatized banks by divesting the remaining government shareholding and allowing complete control to the private sector owners. Specific targets were set down to be achieved for branch and staff reductions at the NCBs as well as for an improvement in the cost income ratio. The progress made in the rationalization and retrenchment process helped to facilitate earlier privatizations than was anticipated when the loan was being put in place. Two of banks (UBL and HBL) were privatized well in advance of the period of the BRSP and this generated savings in the operation that have been used to finance some costs of bank recapitalization. Moreover, NDFC was amalgamated with the National Bank of Pakistan in December 2001.

D. BANK PRIVATIZATION

1.57 In **Egypt**, before the 2004-2008 financial reform program, state owned or controlled banks accounted for 80-percent of banking assets (58 percent through the four state-owned banks and 22 percent through the 23 joint-venture banks, in which state-owned financial institutions held majority stakes). This structure of ownership was at the root of governance and conflict of interest issues that effectively resulted in market segmentation and weak competition. The divestiture of state-owned bank shareholdings in joint-venture banks achieved a significant expansion of the private sector presence in the banking system.

1.58 The privatization of the Bank of Alexandria followed a competitive bidding process subject to due diligence. The bank's assets had been cleaned from all NPLs. 80 percent of the capital of the bank was sold to the Italian Intesa San Paolo IMI bank, which submitted the highest bid valuing the bank at US$ 2 billion, and 5 percent was allocated to bank employees. The remaining 15 percent was due to be floated on the stock market but the IPO has not been completed because of adverse market conditions, related to the financial crisis of 2008-2009. In 2008, the government also prepared *Banque du Caire* for sale but the coming of the crisis limited the size of the offers and none were accepted.

1.59 In **Morocco**, partial privatization of the *"Credit Immobilier et Hotelier"* was pursued after its financial restructuring, which led to opening the bank's capital to a strategic partner. The French Caisse Nationale des Caisses d'Epargne (CNCE), later merged into Banque Populaire Caisses d'Epargne (BPCE), was introduced as a strategic investor, with 24 percent of equity capital.

1.60 In **Pakistan**, with support from the BSRP project, the government successfully sold its shareholding in *Muslim Commercial Bank* and reduced its shareholding in *Allied Bank* to 11.9 percent. *Habib Bank* and *United Bank* were successfully privatized during the time frame of the BSRP, exceeding expectations. This was largely due to a combination of factors: Firstly the restructuring process had commenced prior to 2001. New boards and management had been put in place and significant progress had been made under their leadership combined with strong government support; secondly, the market conditions were more favorable towards Pakistan and the financial sector at that time and this enabled a quicker than anticipated sale to strong shareholders. Performance of both banks has been strong post privatization and even though the government still has a minority position and some representation at board level there has been no evidence of any interference in the operations and management of these banks post privatization. Regarding the National Bank of Pakistan, 23 percent of its shares were sold through a combination of an IPO and a market sale in tranches between November 2001 and November 2003.

Contrary to the BSRP project, the Bank's BSDP credit did not have a material impact on privatization of state-owned banks. The privatization of the NCBs had been concluded before the BSDP loan in 2005 and the loan did not have any impact on this process. Essentially, with the BSDP loan the government was provided with financing for recapitalization costs incurred earlier. This approach reflected the Bank's policy in Pakistan, which consisted in linking recapitalization support to successful bank privatization. However, BSDP missed an opportunity to try to continue with future enhancements to the banking and financial sector which a policy based program may have assisted. The privatization of NBP was, for example, never completed, even though this had been mentioned in earlier programs as a bank which was being prepared for privatization.

REFORM OF CAPITAL MARKETS AND NON-BANK FINANCIAL INSTITUTIONS

1.61 In **Egypt** and **Morocco** the Bank's assistance to financial sector development extended beyond the banking sector to encompass capital markets and Non Bank Financial Institutions (NBFIs). In both countries, a key objective was the implementation of an effective and modern legal, regulatory and supervisory framework, in line with international standards, across the securities markets and insurance so as to improve financial intermediation and risk-taking behavior, and foster a more efficient mobilization of savings. The promotion of institutional investors was targeted through the liberalization and restructuring of the insurance sector, and the adoption of new regulatory frameworks for private pension funds and collective investment schemes. These measures were expected to have a long-term impact on the growth of securities markets and institutional investors.

1.62 In **Pakistan**, as the government had seemed committed to developing fully fledged banking and financial markets that would largely be privately owned, it seems that an opportunity may have been missed by the Bank's BSDP in this context. The banking sector still represents about 93 percent of Pakistan's financial system. The securities markets, insurance and pension funds have not developed to any extent and there are no longer term funding sources—an impediment to the provision of project and term finance as well as for the development of the mortgage market. More developed capital markets could have increased competition with the banking system for corporate financing, thus leading to lower costs of financial intermediation.

A. STRENGTHENING SECURITIES MARKET REGULATION AND SUPERVISION

1.63 In **Morocco**, in the area of securities market regulation and supervision, six new laws expanded the powers of the regulator and applied new rules to the stock exchange, the central securities depository (Maroclear), mutual funds, public offerings, and repurchase agreements. The surveillance and investigative powers of the regulator were significantly reinforced. Guidelines were issued about how to deal with insider information and the system of sanctions for violations was modified to provide for a greater range and gradualism of penalties. Licensing of mutual fund companies is now granted by the regulator and not the Minister of Finance, although the licensing mechanism continues to be focused on the mutual fund product rather than the management company. The regulator was also given adequate powers to stipulate detailed regulations through circulars that have legal force and are issued after broad consultation. The regulator was granted budgetary autonomy, allowing expansion of human, technical and financial resources necessary for undertaking on-site inspections and investigations of financial misconduct (such as insider trading, market manipulation, false information, and mishandling of quotations). However, formal autonomy was not granted prior to the 2009 DPL and as in the case of the insurance sector, this has been included in the objectives of the 2009 DPL.

1.64 In **Egypt**, the two DPLs initial focus in insurance regulation was strengthening the Egyptian Insurance Supervisory Authority (EISA), which faced substantial challenges in moving from a compliance-based approach of a largely state owned sector to risk-based supervision in what was expected to become a competitive market environment. Later, however, in 2009, the focus shifted to the new Egyptian Financial Supervisory Authority (EFSA) when the latter was created by the new law on regulating the non-bank financial markets, institutions and instruments. EFSA assumed the functions of three pre-existing authorities, EISA, the Capital Market Authority (CMA) and the Mortgage Finance Authority (MFA). EFSA started operations in July 2009 and adopted a functional approach to its organization. EFSA enjoys operational and financial independence and has embarked on an ambitious skills development program, recruiting young graduates and implementing intensive training courses.

1.65 Several measures were also adopted to improve the efficiency of securities markets. These included the introduction of IFRS standards for listed firms and securities companies, the establishment of a registry for external auditors, the imposition of stricter rules on external auditor qualifications, and the adoption of international auditing standards, the strengthening of capital adequacy and risk management standards for securities firms, the simplification of stock exchange listing schedules, the regulation of takeovers and public tender offers, and the 2010 creation of NILEX, a new exchange for listing and trading SMEs.

B. INSURANCE SECTOR REFORM

1.66 In the insurance sector in **Morocco**, the liberalization of insurance premiums was completed with the lifting of controls on motor insurance premiums. The promulgation of an implementing regulation of the new Insurance Code that covered the diversification and valuation of assets, solvency rules, the calculation of technical provisions, and recourse to reinsurance brought the regulatory and supervisory framework into greater compliance with IAIS standards. Revised accounting standards for the insurance sector were adopted. All insurance companies except three complied with solvency and prudential requirements, while restructuring plans were adopted for the remaining three. Action plans were prepared for the reform of labor funds, the insurance of work-related accidents, and the introduction of insurance mechanisms for natural disasters and political risks. However, little progress has been made in increasing the autonomy of the insurance regulator and this goal has been included in the 2009 FS DPL.

1.67 In **Egypt**, the regulation of insurance was considerably improved with the enactment of amendments to the Insurance Code. These raised the minimum capital of insurance companies, required the separation of life and non-life business, and authorized corporate insurance brokers. The broader development of the actuarial profession was also envisaged. Main emphasis was placed on improving the underwriting and reserving of motor third-party liability (MTPL) and the calculation of mathematical reserves for life insurance and pension funds. In response to a diagnostic study that demonstrated that MTPL premiums covered only 20 percent of costs, premiums were raised to cover half of the shortfall, while a new law was passed that imposed caps on claim payouts. The enactment of a new Stamp Law in 2006 lowered by 50 percent the stamp duty on non-life policies and removed it altogether from life insurance contracts. On-site inspections of insurers, using a risk based modality, started to be conducted although the supporting supervisory database and information system were still being upgraded and remedial action was rather limited. A draft law was prepared to address the problems of the currently small and seriously underfunded private pension funds. The new law will allow insurance companies and specialized fund managers to offer a wider variety of pension plans under the supervision of EFSA.

1.68 The Bank's assistance in **Egypt** also included the restructuring of state-owned insurance companies. The plan envisaged the appointment of specialist consultants, with detailed terms of reference, to advise on their corporate and operational restructuring (first phase) and the eventual privatization of three of the four companies (second phase). However, the option of selling the insurance companies to strategic investors was discarded, although an IPO on the stock exchange for part of the capital of Misr Life Insurance was envisaged. The approach adopted by the authorities after the completion of the advisory report was to create an Insurance Holding Company in October 2006 to facilitate the management, reform and restructuring of the state-owned insurers. The holding company took over ownership of all state-owned insurance companies.

FINANCIAL SECTOR INFRASTRUCTURE AND INTEGRITY

1.69 In all four countries the Bank's assistance included measures with the aim of developing the financial sector infrastructure. Focus varied depending on country priorities: Modernizing the payment system was a focus area in **Egypt**, **Morocco**, and **Guatemala**; while improving the integrity of the financial sector through better anti-money laundering policies was supported in **Morocco**, **Guatemala**, and **Pakistan**. Enhancing the quality of financial information by upgrading accounting and auditing standards was part of the reform agenda supported in **Egypt** and **Morocco**. Measures to enhance access to credit, through the establishment of a credit bureau, and to strengthen creditor rights, through the establishment of economic courts, were supported in **Egypt**, while better financial inclusion through improved microfinance legislation was a program aim in **Guatemala**. More recently, the Bank's assistance in **Egypt** and **Morocco** shifted its focus to financial inclusion.

A. PAYMENTS SYSTEM MODERNIZATION AND ANTI-MONEY LAUNDERING MEASURES

1.70 In **Egypt**, a Real Time Gross Settlement (RTGS) system was installed by the CBE and became operational in March 2009. In addition, the CBE developed an Automatic Clearing House (ACH) to reduce the total processing time of checks. Regarding retail payments, the CBE has promoted the use of plastic cards and automated terminals for the payment of public sector salaries and pensions.

1.71 The modernization of the payment system in **Morocco** included the launching in September 2006 of the Real Time Gross Settlement system (RTGS) for large value payments and the use of check imaging and other electronic payment instruments for small-value payments, such as standing credit and direct debit orders, to replace paper-based payment methods. A national committee for the payment system to improve the regulatory framework and the national coverage and processing efficiency of all payment instruments was established in April 2006.

1.72 A new law on anti-money laundering was adopted in **Morocco** in April 2007. The law defines money laundering offences and sets out preventive measures for parts of the financial sector and designated nonfinancial business and professions. A Steering Committee was appointed to implement the Accounting and Auditing Action Plan. Companies making public offerings are now mandated to publish audited consolidated financial statements prepared in compliance with international norms (IFRS).

1.73 In December 2001, **Guatemala** enacted an Anti-Money Laundering Law. The law established the creation of an AML Unit in the SIB. By the end of 2002, the unit became operational and the GAFI Financial Action Task Force (Review Group for the Americas) indicated that Guatemala met all its 25 qualification criteria. In 2004, Guatemala was taken off the list of GAFI's non-cooperative countries. Although the Anti-Money Laundering Law was passed before the FSAL, it helped to improve the effectiveness of the four major laws supported by the FSAL, including providing the basis for offshore supervision. The FTAL provided technical assistance, training and funds for hardware acquisition to the AML Unit.

1.74 Anti-money laundering legislation was also designed in **Pakistan** to ensure that it would become increasingly difficult to utilize the banking system for transferring or holding funds for illegal activities. Guidelines were issued in March 2003 and a system was put in place to monitor adherence to these guidelines.

B. CREDIT INFORMATION AND ACCESS TO FINANCE

1.75 In **Egypt**, a private credit bureau was established in 2007 and became operational in March 2008. It is building its database from several sources, including the public credit registry, banks and non-bank financial institutions, and mobile phone operators. Credit reports are updated on a monthly basis and include both positive and negative information. The quantity and quality of information on client creditworthiness at the public credit registry were also significantly improved by recording the length of the outstanding loans, the history of loan balances and repayments, and any changes in the terms of the loan. The last provision helps identify cases of rescheduling and rolling over of loans.

1.76 However, a proposal by the credit bureau to create an SME rating service did not succeed because of lukewarm support by the leading commercial banks. Important weaknesses in the regulatory framework for access to credit also remain because of the failure to enact a new insolvency law and create a registry for collateral security on movable assets. The provision of credit to the private sector, and more especially to SMEs, continues to fall below the required level for sustainable economic growth and employment creation, while the safeguards against retrogression in the lending policies and practices of state-owned banks do not appear to be sufficiently strong.

1.77 In **Guatemala**, an insurance law and a secured transactions moveable property law were presented to the congress and both have been passed. A Microfinance (NBFI) law was also presented to the congress but still has not been passed as institutions in the microfinance sector were diverse and were concerned that a new law would overly favor one segment or another of the institutions. Although the Parliament has not passed the Microfinance (NBFI) Law that was submitted under the FSAL, small scale and micro lending and small depositors' access to deposits have grown substantially. Within the banking sector, BanRural ("*Banco de Desarollo Rural"*), owned 18 percent by the state and 82 percent by coops, has expanded dramatically, to become the third largest bank in the country, owning over half of Guatemala's bank branches. Performance on its loans has been good, with full provision of NPLs. BanRural has set up an internal system of information on micro-credits and has been trying to get other banks to contribute to it.

4. Conclusions and Lessons Learned

1.78 A main finding of this evaluation is that the reforms supported by the Bank's operations strengthened the financial sectors of the four focus countries and helped them resist the impact of the financial crisis of 2008-2009.

1.79 In all countries the financial systems are still banking oriented but the banking sector is much stronger and generally in a better position to respond to the financing needs of the private sector. Yet, risks remain, as credit growth is often concentrated, credit risk management systems need further strengthening, and, in some cases, credit to state-owned enterprises is not entirely based on market criteria. Moreover, in most of the focus countries, growth in private sector credit has not reached the levels anticipated or desired.

1.80 In parallel with the specific conclusions reached in the PPARs of the individual operations, a number of lessons can be drawn from findings common to the four countries. Even though the measures supported by these operations were not necessarily representative of financial sector reform efforts around the world, lessons drawn from the comparison of experiences may be useful to the governments in question, in addition to expanding the knowledge base regarding the design of these types of operations as well as the approaches they took and the results achieved.

(i) The quality of analytical work is crucial for the success of policy-based operations in the financial sector.

1.81 In three of the four countries, the policy content of the operations was closely based on the findings of recently completed FSAPs and further technical analysis conducted during preparation. In **Guatemala**, the high quality of the technical analysis in the 2000 FSAP and the FSAL preparation was crucial to engage the government's commitment to the reform agenda. This included interactions between the Bank and the Parliament. In **Morocco**, the 2002 FSAP recommendations were incorporated in the design of the Bank's operation. They were fully accepted by the authorities who endorsed the need for decisive action and committed to overhaul the regulatory framework and undertake a fundamental financial and operational restructuring of state-owned financial institutions. The high quality of the technical analysis (FSAP and Accounting and Auditing ROSC) provided the basis for the policy dialogue and technical discussions during the preparation and implementation of the operation, and underpinned the extensive and effective cooperation between the government and the Bank team during implementation.

1.82 The preparation of the programmatic operations in **Egypt** also built on the policy dialogue that had been conducted with the authorities over a long time and particularly in the context of the 2002 FSAP, the 2007 FSAP Update, and related analytical work. In addition to valuing the Bank's experience in designing development policy loans in the financial sector, the authorities placed special weight on the Bank's role in coordinating in a concerted and effective way the offers of technical and financial assistance of bilateral and multilateral donors. The division of labor among donors aimed at maximizing the financial and technical benefits for Egypt, although this may also create a challenging task in project monitoring and supervision (see below). **In Pakistan**, the BSRP was not prepared on the basis of a recent FSAP. The BSDP, however, picked up some of the recommendations of the FSAP carried out in early 2004, which took stock of the banking sector reforms that had been implemented so far.

1.83 In general, the analytical work undertaken by the Bank in the four countries has reflected a significant change in policy direction. Whereas in the 1980s, a main focus was placed on moving away from direct to indirect methods of monetary and credit control, the last two decades have seen a growing emphasis on micro prudential controls that seek to strengthen the soundness and safety of banks, insurance companies and other financial institutions. The Bank's analytical work has stressed the importance of maintaining reasonable macroeconomic and financial stability, entailing moderate inflation as well as small fiscal and external deficits. Less attention has been paid until relatively recently to macro prudential issues, perhaps because the banks and other financial institutions operating in these countries have not engaged in activities that created large systemic risks. Unlike banks in many European countries, there has been little reliance on wholesale funding and limited recourse to consumer and housing loans denominated in, or indexed to, foreign currencies. The authorities have applied higher capital adequacy requirements to reflect the higher credit risks facing banks in developing countries but have not considered a more extensive use of macro prudential controls.

(ii) Effectiveness of implementation support is a key condition for results because financial sector reforms are easy to design but difficult to implement.

1.84 This was most evident in **Guatemala,** where high quality technical analysis and advice was provided as part of implementation support of the Bank’s FSAL, not only through the supervision of the operation but also through the FTAL operation of technical assistance. This continued technical and policy dialogue with the authorities and their technical teams was important to maintain the authorities’ ownership and commitment to the FSAL development objectives during the course of two administrations. The Bank extended technical assistance that has greatly helped strengthen the capacity of the Bank of Guatemala and the Superintendent of Banks to implement the reform actions supported by the FSAL. The high quality of TA under the FTAL was critical in setting up the deposit insurance and bank resolution agencies and in setting up the legal authority to carry out bank resolution, a system that responded successfully to the two problem banks in 2006 and 2007. Supervision missions of the FSAL, complemented by supervision of the FTAL operation, provided timely technical assistance and advisory services to the implementing agencies, including following the failure of the fourth largest bank during the second half of 2006.

1.85 This intense level of technical assistance efforts is often crucial for the success of policy-based operations, but the needed resources are not always available to Bank teams if, contrary to the case of Guatemala, there is no parallel technical assistance loan. Although grants for TA may be available from other development partners, the coordination with Bank operations can be too slow and complex when country problems must be met quickly to achieve the best results for the country.

1.86 In **Egypt,** by contrast, the effectiveness of operation implementation support suffered from the division of labor among several participating donors and an apparent failure to provide for joint supervision, implementation completion reports, and evaluation missions. The Bank played a key coordinating role in the division of labor during the preparation of the loan operations but failed to act as a clearing house for implementation support. As a result, crucial comprehensive reports on key aspects of the reform program, such as the effectiveness of the capacity building program in banking supervision and the solidity of the financial and operational restructuring of state-owned commercial banks, have not been compiled. Greater attention needs to be placed on the organization of effective project supervision when several financiers participate in complex operations. Multi-donor operations, as those in Egypt, face a challenging task of effective coordination and supervision, especially when there is a division of labor in the provision of technical assistance that is crucial for the successful implementation of the reform program.

1.87 Enhancing the quality of Monitoring and Evaluation (M&E) frameworks can play a key role in strengthening program implementation and improving outcomes as suggested by evidence from several evaluations conducted by IEG. This requires adequate design of M&E, with well-specified outcome (rather than output) indicators; adequate baselines and realistic targets; strong ownership and alignment with data collection capacity of client implementing agencies. But good M&E also requires a greater transparency of the reform program, through the regular publication of comprehensive data and assessments. Enhanced transparency conveys the continuing strong commitment of the authorities and inspires greater confidence that the reform is genuine and goes beyond mere cosmetic initiatives. Lessons learned are shared with a broader audience and do indeed generate greater demand for further reforms as well as for corrective adaptations when particular measures appear to be counter-productive and overly costly. Lack of transparency veils the whole reform program in excessive secrecy and risks undermining its credibility.

1.88 **Egypt** offers an example where information gaps do not facilitate monitoring and evaluation of the reform program. The CBE highlights in its annual reports the objectives and broad outlines of the capacity building program but contains little detailed information on the changes that have taken place or an evaluation of the impact of the new approach on bank solvency and efficiency. There is no indication of the success of the new approach in supervising the complex operations of modern banking groups and in redressing the regulatory forbearance that had long characterized its relations with the large state-owned banks. The same also applies to the financial and operational restructuring of the state-owned commercial banks. In **Morocco** there is regular publication of extensive economic and financial data, including a detailed annual report on banking supervision and bank performance. These permit a comprehensive assessment of the pace and achievements of the reform program.

(iii) Multi-tranched financial sector adjustment operations are effective instruments to support major financial sector reforms.

1.89 The success of the **Guatemala** FSAL and the **Morocco** FSDPL shows that a multi-tranched adjustment operation can be very effective in cases of major financial sector reforms that involve the enactment of new basic legislation and its regulations, and the institutional strengthening of the agencies in charge of implementing the reforms, particularly agencies that carry out bank resolution. A multi-tranched adjustment operation can support the process of reform at different stages and respond to unforeseen challenges that could derail the reform process. By contrast, the stand-alone, single-tranched Banking Sector Development Policy Credit for **Pakistan** did not have a material impact on privatization of state-owned banks, which was concluded prior to this operation. The focus of the operation was on institutional building issues and further strengthening the State Bank of Pakistan, but sustained progress in such areas are difficult to achieve with a stand-alone, single-tranche operation, with no follow up and no associated technical assistance. Similarly to multi-tranched operations, programmatic loans are also potentially effective in supporting reform programs, but may require more focused efforts to obtain the best results from major reform processes. The slippages observed in the outcomes of the DPL-2 in **Egypt**, compared with the DPL-1, illustrate, although the two operations were not formally part of a programmatic series.

(iv) A strengthened regulatory framework and banking supervision enhance credit risk management and help withstand shocks but do not eliminate the risk of overextension of credit and deterioration of the quality of bank portfolios.

1.90 Reflecting tighter supervision and the adoption of improved risk management practices, but also other factors, such as the limited development of their financial markets, the commercial banks in all four countries that received Bank assistance did not suffer large losses from the global financial crisis because they did not hold toxic assets and did not rely on wholesale funds to support their lending. They did not suffer from either maturity or currency mismatching, while neither bank leverage nor credit expansion were excessively high. Tighter prudential rules and the adoption of improved risk management practices contributed to this favorable outcome.

1.91 **Pakistan** offers perhaps the best illustration of the effectiveness of these reforms, as the banking system was able to withstand the impact of the global financial crisis as well as the various bouts of domestic turbulence both political and due to the 2010 flooding. The banking sector in Pakistan has not had any major issues following the global financial crisis, partially because the banks in Pakistan did not have significant foreign exposures and also banks were not active in trading or investing in derivatives and other off balance sheet type instruments. NPLs have increased since 2007 but the banks are well provisioned against the potential loss and are actively involved in resolving these loans. In **Egypt** too, the banking system seems to have withstood the political turbulence in 2011 relatively unscathed so far.

1.92 But **Morocco** illustrates a case were the banks expanded at a very rapid pace their financing of housing, among other sectors, and faced the risk of growing NPLs in the future resulting from the abrupt fall of sales of housing units targeted to nonresident buyers.

Because the banks followed conservative lending policies and insisted on relatively low leverage levels by the property developers they financed, they were not, at least initially, impacted heavily from the collapse of housing sales. However, NPLs from property developers may increase in the future if the economic recovery in Europe is overly slow or if the sovereign debt crisis were to further intensify. The central bank took steps to ensure the resiliency of the banking system by raising the minimum CAR and the commercial banks responded by slowing down the rate of credit expansion, but these actions were taken somewhat late in the process.

1.93 In **Pakistan** too, the rapid expansion in consumer and SME credit in the period from 2000 to 2007 affected the quality of bank loan portfolios, partly owing to poor credit assessment standards and the absence of a credit bureau during this period. A credit bureau has been established recently and could help enhance the quality of consumer lending by improving the information available to lenders regarding the credit history of borrowers. Banks are well provisioned against NPLs but the absence of a satisfactory property registration mechanism creates uncertainty as to the ownership of property and thus the value of collateral held by banks.

1.94 The evidence reviewed by the PPAR in the four focus countries does not permit to draw insights on the desired sequence of reforms in the financial sector—a perennial quest of analysts and policymakers. Experience from the reviewed operations, as well as from other countries, suggests that reformers must implement change wherever they can and push for more extensive reforms as they go along. However, the one area where some progress is needed prior to the reform is in improving the regulatory framework—otherwise liberalization, deregulation, privatization and restructuring are likely to fail if no attempt is made to strengthen prudential regulation. Strengthening the prudential and regulatory framework is a major challenge and is bound to take time. Moreover, it cannot be done while the system continues to be state-owned, undercapitalized, under-provided, overstaffed, and generally improperly managed. Thus, as also suggested by the experience of the four focus countries of the PPAR, structural reform and regulatory strengthening can only be done in parallel and require the strong and lasting commitment of the authorities and a willingness to learn from experience and adapt as needed.

(v) Restructuring of state-owned banks without privatization requires strong safeguards to prevent retrogression into unsound practices.

1.95 In **Pakistan**, where financial and operational restructuring of state-owned banks was actively pursued with Bank support, transfer of bank ownership to the private sector was considered a key prerequisite for improved financial intermediation. The privatized banks were pushing ahead with institutional development plans to leverage their strengths and address their weaknesses and better position themselves as private sector banks. In **Morocco**, the restructuring and partial privatization of formerly specialized state-owned financial institutions was also implemented in a decisive and effective way.

1.96 In **Egypt** the reform program did not include the privatization of the two largest commercial banks nor the large insurance companies but many measures were taken to improve the management of these institutions, which one commentator resembled to an effective "privatization of management" rather than "privatization of ownership". The reform program has privatized the smallest of the four state-owned commercial banks and has divested public bank shares in joint-venture banks. However, state-owned institutions still control close to 50 percent of banking assets and a higher market share of insurance business.

1.97 A dogmatic approach to the ownership question would not be justified, especially after the public rescue of so many leading private banks and insurance companies in high-income countries around the world during the 2008 global financial crisis. However, as in far too many countries state-owned banks have extended loans on non-commercial criteria to borrowers with strong political connections and have suffered from large and persistent NPLs from both state-owned enterprises and large private sector borrowers, strong safeguards would be required to ensure that their operational and financial reform is viable. In **Egypt**, the safeguards that have been created to prevent retrogression into unsound practices do not appear to be sufficiently strong since bank lending to SOEs on a long-term basis and thin margins has been resumed. Despite the impressive scope of the overall reform program, the objective of creating a resilient and competitive financial sector appears to call for stronger safeguards.

(vi) Better access to credit for the private sector requires a broader set of reforms, including a favorable macroeconomic framework.

1.98 Bank financial restructuring, privatization, and strengthening of the prudential framework and supervision of banks can lay the groundwork for an increase in credit to the private sector on a sound basis but do not necessarily entail an increase in lending volumes in the short term. If anything, as a result of cleaning up the balance sheets of banks and writing down provisioned NPLs or NPLs settled by the government, the volume of outstanding bank credit to the private sector may decline. Depending on country circumstances, a broader array of reforms, especially in the legal area, may need to complement bank sector reform to help achieve a visible improvement of access to credit.

1.99 Key legal reforms include the establishment of an efficient bankruptcy legislation and insolvency regime; the establishment of a credit bureau to share borrower information; the creation of a modern collateral regime. However, these legal reforms are more difficult to implement and take longer to become effective. For example, it takes time to start a credit bureau up, get the data and get the banks to use it. But these reforms are important and should not be overlooked. And because they take time it is important that they be initiated early in the reform process. Other factors that may delay the impact of these legal reforms is that specific institutions may need to change the way they work in order to better serve potential clients. This again takes time, even when a distortion-free regulatory framework is in place—it takes, for example, time to set up a greater branch network to reach underserviced clients or to strengthen bank appraisal capabilities by assessing projects by cash flow. Bank restructuring and privatization contribute to these outcomes but their impact may not be strong enough if the legal reforms that facilitate access to credit are neglected.

1.100 In **Egypt,** the provision of credit to the private sector, and more especially to SMEs, continues to fall below relative to the needs for sustainable economic growth and employment creation. Partly as a result of writing down NPLs, partly reflecting tighter bank lending standards, and partly owing to the global financial crisis, and increased government borrowing from the banks as foreign holdings of bonds declined, the credit to the private sector in proportion to GDP declined from 54 percent in 2004 to 36 percent in 2009. Two fundamental shortcomings of the Egyptian legal framework that impede the rapid and sound expansion of credit facilities to SMEs include the absence of a modern bankruptcy law and insolvency regime; and the lack of an efficient registry of collateral security on movable assets. And while a credit bureau has been established, an attempt to develop an SME rating service did not succeed. These shortcomings were not addressed by the two Bank operations reviewed.

1.101 Another example is **Pakistan**, where growth in private sector credit has not reached the levels anticipated or desired. The Bank's operations were designed primarily to assist the privatization of the NCBs and to shift the structure of the market from one dominated by state-owned, loss-making, and inefficient banks to private, profitable, and well-managed banks. In addition the Bank' operations supported the strengthening of the Central bank and the removal of certain legal and structural distortions in the system. The reform should have facilitated increased lending to Pakistan's private sector and, indeed, banks expanded their lending portfolios post privatization in the years up to 2007. However, as a result of still weak risk management practices and economic shocks, they suffered some losses from NPLs, thus adopting more cautious lending approach.

1.102 In addition, a number of impediments stemming from the macroeconomic and fiscal situation have been present: (i) inflation rates have been running in excess of 20 percent, resulting in very high interest rates; (ii) state borrowing from the banking system including T-Bills amounts to about 34 percent of bank assets, in effect beginning to crowd out the private sector; (iii) banks are in a position to generate very attractive margins from investing in T-Bills, with little incentive to pursue lending to the SME sector and consumers which is much more risky and carries a much higher administrative cost. Maintaining macroeconomic stability appears a necessary complement to bank sector reform in order to achieve viable growth in private sector access to credit. Similar trends have developed in Egypt, where bank lending to the private sector is being crowded out by growing bank holdings of government securities, as the budget deficit has steadily increased and foreign investor demand for government bonds has decreased since the onset of the global financial crisis.

Annex A. Egypt Financial Sector Development Policy Loan I (No. IBRD No. 73910) & II (No. 75280)

Summary

1. This Project Performance Assessment Report (PPAR) covers two financial sector Development Policy Loans (DPLs) to Egypt that were respectively approved in June 2006 and May 2008. A third financial sector DPL was approved in May 2010. The DPLs supported a multi-year reform program with a very broad scope. The Financial Sector Development Policy Loans I and II were single-tranche loans of US$ 500 million each. They supported the government's financial sector reform program, the basic objective of which was to build a more competitive financial sector, with a sound banking system and insurance industry, able in the medium-term to provide modern and efficient financial services. Because the two operations supported a long-term reform program that is implemented gradually over a number of years, the DPLs contained several overlapping policy areas. The two operations are reviewed separately below but lessons learned are presented synthetically for both at the end of the review of DPL II.

2. In addition to the two DPLs that are reviewed in this PPAR, the Bank supported the July 2006 Mortgage Finance Project, which aimed at establishing a mortgage finance liquidity facility, strengthening the regulatory framework for mortgage lending, and modernizing the registration of property rights. The Financial Sector DPL III that was approved in June 2010 was perceived as a precautionary response to alleviate the budgetary impact of the global financial crisis. Its main focus was a promotion of financial inclusion and broadening of access to financial services by households and small- and medium-sized enterprises (SMEs), but it also furthered some objectives that were already covered in DPLs I and II. DPL III was prepared in a relatively short time, which perhaps explains its failure to address two fundamental shortcomings of the Egyptian legal framework that impede the rapid and sound expansion of credit facilities to SMEs: the absence of a modern bankruptcy law and insolvency regime; and the lack of an efficient registry of collateral security on movable assets. Other recent financial sector loan operations included the August 2009 Affordable Mortgage Finance Program DPL (US$ 300 million), which focused on replacing the current system of inefficient and poorly targeted supply-side housing subsidies with a transparent and economically efficient demand-side subsidy system and the February 2010 Enhancing Access to Finance for Micro and Small Enterprises Project (US$ 300 million), which aimed at expanding access to financial services by micro and small enterprises.

First Financial Sector Development Policy Loan

Principal Ratings

	*ICR**	*ICR Review**	*PPAR*
Egypt First Financial Sector Development Policy Loan (*No. IBRD No. 73910*)			
Outcome	Satisfactory	Satisfactory	Satisfactory
Risk to Development Outcome	Negligible to low	Negligible to low	Moderate
Bank Performance	Satisfactory	Satisfactory	Moderately Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory

* The Implementation Completion and Results Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (OED) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
First Financial Sector Development Policy Loan (*No. IBRD No. 73910*)			
Appraisal	Samir El Daher	Hossein Razavi	Emmanuel Mbi
Completion	Sahar Nasr	Zoubida Allaoua	Emmanuel Mbi

1. Background and Context

3. In the early 1990s Egypt embarked on a comprehensive adjustment program to reverse the inward-looking and public-sector-led development strategy of the preceding four decades. Supported by an IMF Stand-By Arrangement, a World Bank Structural Adjustment Loan, and especially a 50 percent debt\debt service reduction (DDSR) granted by Paris Club creditors and other bilateral donors, the program sought to address the serious economic problems and structural imbalances that had accumulated over time. The program liberalized prices and interest rates, lowered subsidies, unified the foreign exchange market, and removed several major barriers to trade and private sector investment.

4. The program succeeded in stimulating growth while reducing both the fiscal and balance of payments deficits and lowering inflation and nominal interest rates. However, a commitment to privatize two of the four state-owned banks and sell the public bank shares in joint-venture banks was not realized. While there was some improvement in the prudential regulation of banks, covering solvency margins, loan classification and provisioning, this did not go very far and the state-owned banks re-accumulated large non-performing loans (NPLs).

5. The financial sector continued to face important challenges given low levels of competition, relatively high intermediation costs, limited innovation, and dominance of state ownership. The banking system was burdened by high levels of non-performing loans, while the non-bank segment was characterized by underdeveloped bond, insurance, and mortgage markets, thin trading in equities, weak corporate governance, and weak infrastructure for effective payment and credit information systems.

6. The 2002 Financial Sector Assessment Program (FSAP) acknowledged the strengthening of prudential regulation and supervision of banks that took place in the 1990s but also noted that the problematic loans of the state-owned banks were significantly under-reported. Despite the large increases in provisions, the level of provisioning was far from

adequate, depended on the reported profits of the banks, and did not take into account the deteriorating prospects of rescheduled loans. The FSAP report identified the main weaknesses in the banking and non-banking segments of the financial system and highlighted the key priorities for reform. Policy recommendations included a significant increase in the presence of private institutions, the financial and operational restructuring of the state-owned banks, the strengthening of the intervention and remedial powers of financial regulators, and major improvements in financial infrastructure, including payment systems, credit information and debt recovery. These recommendations were endorsed by the authorities. The reformist government that was appointed in 2004 undertook an extensive reform of the financial sector.

7. The 2007 FSAP Update noted the significant progress that had already been made in reforming the banking sector (privatization of a major state-owned bank, exit through merger or takeover of several weak banks, and the financial and operational restructuring of the large state-owned commercial banks). It also underscored the major effort that had been undertaken in strengthening banking regulation and supervision, promoting the development of the non-bank segment of the financial system, and modernizing the financial infrastructure. However, the 2007 FSAP Update also highlighted the continuing weaknesses in the legal framework for credit operations, especially the antiquated insolvency regime and the poor registration and enforcement of collateral security.

8. Wide-ranging structural reforms were implemented over the period 2004-2008. In addition to the restructuring of the financial sector, these included trade liberalization, an overhaul of the tax system, and an ambitious privatization program. Responding to the structural reforms the Egyptian economy experienced rapid growth over this period. However, the banking sector played a limited role in financing the growth acceleration since the level of bank lending to the private sector declined during this period. Growth was mainly financed from retained earnings and foreign direct investment.

9. The growth acceleration was achieved without a large rise in the overall investment ratio, implying greater efficiency in the utilization of economic resources. The greater efficiency may be explained by the privatization drive and the greater presence of foreign direct investment (FDI). It may also reflect a catching up in growth performance from the preceding period of low growth from 1998 to 2004. The Egyptian economy had experienced high growth in the years before the 1997 Asian crisis and also in the early 1980s but these were followed by prolonged periods of low growth. No detailed studies of economic efficiency have been undertaken so far.

10. The Bank has a long engagement in the financial sector of Egypt. The critical contributions of the joint IMF/Bank 2002 FSAP report and the 2007 FSAP Update have already been noted. The Bank also supported through the FIRST Initiative (www.firstinitiative.org) several technical assistance projects on banking supervision, credit information, and payment systems. Several other reports, including the 2005 and 2006 Investment Climate Assessments, the 2007 report on *Access to Finance*, the fee-based Technical Assistance on Governance, Anti-Corruption, and Regulatory Reforms, the State-Owned Enterprise (SOE) Corporate Governance Study, and the Accounting and Auditing Report on the Observance of Standards and Codes (ROSC) Update, provided analytical content to the reform program.

2. Objectives and Design

11. The Financial Sector Development Policy Loan I supported the first phase of the government's financial sector reform program, the development objective of which was **"to build a more competitive financial sector, with a sound banking system and insurance industry, able in the medium-term to provide modern and efficient financial services"** (Loan and Program Summary). The operation supported a long-term reform program, which was to be implemented gradually over a number of years, spanning three phases, from 2006 to 2009 (according to the DPL's Operational Policy Matrix). Several of the DPL's policy areas were thus supported by measures to be implemented over this longer time period, which were expected to be included in the components of the operations to follow, DPL II and III. Based on the Operational Policy Matrix, the policy areas of DPL I can be grouped as follows:

i. Strengthening the legal, regulatory and supervisory framework in banking and insurance
ii. Institutional and operational restructuring of state-owned banks
iii. Financial restructuring of state-owned banks
iv. Reducing public sector ownership and control over banking sector institutions
v. Restructuring and privatizing state-owned insurance companies
vi. Strengthening the fiduciary framework for public financial management and corporate financial reporting

3. Relevance of Objectives and Design

12. **Relevance of Objectives.** Strengthening the capacity of the financial system to facilitate private sector development was one of the main strategic objectives of the Bank's Country Partnership Strategy (CPS) for 2006-09 with Egypt—alongside the objectives of improving the provision of public services and promoting equity. The Bank's engagement in the financial sector has supported operations that have aimed to reduce the extent of state ownership in finance and create a regulatory and supervisory framework that would promote the development of a stable and sound financial sector. The operation was therefore highly relevant to promoting the attainment of the CPS strategic objective and addressing the challenges facing the Egyptian financial system. Relevance of objectives is rated *high*.

13. **Relevance of Design.** The operation was designed around policy areas *substantially relevant* for the achievement of its overall development objective. However, the relevance of design of the operation was hampered by other factors: The design of the operation as a stand-alone single-tranche loan reflected the desire to link disbursement to measures adopted prior to Board presentation and to use subsequent loans to support additional measures that would deepen and solidify the reform program. The Operational Policy Matrix included policy reform milestones for the transition to follow up operations in the period through 2009. DPL I took into account the gradual expansion of the reform program and the implementation constraints that impeded the adoption of more ambitious goals in the first phase of the government's reform program. However, in view of the several implementation risks (see see section on Bank performance—Quality at entry), the design of DPL I as a stand-alone single-tranche operation fell short of offering enough assurance that focused effort would be consistently applied to difficult areas of a major reform agenda.

14. Despite these deficiencies, overall, because the building blocks of the operation were relevant for the achievement of its development objectives, the relevance of design of DPL I is rated *substantial*.

4. Implementation

15. The outputs from implementation of the six policy areas overall contributed to **substantial** achievement of the operation's development objective of building a more competitive financial sector, with a sound banking system and insurance industry, able in the medium term to provide modern and efficient financial services.

Policy Areas

Strengthening the legal, regulatory and supervisory framework in banking and insurance.

16. The main emphasis was placed on strengthening the legal, regulatory and supervisory framework of banking, although over time the regulatory and supervisory challenges confronting the nonbank financial institutions and markets, especially the insurance sector and securities markets, were also addressed. The legal framework for banking was considerably strengthened by the enactment of the 'Central Bank, Banking and Credit Law' (Law 88 of 2003), which *inter alia* sought to bolster the independence of the central bank and sharpen prudential regulation and supervision.

17. The Central Bank of Egypt (CBE) embarked on a comprehensive multi-year program of capacity building, covering extended areas of its regulatory and supervisory functions with a view to eventually moving from the traditional compliance-based approach to a modern risk-based supervision. This program was supported by Euorpean Union (EU) funding and technical assistance from the European Central Bank, through several national central banks of member countries. The program included an early diagnostic assessment of the banking supervision function at the CBE and the preparation of a detailed plan of action for capacity building.

18. Based on this capacity-building program, the CBE proceeded to an organizational restructuring of banking supervision, the creation of new capabilities in such areas as monitoring macro prudential risks, legal and regulation oversight, and information technology (IT) support, improving credit risk management in banks, and especially the state-owned banks, strengthening corporate governance and internal control systems, developing an early warning system based on stress testing analysis, and adopting a framework for prompt corrective action in problem banks. Two new units—macro-prudential and regulations—were established, focusing mainly on financial stability, to address any systemic risks facing the banking sector. Implementation of the program has been continuing with support from DPL II (see below). However, no comprehensive report documenting in sufficient detail the changes that have taken place and evaluating their impact on bank solvency and efficiency has been prepared. (If such a report exists, it has not been provided to the IEG team.)

19. Efforts supported by DPL I were initially focused on strengthening the Egyptian Insurance Supervisory Authority (EISA), which faced substantial challenges in moving from a

compliance-based approach of a largely state owned sector to risk-based supervision in a competitive market environment. A supervisory development plan was implemented with the support of technical assistance from resident advisors that were funded by USAID. The broader development of the actuarial profession was also initiated. Main emphasis was placed on improving the underwriting and reserving of motor third-party liability (MTPL) and the calculation of reserves for life insurance and pension funds. These efforts continued with support from DPL II (see below).

Institutional and operational restructuring of state-owned banks

20. Comprehensive 4-year plans for the financial, institutional and operational restructuring of the two state-owned commercial banks (National Bank of Egypt and Banque Misr) were adopted. The plans covered all aspects of their activities and aimed at a radical revamping of their operations to enable them to compete on a level playing field with private sector banks. The plans focused in particular on improving financial risk management, the better deployment of human resources, and the development of management information systems and information technology. The plans were supervised by the Banking Reform Unit of the CBE and were supported with technical assistance provided by two European banks financed from EU sources.

21. The operational restructuring of state-owned banks entailed a major upgrading of the management of financial and operational risks, human resources, and automation systems. The banks were advised by international consultants funded by EU financial support. There is ample anecdotal, and in some cases written, evidence that significant progress has been made by both banks, but as in the case of banking supervision by the CBE, no comprehensive report appears to have been prepared by either of the two state-owned banks, the CBE Bank Reform Unit, or the EU and Bank teams. If such a report exists, it has not been provided to the IEG team. Some aspects of the technical restructuring of the state-owned banks are well documented in their annual reports. The NBE reports highlight both the adoption of management information systems, the gradual expansion of automation and the linkage of a growing proportion of its branch network to modern on-line systems.

Financial restructuring of state-owned banks

22. The financial restructuring of the state-owned banks entailed the resolution of their large volume of NPLs with both state-owned enterprises (SOEs) and private sector borrowers. The volume of SOE NPLs of the two state-owned banks (National Bank of Egypt and Banque Misr/Banque du Caire) amounted to EGP 26 billion. The independent audits of the two state-owned banks that were conducted over the period 2004-2006 estimated the total volume of NPLs in FY 2005 at EGP 73 billion, representing 23 percent of their total loans and 12 percent of GDP. This implied that private sector NPLs amounted to EGP 47 billion. The fiscal cost of restructuring the loan portfolios of state-owned banks was estimated at EGP 50 billion.

23. For the settlement of SOE NPLs, the initial government proposal in the 2004 reform program was for the issuance and swapping of 20-year floating rate bonds, cross guaranteed by the state-owned holding companies. However, the Bank team pointed out that international experience with similar swaps was not positive and the authorities agreed to settle the NPLs in

cash. Sixty percent of the SOE NPLs were settled by the end of June 2008 with the proceeds from the privatization of the Bank of Alexandria and other state-owned enterprises and the divestiture of shares in joint-venture banks (see also DPL II below).

24. The settlement of private sector NPLs proved more challenging. First, the volume of these NPLs was double the SOE NPLs. Second, the settlement often appeared to involve considerable rescheduling rather than cash collections through debt repayment or the realization of collateral security. At the time of DPL I appraisal it was estimated that already before June 2006, 46 percent of private sector NPLs had been settled, involving just 12 percent in cash collections (World Bank 2006, para 72). Later, the proportion of settled private sector NPLs from January 2004 to December 2007 was raised to 80 percent with cash collections of 30 percent (World Bank 2008a, para 68). The CBE established a unit that monitors the performance of state-owned banks against agreed-upon quantitative and qualitative targets. Their performance is being monitored against private sector banks, with the aim of ensuring that there is no relapse and that performance gradually is on par with private sector competitors.

Reducing public sector ownership and control over banking sector institutions

25. Before the 2004-2008 financial reform program, state owned or controlled banks accounted for 80 percent of banking assets (58 percent by the four state-owned banks and 22 percent by the 23 joint-venture banks, in which state-owned financial institutions held majority stakes). The joint venture banks, with assets ranging from less than one to over four percent of banking system assets, were registered under the provisions of 'Law 43 of 1974', which allowed financial and non-financial institutions to operate as private sector entities, irrespective of the share of public ownership. Public sector shares in these joint-venture banks were held by public sector financial institutions, mainly banks (with shares in 17 of the largest entities), but also insurance companies, and the National Investment Bank. The 17 joint venture banks, in which state-owned banks were shareholders, accounted in aggregate for 20 percent of total banking assets. This structure of ownership was at the root of governance and conflict of interest issues that effectively resulted in market segmentation and weak competition. Full divestiture of state-owned bank shareholdings in joint-venture banks achieved a significant expansion of the private sector presence in the banking system.

26. The privatization of the Bank of Alexandria followed a competitive bidding process subject to due diligence. The bank's assets had been cleaned from all NPLs. Eighty percent of the capital of the bank was sold to the Italian Intesa San Paolo IMI bank, which submitted the highest bid valuing the bank at US$ 2 billion. The transfer of ownership was completed in December 2006. However, the 15 percent Initial Public Offering for Bank of Alexandria has not been completed because of adverse market conditions.

Restructuring and privatizing state-owned insurance companies

27. With support from DPL I specialist consultants were appointed, with detailed terms of reference, to advise on the corporate and operational restructuring of state-owned insurance companies (first phase) and the eventual privatization of three of the four companies (second phase). The consultants prepared due diligence reports on the assets and liabilities of the four

companies and a detailed plan, including financial and operational restructuring, for optimizing their privatization prospects. Recommendations were formulated on strengthening the management of the state-owned insurance companies, cleaning their balance sheets, updating the valuation of their remaining assets and technical liabilities, and preparing the ground for the introduction of private sector shareholders. Based on this due diligence, further actions were taken with support from DPL II (see below).

Strengthening the fiduciary framework for public financial management and corporate financial reporting

28. The 2003 Country Financial Accountability Assessment (CFAA) concluded that the Egyptian Public Financial Management system constituted a significant fiduciary risk due to the perceived weaknesses in public sector accounting and reporting standards and oversight functions whether through internal audit, external audit, or the Parliament. DPL I provided for an action plan to enhance transparency and compliance with accepted standards of public financial management, including the budget process, control over revenues, consolidated government accounts, cash management, and internal audit.

29. A 2007 CFAA Update noted some significant improvements in transparency, budget consolidation of quasi-fiscal payments and consolidation of many special revenue accounts of ministries, departments and agencies. The Ministry of Finance was continuing its work to establish a well-trained macro-fiscal unit to prepare a multi-year fiscal and expenditure framework to guide future budget preparation activities and issued a policy forbidding state guarantees for state enterprises. Further measures in PFM, to operationalize the action plan adopted supported by the first DPL, were not included in subsequent financial sector DPLs.

30. Progress in PFM has been assessed by the Public Expenditure and Financial Accountability (PEFA) exercise, conducted in 2009, led by the EU Commission and with participation of the World Bank and Egypt's other development partners. Several PEFA scores remained poor, including for effectiveness of internal controls on payrolls and non-salary expenditures; effectiveness of internal audit; and unreported government operations, although these were targeted areas for improvement in DPL I and the action plan that was supported by this operation. The 2010 World Bank regional report on PFM Reforms in the Middle East and North Africa region highlighted some steps taken in improving PFM systems in Egypt, especially in tax and customs administrations, but also noted the uneven pace of these reforms and the remaining weaknesses in several other areas. Internal audit is one of these lagging areas, although according to plans set out in DPL I, a fully operational internal audit function was expected in all revenue and expenditure units by 2009.

31. The quality of corporate financial reporting was improved by initiatives to align CFR requirements to international standards and to close the "compliance gap" in both accounting and auditing practices. Further advances in CFR were included in the program of reforms adopted by EFSA.

Outcomes

32. The basic achievements of DPL I were a much stronger framework for financial sector regulation and supervision and a substantially reformed banking sector. Substantial contributions to these achievements were made by the reforms undertaken under policy areas (i)-(iv). A key factor was the capacity building program of banking supervision by the CBE, while the banking sector was reformed through a major consolidation drive, a significant increase in the presence of private banks, and the financial and operational restructuring of state-owned banks. As a result of state divestiture from the banking system, the share of state-owned banks in total bank assets fell from 60 percent in 2006 to 49 percent in 2009. Consolidation of the banking system drove the number of banks from 57 in 2004 to 39 in 2008. The settlement in cash of a large fraction (60 percent) of long-standing NPLs from SOEs was an important achievement. The resolution of private sector NPLs involved relatively small cash collections, leaving open the question of possible extensive rescheduling of NPLs. As a result of these actions, NPLs were reduced in 2009 to 13.4 percent of total gross loans of commercial banks, from 26.5 percent in 2005. Moreover, NPLs were fully provisioned in 2009, while in 2005 provisioning stood at merely 51 percent. In parallel, the capital adequacy ratio of commercial banks had increased from 13.7 percent of risk-weighted assets in 2005 to 15.1 percent in 2009. In parallel, DPL I set the stage for the long-term development of NBFIs by initiating the process for the restructuring of state-owned insurance companies and the adoption or preparation of a multitude of measures to strengthen the regulation and supervision of NBFIs and the securities markets.

5. Ratings

PROJECT OUTCOME

33. Achievements under the operation's policy areas contributed substantially to the overall development outcome sought by the operation of building a more competitive financial sector, with a sound banking system and insurance industry, able in the medium term to provide modern and efficient financial services. This contribution was, however, more tangible in the banking sector than in the insurance industry, as reforms in this sector take longer to bear fruit. Overall, the achievement of the operation's development objectives (efficacy) is rated by this review as ***substantial***. The relevance of objectives of DPL I was rated by the PPAR ***high***, while the relevance of design was also rated ***substantial*** despite some minor shortcomings noted. Based on these ratings for efficacy and for relevance of objectives and design, this review rates the Overall Outcome as ***Satisfactory***. .

RISK TO DEVELOPMENT OUTCOME

34. The risk to development outcome is considered **Moderate**. The authorities viewed the promotion of a resilient and competitive financial sector as a central part of their policy priorities. They adopted a multi-year program of structural reforms that was effectively implemented and they took many steps to prepare the ground for the adoption of risk-based supervision and solvency rules in both banking and insurance. However, as also noted for the follow on operation DPL II (see below), the low level of credit to the private sector, the failure to introduce a modern insolvency regime and create an efficient registry of collateral security

on movable assets, which would have supported increased sound lending to SMEs, and the absence of sufficiently strong safeguards against retrogression by the state-owned institutions in their lending to state-owned entities, suggest a moderate risk to the development outcome and the long-term sustainability of the reform effort. Uncertainties surrounding the post-January 25 Revolution direction of economic policy, including the disruption of the regulatory reform of the financial sector, as well as challenges posed by the growing pressure on the fiscal position and the cost of borrowing, corroborate an upward revision to the risk to the Development Outcome at the time of this evaluation.

MONITORING AND EVALUATION

35. **Design.** Some of the monitoring indicators were outputs (actions) of the operation as opposed to outcomes related to the achievement of the operation's policy areas. These included enactment of specified laws or their submission to Parliament, adoption of specified plans (such as a plan for the settlement of SOE NPLs in state-owned banks or a plan for reforming the regulatory framework of MTPL insurance), completion of specific actions (such as the privatization of Bank of Alexandria, the divestiture of state-owned-bank shares in joint venture banks, and the completion of the independent audits of four state-owned commercial banks). Other indicators were closer to measurable outcomes (such as the consolidation of the banking system into a specified number of banks, the reduction of the market share of state-owned banks below a specified level, the settlement of a specified percentage of SOE NPLs, and improved provisioning levels by state-owned commercial banks).

36. **Implementation and Utilization.** The operation also included several multi-year reform efforts, such as the revamping of banking and insurance supervision and the restructuring of state-owned banks and insurance companies. Monitoring the success of these initiatives required a thorough evaluation of their progress and effectiveness and were not amenable to the use of simple monitoring indicators. The division of labor among donors was well coordinated at the preparation stage of the operation but the monitoring of outcomes and the preparation of qualitative reports evaluating the effectiveness and impact of these multi-year efforts was not well organized. As a result, the monitoring and reporting on these very important ingredients of the reform program was not satisfactory—a finding also relevant for DPL II (see below). Based on these considerations, the quality of M&E framework is rated ***modest***.

BANK PERFORMANCE

37. **Quality at entry.** The involvement of the Bank built on the policy dialogue that had been conducted with the authorities over a long time and particularly in the context of the 2002 FSAP report and related analytical work. The authorities valued the Bank's experience in designing development policy loans in the financial sector and its willingness to remain engaged over the longer run. Special weight was placed on the Bank's role in coordinating in a concerted and effective way the offers of technical and financial assistance of bilateral and multilateral donors. The division of labor among donors aimed at maximizing the financial and technical benefits for Egypt, although it also created a challenging task in project monitoring and supervision (see below).

38. Implementation risks and mitigating mechanisms were extensively discussed. The project document noted the risk of retrogression into unsound lending practices that is inherent when state-owned financial institutions undergo financial and operational restructuring without a commitment to their subsequent privatization. To prevent the recurrence of NPLs to SOEs, emphasis was placed on close monitoring and scrutiny of future relationships of public sector banks with SOEs - especially those responsible for the large nonperforming loans - to 'ensure that lending transactions are conducted on an arm's length basis along exacting credit standards applicable equally to all prospective private or public borrowers' (para 71 of World Bank 2006). However, no indicators were included in the policy matrix to gauge actual NPLs to SOEs. The expected outcomes in the matrix referred to the NPLs to SOEs outstanding in state-owned banks as of end of FY04. Recurrence of NPLs to SOEs after 2005 would have not been captured by this indicator.

39. The Bank team reviewed the performance of SOE loans in the preceding four years and ascertained that no new financing had been extended to defaulting SOEs. This review was conducted before the appraisal of DPL I. The project document discussed the fiscal risk posed by the large outlay needed to cover the NPLs of SOEs. It was noted that the proceeds from the privatization of various entities, including the Bank of Alexandria, would cover most of the cost and it was unlikely that new borrowing on the bond market would be required. In the event, privatization proceeds were not adequate, suggesting that a more conservative approach on the earmarking of privatization proceeds would have been appropriate due to the considerable uncertainty surrounding privatization transactions.

40. A more important risk was linked to the political and social feasibility of the reform program. Ownership of the program and commitment to its implementation by the authorities was a crucial factor for its success. The project document mentioned various measures that were taken to mitigate opposition to the reforms, such as the voluntary early retirement schemes to alleviate the burden of redundancies and the allocation of bank shares to employees to generate support for privatization. However, the importance of transparency and public accountability, offering a clear explanation of the benefits and costs of the reforms, was not sufficiently emphasized. Public reports needed to underscore the long-term costs of NPLs and the measures that were taken to prevent their recurrence.

41. The structure of the operation and its specific objectives were well designed and were congruent with the CPS development objectives. The Bank also performed an effective coordinating role in the division of labor among participating donors during the preparation of the loans. Quality at entry is rated ***satisfactory*.**

42. **Quality of supervision.** The main shortcoming of Bank performance at the implementation stage was its failure to coordinate effectively with other involved development partners for the supervision of the loans, monitoring the performance of multi-year programs, and operating as a clearing house for all supervision reports. No data have been collected by the Bank on loans to subsidized SOEs—a shortcoming in implementation support, especially in view of the continuing engagement of the Bank in the sector. Quality of supervision is rated *moderately satisfactory*. Based on these ratings, overall Bank performance is rated ***moderately satisfactory***.

BANK PERFORMANCE

43. The Borrower's performance is rated ***satisfactory***. This reflects the strong commitment of the authorities to a multi-year and extensive reform program. Most of the 2002 FSAP recommendations were accepted by the authorities and were incorporated in the design. Considerable progress has been made in all areas of the reform programs. However, as for DPL II (see below), the reform effort is clouded by the absence of comprehensive reports on the impact of both the capacity building program in banking supervision and the restructuring plans of state-owned commercial banks as well as the lack of strong safeguards against retrogression in the lending practices of state-owned banks.

Second Financial Sector Development Policy Loan

Principal Ratings

	*ICR**	*ICR Review**	*PPAR*
Egypt Second Financial Sector Development Policy Loan *(No. 75280)*			
Outcome	Moderately Satisfactory	Satisfactory	Moderately Satisfactory
Risk to Development Outcome	Negligible to low	Negligible to low	Moderate
Bank Performance	Satisfactory	Satisfactory	Moderately Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory

* The Implementation Completion and Results Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (OED) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Second Financial Sector Development Policy Loan *(No. 75280)*			
Appraisal	Sahar Nasr	Ritva S. Reinikka	Emmanuel Mbi
Completion	Sahar Nasr	Ritva S. Reinikka	A. David Craig

1. Background

44. DPL II was approved in May 2008, a few months prior to the onset of the global financial crisis. The Egyptian banking sector was not directly impacted by the global financial crisis. The banking sector did not have any exposure to toxic assets and did not suffer any withdrawals of deposits. Public anxiety from the global crisis was connected to the deteriorating growth and employment prospects rather than to concerns about bank soundness. In contrast, the securities markets, both the government debt market and the stock market, experienced a sharp deterioration as a result of the sudden large outflows of foreign portfolio investment.

45. The real sector of the economy suffered from a slowing aggregate external demand and the retrenchment of foreign direct, and especially foreign portfolio, investment. In response to the global crisis, the authorities adopted fiscal and monetary stimulus measures and postponed some key fiscal reforms. These measures accelerated infrastructure investment projects, increased export subsidies, and lowered import tariffs on intermediate and capital

goods, while the central bank eased monetary policy by lowering interest rates and waiving the 14 percent reserve requirement on deposits that fund commercial bank loans to SMEs.

46. The impact of the global crisis on Egyptian growth was not as large as originally feared. Prior to the political uprising, growth was expected to exceed 5 percent in FY 2011 and capital inflows, foreign exchange reserves and the exchange rate had resumed their pre-crisis levels. However, the January 25 Revolution is likely to have a negative impact on economic growth, which is estimated at 1 percent in 2011, down from 5.1 percent in 2010. Even before the political uprising, the authorities faced the challenge of managing a large fiscal deficit and a sizeable public debt stock in an uncertain global environment and with a still-underdeveloped domestic capital market. Additional challenges included attaining lower and stable inflation, promoting enterprise finance, and developing long-term savings instruments. Now, after the political uprising, dealing with its economic and financial impact will dominate short-term economic policy considerations, with the fiscal deficit estimated to have increased to 9.7 percent of GDP in 2011, from 8.1 percent in 2010 and 6.9 percent in 2009.

2. Objectives and Design

47. The Financial Sector Development Policy Loan II supported the second phase of the government's financial sector reform program, the development objective of which was **"to build a more competitive financial system, with sound banking and non-banking institutions, led by the private sector, and able in the medium term to provide efficient financial services"** (Loan and Program Summary). The operation's policy areas were to a large extent designed as a continuation of the reforms supported by the preceding operation, DPL I, with emphasis shifting relatively more to non-bank financial institutions and the capital markets. Based on the Operational Policy Matrix, the policy areas of DPL II can be grouped as follows:

i. Reduction of public ownership and control of banks and consolidation of the banking sector

ii. Financial and operational restructuring of remaining commercial state-owned banks and specialized state-owned banks

iii. Strengthening the regulatory and supervisory framework in the banking sector

iv. Restructuring of state-owned insurance companies

v. Strengthening the regulatory and supervisory framework in insurance and pensions

vi. Improving the efficiency of capital markets

vii. Strengthening the financial sector institutional infrastructure

3. Relevance of objectives and design

48. **Relevance of Objectives.** The objectives of DPL II were similar to those of DPL I in supporting the second phase of the government's financial sector reform agenda and remained closely aligned to the strategic objectives of the Bank's CPS with Egypt. The operation was therefore highly relevant to promoting the attainment of the CPS strategic objective and addressing the challenges facing the Egyptian financial system. Relevance of objectives is rated ***high***.

49. **Relevance of Design.** DPL II continued to support reforms in areas substantially relevant for the achievement of its development objective. In particular, support to the reduction of state-owned bank NPLs to SOEs continued, although with shortcomings noted below (see next section on achievement of objectives). Support to the DPL I policy area of strengthening the fiduciary framework for public financial management and corporate financial reporting was discontinued in DPL II, despite the significant remaining agenda in this area. Similarly to DPL I, the importance of transparency and public accountability was not sufficiently emphasized by DPL II. Public reports needed to underscore the long-term costs of NPLs and the measures that were taken to prevent their recurrence.

50. Another limitation in the relevance of design of DPL II was its failure to address two fundamental shortcomings of the Egyptian legal framework that impede the rapid and sound expansion of credit facilities to SMEs, although the provision of efficient financial services was a key part of the operation's development objective. These are: (i) the absence of a modern bankruptcy law and insolvency regime; and (ii) the lack of an efficient registry of collateral security on movable assets. These issues were also neglected by the follow up operation DPL III. Draft laws to rectify both of these shortcomings are apparently held up at the Ministry of Justice. The Bank adopted the view that for these important legal reforms to be effective, comprehensive judicial reform would be required for their enforcement. These reforms were thus considered beyond the scope of this operation, and also beyond the scope of the financial sector as a whole, and they were not addressed.

51. Reflecting these considerations, overall, the relevance of design of DPL II is rated ***modest***.

4. Achievement of Objectives (Efficacy)

Policy Areas

Reduction of public ownership and control of banks and consolidation of the banking sector.

52. Efforts to reduce public ownership and control of banks, initiated with support from DPL I, were continued under DPL II. The intention to privatize Banque du Caire through the sale of 67 percent of its capital to a strategic investor was announced by the government in July 2007. The bank's balance sheet was cleaned by the transfer of its NPLs to Banque Misr. An advisor was appointed in October 2007 and three bids were received in May 2008. However, because of the global financial crisis, the offered price was much lower than

expected and the transaction was not completed. Banque du Caire remains a subsidiary of Banque Misr, managed separately by an independent executive management and board of directors. Its management indicated to the IEG mission that a full merger of the two banks was still an option.

53. The overwhelming state presence in the banking sector was reduced by the divestiture of the state-owned bank shares in 13 joint-venture banks representing 94 percent of their total assets and the privatization of Bank of Alexandria, the smallest of the four state-owned banks, with a 7 percent market share. As a result, the share of state-owned and controlled banks declined from 80 to 53 percent in 2006. Subsequent market developments lowered the share of public sector banks to 47 percent.

54. In parallel with privatization, the consolidation of the banking sector by removing small and weak banks aimed at increasing its robustness and stimulating sound competition. This objective was achieved by raising the minimum capital of banks to EGP 500 million (nearly USD 100 million) and encouraging the merger of small and weak banks or their absorption by stronger institutions. The number of banks fell from 57 in 2004 to 43 in June 2006 at the time of effectiveness of DPL I and 39 in June 2008. Three small banks were merged into a bank that is owned by the CBE. No explanation was provided on the reasons for this unusual solution and the future plans for this bank are not clear at this stage. The increased capital base of banks and the absorption of small and weak banks have increased the solidity of the banking sector and created better conditions for intense but sound competition.

Financial and operational restructuring of remaining commercial state-owned banks and specialized state-owned banks.

55. Only 60 percent of state-owned bank NPLs to SOEs were settled by the Government by June 2008, when DPL II was initiated (see review of DPL I above). The remaining 40 percent was not settled in cash before the closing date of DPL II but was resolved two years later, in June 2010, with a land-for-debt swap. This departed from the original commitment and created both opportunities and challenges for the management of state-owned banks. The opportunities arose from the prospects of significant long-term appreciation of land values, while the challenges stemmed from the need to create specialized subsidiaries that are able to engage efficiently and profitably in property management. In addition, ownership of land holdings with long-term appreciation prospects implied limited contribution to current earnings with negative effects on the current profitability of banks.

56. The settlement of SOE NPLs was a positive development in cleaning up the balance sheets of the state-owned banks. However, the risk of potential recurrence in the future was noted in the project documents for both DPL I and II. In this regard, sufficiently strong safeguards appear to have been put in place to prevent the accumulation of new bad loans to SOEs by the state banks. Some safeguards have been introduced as part of the Government's reform program, although these measures were not included in the DPLs: For example, the Ministry of Finance issued a policy forbidding state guarantees for state enterprises, which in effect, put them on a more level playing field with other enterprises and eliminated the directed lending that was largely responsible for the non-performing loans of state-owned enterprises held by state-owned commercial banks. The Bank's review of bank loans to SOEs

indicated that over the four years leading up to DPL II, state-owned banks hardly extended any new financing to defaulting SOEs. According to IMF International Financial Statistics data, lending to state owned enterprises is still a minor fraction of the portfolio of banks. According to the authorities, loans to SOEs are being granted on full assessment of borrower and project viability with full-fledged analysis of cash flow repayment capacity with pricing at market norms. However, based on the findings of the IEG mission, state-owned banks continue to provide loans to SOEs at very long maturities and fixed rates, with small margins compared to the cost of their resources (for, example, long-term loans of the NBE to the Electricity Company). Profitable SOEs obtain financial services from competing private banks since they represent attractive risks but SOEs that depend on public subsidies for their commercial viability may not have this option, especially at times when the budget may come under strong pressure. Project documents emphasized the importance of transparency and close monitoring but neither was in evidence at the time of the IEG mission.

57. Regarding private sector NPLs, the CBE established an arbitration-based conciliation mechanism to facilitate the search for extra-judiciary settlements to avoid the lengthy and cumbersome court process. The banks created specialized work-out units with fully dedicated staff to monitor the performance of rescheduled loans, but it is too early to tell whether this approach was effective in preventing the re-emergence of problem loans. A lack of detailed data and analysis hinders a proper evaluation of this initiative.

58. Progress in financial and operational risk management is more difficult to discern. The state-owned commercial banks continued to suffer from high levels of NPLs and the independent audits ascertained that these were very seriously under-reported as was surmised by the 2002 FSAP report. The banks increased their provisions but the level of provisioning continued to be dictated by the level of current profits. In FY 2008, the National Bank of Egypt allocated a very large sum to provisions but in that year it also reported a very large financial gain. As already noted, the published information on the total amounts collected in cash, the loan amounts that were written off (even if debt recovery was still pursued), and the loans that were rescheduled, is far from clear.

59. Like nearly all other banks, the state-owned commercial banks not only exceeded by a large margin the capital adequacy rate (CAR) of 10 percent required by the prudential rules but were also able to increase their rates in recent years. However, this achievement was made easier by the substantial decline of lending volumes and the corresponding increase of holdings of government bonds and claims on the central bank. In fact, because of the different risk weights attached to these asset classes, the CAR could be increased even with a reduction in regulatory capital.

60. The overall financial performance of the state-owned commercial banks continued to lag considerably behind that of the private banks, especially the more successful and efficient among them. Only in the last couple of years have the results of the NBE seemed to come closer to those of the private banks. This coincided with a very low allocation to provisions, which implied that the level of provisioning may now be deemed adequate. This could represent a landmark achievement by the NBE, although the decline in economic growth caused by the political uprising is likely to affect adversely the financial results of the next few years.

61. Operational restructuring of NBE and Banque Misr, initiated with support from DPL I, continued under the reform program supported by DPL II. In the area of human resources in particular, both banks have expanded the recruitment of young graduates as well as experienced senior professionals with specialized skills, and have adopted promotion systems based on performance rather than seniority. In the case of one of the banks for which a detailed human resources report was provided to the IEG team, newly recruited young graduates over the period 2006-2010 represented 35 percent of the total labor force in 2010. The total number of staff fell by 12 percent between 2006 and 2007 but reverted to its earlier level by 2010. This implied that, encouraged by a voluntary retirement program, an equal number of staff left bank employment during this period. Both banks substantially increased their training budgets and the number of staff training hours.

Strengthening the regulatory and supervisory framework in the banking sector

62. The CBE continued the implementation of the capacity-building program initiated with support from DPL I. It hired new staff with extensive banking experience and specialized skills, expanded its training programs, and adopted new methods and tools in both off-site surveillance and on-site inspections. Anecdotal evidence from commercial banks indicates that CBE inspections have become more thorough and focus on evaluating internal control and risk management systems. Inspection reports are prepared without undue delay and are extensively discussed with management to ensure that corrective action is taken to address shortcomings and gaps in bank management. New supervisory tools are being introduced, to act as early warning signals of risks, notably stress testing, internal bank rating, and monitoring of large corporate clients at the industry or sector levels, to proactively assess their creditworthiness. Current objectives of the capacity building program include the introduction of consolidated supervision of banking institutions and adoption of the Basel II approach to capital standards and risk-based banking supervision. A specialized unit was created to prepare the ground for the implementation of the Basel II accords.

63. However, neither the CBE nor the EU or Bank teams seem to have prepared a comprehensive report documenting in sufficient detail the changes that have taken place and evaluating the impact of the new approach on bank solvency and efficiency. (If such a report exists, it has not been provided to the IEG team.) There is no clear indication of the success of the new approach in enhancing supervision of complex operations of modern banking groups and in redressing the regulatory forbearance that had long characterized relations with the large state-owned banks. A positive indication is that the European Central Bank continued to provide support to the second phase of the Egyptian banking sector reform program for the implementation of Basel II standards.

Restructuring of state-owned insurance companies

64. The approach adopted by the authorities after the completion of the advisory report was to create an Insurance Holding Company in October 2006 to facilitate the management, reform and restructuring of the state-owned insurers. The holding company took over ownership of all state-owned insurance companies. In August 2007, Al Chark Insurance Company and the Egyptian Reinsurance Company were merged into Misr Insurance Company, which became a non-life company. The fourth company, National Insurance

Company, changed its name to Misr Life Insurance Company and became a life insurer. The real estate properties of the two insurance companies were transferred to a newly established real estate management company at prices that were closer to market values and much higher than book values. This bolstered their reserves and also allowed a more professional management of real estate. The group also created an asset management company that is jointly owned by the holding company and the two insurers. The option of selling the insurance companies to strategic investors was discarded although an IPO on the stock exchange for part of the capital of Misr Life Insurance was envisaged.

Strengthening the regulatory and supervisory framework in insurance and pensions

65. Under reforms supported by DPL II the focus shifted to the new Egyptian Financial Supervisory Authority (EFSA) when the latter was created by the new law on regulating the non-bank financial markets, institutions and instruments (Law 10 of 2009). EFSA assumed the functions of three pre-existing authorities,the Egyptian Insurance Supervisory Authority (EISA), the Capital Market Authority (CMA) and the Mortgage Finance Authority (MFA). EFSA started operations in July 2009 and adopted a functional approach to its organization. EFSA enjoys operational and financial independence and embarked on an ambitious skills development program, recruiting young graduates and implementing intensive training courses.

66. The regulation of insurance was considerably improved with the enactment of amendments to the Insurance Code. These raised the minimum capital of insurance companies, required the separation of life and non-life business, and authorized corporate insurance brokers. In response to a diagnostic study that demonstrated that motor third-party liability (MTPL) premiums covered only 20 percent of costs, premiums were raised to cover half of the shortfall, while a new law was passed that imposed caps on claim payouts. The enactment of a new Stamp Law in 2006 lowered by 50 percent the stamp duty on non-life policies and removed it altogether from life insurance contracts. On-site inspections of insurers, using a risk based modality, started to be conducted although the supporting supervisory database and information system were still being upgraded and remedial action was rather limited. A draft law was prepared to address the problems of the currently small and seriously underfunded private pension funds. The new law will allow insurance companies and specialized fund managers to offer a wider variety of pension plans under the supervision of EFSA.

67. Other legal and regulatory initiatives covered the regulation of collective investment schemes, the protection of investors through more effective regulation of insider trading and market manipulation, measures to stimulate the growth of the corporate bond market, and a new regulatory framework to promote the establishment and operation of leasing and factoring companies as well as microfinance institutions.

Improving the efficiency of capital markets

68. Several measures were adopted to improve the efficiency of securities markets. These included the introduction of International Financial Reporting System (IFRS) standards for listed firms and securities companies, the establishment of a registry for external auditors, the

imposition of stricter rules on external auditor qualifications, and the adoption of international auditing standards, the strengthening of capital adequacy and risk management standards for securities firms, the simplification of stock exchange listing schedules, the regulation of takeovers and public tender offers, and the creation of NILEX, a new exchange for listing and trading SMEs.

69. The promotion of institutional investors was targeted through the liberalization and restructuring of the insurance sector, and the adoption of new regulatory frameworks for private pension funds and collective investment schemes. However, these measures were expected to have a long-term impact on the growth of securities markets and institutional investors. Owing to the turmoil in capital markets caused by the global economic crisis and the uncertainties related to the domestic political situation in Egypt, capital markets had remained depressed up until the time of the IEG PPAR mission (January 2011).

Strengthening the financial sector institutional infrastructure

70. A private credit bureau was established in 2007 and became operational in March 2008. It is building its database from several sources, including the public credit registry, banks and non-bank financial institutions, and mobile phone operators. Credit reports are updated on a monthly basis and include both positive and negative information. The quantity and quality of information on client creditworthiness at the public credit registry were also significantly improved by recording the length of the outstanding loans, the history of loan balances and repayments, and any changes in the terms of the loan. The last provision helps identify cases of rescheduling and rolling over of loans. However, a proposal by the credit bureau to create an SME rating service did not succeed because of lukewarm support by the leading commercial banks.

71. A Real Time Gross Settlement (RTGS) system was installed by the CBE and became operational in March 2009. In addition, the CBE developed an Automatic Clearing House to reduce the total processing time of checks inside the CBE from 25 days to 2-3 days. Regarding retail payments, the CBE promoted the use of plastic cards and automated terminals for the payment of public sector salaries and pensions.

Outcomes

72. Reforms undertaken in DPL II under policy areas (i)–(iii) continued to contribute to the achievement of a stronger framework for financial sector regulation and supervision and a substantially reformed banking sector. A key factor was the capacity building program of banking supervision by the CBE, which has contributed to enforcing better soundness of commercial banks, as suggested by the improvement of all bank soundness indicators (NPLs, provisioning of NPLs, capital adequacy—see indicators listed in outcome section for DPL I). The second phase of financial and operational restructuring of state-owned banks also contributed to the improved soundness of the banking system. The settlement of long-standing NPLs from SOEs was an important achievement. However, 40 percent of these NPLs were settled by a land-for-debt swap. As noted for DPL I, the resolution of private sector NPLs involved relatively small cash collections, leaving open the question of possible extensive

rescheduling of NPLs. A shortcoming of DPL II was the neglect of sufficiently strong safeguards to prevent a recurrence of lending by state-owned banks to loss-making SOEs.

73. Overall, the reform program supported by the two DPLs allowed the banking system to weather several “real life” stress tests, starting with the impact of the global financial crisis, followed by the uncertainty created by the Euro sovereign debt crisis, and finally the economic and financial implications of the January 25 Revolution in 2011 (see table, Appendix 2). The Egyptian banking sector did not have any exposure to complex financial products that gave rise to the financial crisis and leverage was not excessive. But it did suffer some withdrawal of deposits, and its liquidity also came under pressure after the January 25 Revolution. Consolidation of the banking sector, with support from the DPLs, and the increase in minimum capital requirements strengthened the capital buffers of the banking system in the face of these pressures. Egyptian banks display a high capital adequacy ratio (see table, Appendix 2), which could act as a buffer in the face of adverse economic conditions. Public anxiety from the global crisis was connected to the deteriorating growth and employment prospects rather than to concerns about bank soundness. Confidence in the Egyptian banking sector was reflected in an increase in total deposits by 51 percent, despite adverse conditions, from EGP 650 billion in 2007 to EGP 981 billion in 2011. Loans increased less over the same period, by 38 percent, from EGP 354 billion in 2007 to EGP 490 billion in 2011, of which the majority (EGP 125 billion) was an increase in loans extended to the private sector.

74. On the non-bank financial institution (NBFI) front, the operation consolidated the basis for long-term development of NBFIs by the establishment of EFSA, the restructuring of state-owned insurance companies through the creation of an insurance holding company and greater specialization through life, non-life, real estate, and asset management subsidiaries, and the adoption or preparation of a multitude of measures to strengthen the regulation and supervision of NBFIs and the securities markets. The successful launching of the new real time gross settlement payment system and the establishment of a private credit bureau were major landmarks in upgrading the financial sector infrastructure.

75. Actions under the operation’s policy areas contributed to the overall development outcome sought by the operation to build a more competitive financial system, with sound banking and non-banking institutions, led by the private sector, and able in the medium term to provide efficient financial services. This contribution was, however, muted by some shortcomings: An attempt to develop an SME rating service did not succeed and important weaknesses remain because of the failure to enact a new insolvency law and create a registry for collateral security on movable assets. These reforms were considered by the authorities and the Bank beyond the scope of this operation as comprehensive judicial reform would be required for their enforcement. The provision of credit to the private sector, and more especially to SMEs, continues to fall below the required level for sustainable economic growth and employment creation, while the safeguards against retrogression in the lending policies and practices of state-owned banks do not appear to be sufficiently strong. Another shortcoming of this operation has been the discontinuation of the PFM reform component that had been initiated with the first operation, despite the absence of substantive progress in this area.

5. Ratings

PROJECT OUTCOME

76. Despite the shortcomings noted, the operation substantially achieved several desired outcomes, in particular in promoting a more sound banking system with stronger private sector participation and in consolidating the basis for long-term development of NBFIs. Modest achievements were noted in dealing with NPLs of SOEs and introducing strong enough safeguards against retroversion to unsound lending practices of state-owned banks to SOEs. Overall, the achievement of the operation's development objective (efficacy) is rated by this review ***substantial***. The relevance of objectives of DPL II was rated ***high***, while the relevance of design was rated ***modest***. Based on these ratings for efficacy and for relevance of objectives and design, this review rates the Overall Outcome of DPL II as ***Moderately Satisfactory***.

RISK TO DEVELOPMENT OUTCOME

77. The risk to development outcome for DPL II is considered **Moderate** for reasons similar to those mentioned regarding DPL I. In particular, the absence of strong safeguards against retrogression by the state-owned institutions poses a moderate risk to the development outcome and the long-term sustainability of the reform effort.

MONITORING AND EVALUATION

78. **Design**. As for DPL I, some of the monitoring indicators selected for DLP II were outputs (actions) of the operation as opposed to outcomes related to the achievement of the operation's objectives. Some other indicators were closer to measurable outcomes.

79. **Implementation and Utilization.** The monitoring of outcomes and the preparation of qualitative reports evaluating the effectiveness and impact of multi-year efforts was not well organized. M&E implementation was made more difficult by the division of labor among donor participants and the apparent failure to organize joint supervision missions. Although the Bank played a key coordinating role in the preparation of the loans, it did not adopt an equally active role in coordinating the supervision effort and acting as a clearing house, collecting and disseminating all relevant reports among the donors. The absence of comprehensive evaluation reports by the authorities also complicated the effective monitoring of the multi-year capacity building and restructuring programs.

80. A notable exception to this broad assessment is the Insurance Holding Company, which has prepared a succinct summary of the organizational changes that have been undertaken so far. EFSA has also compiled a short report on its activities although the real progress that has been achieved so far in the NBFI sector is relatively limited given the recent creation of EFSA.

81. The CBE highlights in its annual reports the objectives and broad outlines of the capacity building program but contains little detailed information on the changes that have taken place or an evaluation of the impact of the new approach on bank solvency and

efficiency. There is no indication of the success of the new approach in supervising the complex operations of modern banking groups and in redressing the regulatory forbearance that had long characterized its relations with the large state-owned banks. Neither the EU nor the Bank teams seem to have prepared a detailed report on this crucial aspect of the loan operations. The same also applies to the financial and operational restructuring of the state-owned commercial banks. As in the case of banking supervision, there is ample, mostly anecdotal, evidence of considerable improvement in most aspects of bank operations but no comprehensive evaluation report appears to have been written. Based on these considerations, the quality of M&E is rated ***modest***.

BANK PERFORMANCE

82. **Quality at entry**: The operation was designed in close cooperation with the authorities and was largely based on the recommendations of the 2007 FSAP Update. However,on the difficult issue of state-owned bank NPLs to SOEs shortcomings were noted. Contrary to DPL I, no review of the performance of SOE loans seems to have been conducted ahead of DPL II appraisal. No written report was provided with an analysis of the composition of the NPLs by type of SOE (profitable, unprofitable but viable, defaulting), type and term of loan, and length of nonperformance. It should be noted that the subsequent operation, DPL III, includes a short annex on the Asset Management Program for SOEs operated by the Ministry of Investment. The annex stresses that various measures have been put in place to ensure that 'only financially solid and viable SOEs obtain the required credit to finance their needs' (Annex 12 DPL III project report). However, this issue was not addressed in any detail during the appraisal of DPL II. Yet, as noted below, state-owned banks already extend long-term loans to SOEs that depend on budget subsidies for their viability. No data have been collected by the bank team on loans to subsidized SOEs during implementation support, which appears to be a shortcoming in supervision. DPL II continued to support financial restructuring of state-owned commercial banks through the settlement of NPLs of state-owned enterprises. However, as privatization proceeds were not adequate for the large outlay needed to cover the NPLs of SOEs, the authorities engaged in a land-for-debt swap for about 40 percent of NPLs. This raised the question of the appraisal of the value of the land holdings used in these swaps while creating both opportunities and challenges for the state-owned banks in managing them. Another shortcoming in the design of the second operation was the discontinuation of the PFM component, despite the absence of sufficient progress in this area. Quality at entry is rated ***moderately satisfactory*.**

83. **Quality of supervision**: As for DPL I, the main shortcoming of Bank performance at the implementation stage was its failure to act as a coordinating agent for the supervision of the loans, monitoring the performance of multi-year programs, and operating as a clearing house for all supervision reports. No data have been collected by the Bank on loans to subsidized SOEs—a shortcoming in implementation support, especially in view of the continuing engagement of the Bank in the sector. Quality of supervision is rated ***moderately satisfactory***. Based on these ratings, overall Bank performance is rated ***moderately satisfactory***.

BORROWER PERFORMANCE

84. The Borrower continued to apply strong commitment to the multi-year and extensive reform program supported by DPL II. Most of the 2007 FSAP Update recommendations were accepted by the authorities and were incorporated in the design of DPL II. However, as for DPL I, the reform effort could have been strengthened by the publication of comprehensive reports on the impact of both the capacity building program in banking supervision and the restructuring plans of state-owned commercial banks as well as by introducing safeguards against retrogression in the lending practices of state-owned banks. Borrower performance is rated ***satisfactory***.

6. Lessons learned

85. Financial sector reforms are relatively easy to design but difficult to implement. Successful implementation depends on two crucial factors: the commitment of the authorities to the reform program; and the effectiveness of project supervision.

86. The Egyptian authorities have shown a strong commitment to the multi-year reform program that was designed by the reformist government that was appointed in 2004. The program incorporated many of the policy recommendations of the 2002 FSAP report and covered an extensive area of reforms in both banking and the NBFI sectors, including strengthening the regulatory and supervisory framework, restructuring key state-owned institutions, and promoting a greater presence of the private sector.

87. The reform program did not include the privatization of the two largest commercial banks nor the large insurance companies. However, many measures were taken to improve the management of these institutions, which one commentator resembled to an effective 'privatization of management' rather than 'privatization of ownership'. A dogmatic approach to the ownership question would not be justified, especially after the public rescue of so many leading private banks and insurance companies in high-income countries during the 2008 global financial crisis. Historically and globally state-owned institutions have generally demonstrated a dismal record in terms of solvency and efficiency or even integrity and fairness. In far too many countries, state-owned banks have extended loans on non-commercial criteria to borrowers with strong political connections and have suffered from large and persistent NPLs from both state-owned enterprises and large private sector borrowers. State-owned banks and insurance companies have operated for prolonged periods with bloated staff and excessively high operating costs or have been used as captive institutions for financing large budget deficits. Many countries in Eastern Europe, Latin America, and Asia have implemented ambitious privatization programs, often involving sales to strategic global investors.

88. The Egyptian reform program has privatized the smallest of the four state-owned commercial banks and has divested public bank shares in joint-venture banks. State-owned institutions still control close to 50 percent of banking assets and a higher market share of insurance business. Some safeguards have been created to prevent a retrogression into old practices as part of the reform program. For example, no state guarantees are being issued for state enterprises, which places them on a more level playing field with other enterprises and

eliminates the directed lending that was largely responsible for the non-performing loans of state-owned enterprises held by state-owned commercial banks. However, the safeguards do not appear to be sufficiently strong since bank lending to SOEs on a long-term basis and thin margins has already been resumed. Bank lending to SOEs that depend on public subsidies for their commercial viability may prove particularly risky at times when the budget may come under pressure.

89. The effectiveness of project supervision has suffered from the division of labor among several participating donors (the World Bank, the EU Commission and the African Development Bank) and an apparent failure to provide for joint supervision, implementation completion reports, and evaluation missions. The Bank played a key coordinating role in the division of labor during the preparation of the loan operations but failed to act as a clearing house for supervision reports. As a result, crucial comprehensive reports on key aspects of the reform program, such as the effectiveness of the capacity building program in banking supervision and the solidity of the financial and operational restructuring of state-owned commercial banks, have not been compiled. The organization of effective project supervision is critical when several donors participate in complex operations.

Appendix 1. Basic Data Sheet

Egypt First Financial Sector Development Policy Development Loan (Loan NO. IBRD-73910)

Key Project Data (US$ 500 million)

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	500.0	500.0	100
Loan amount	500.0	500.0	100

Project Dates

	Original	*Actual*
Initiating memorandum	11/11/2005	11/11/2005
Negotiations	12/19/2005	12/19/2005
Board approval	6/15/2006	6/15/2006
Signing	11/13/2006	11/13/2006
Effectiveness	4/30/2007	4/30/2007
Closing date	6/30/2007	6/30/2007

Staff Inputs (staff weeks)

Stage of Project Cycle	*Staff Time and Cost (Bank Budget Only)*	
	No. of Staff Weeks	*USD Thousands (including travel and consultant costs)*
Lending		
FY05	26	127.28
FY06	63	294.13
Total:	**89**	**421.41**
Supervision/ICR		
FY07	19	107.25
FY08		4.93
Total:	**19**	**112.18**

Mission Data

Stage of Month/Year	No. of Persons and Specialty		Performance Rating	
			Implementation Progress	Development Objective
	Count	Specialty		
Lending	*7*	TTL (1), Senior Economist (1), Senior Financial Sector Specialist (1), Sr. Advisor (1), Manager (1), Sr. Counsel, Team Assistant (2)	–	–
Supervision	*5*	TTL (1), Senior Financial Sector Specialist (1), Sr. Advisor (1), Team Assistant (2)	HS	HS

Egypt Second Financial Sector Development Policy Development Loan (Loan NO. IBRD-75280)

Key Project Data (US$ 500 million)

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	500.0	500.0	100
Loan amount	500.0	500.0	100

Project Dates

	Original	*Actual*
Initiating memorandum	9/11/2007	9/11/2007
Negotiations	12/19/2007	12/19/2007
Board approval	5/29/2008	5/29/2008
Signing	10/30/2008	10/30/2008
Effectiveness	3/23/2009	3/23/2009
Closing date	12/31/2009	12/31/2009

Staff Inputs (staff weeks)

Stage of Project Cycle	*Staff Time and Cost (Bank Budget Only)*	
	No. of Staff Weeks	*USD Thousands (including travel and consultant costs)*
Lending		
FY05	26	127.28
FY06	63	294.13
Total:	**89**	**421.41**
Supervision/ICR		
FY07	19	107.25
FY08		4.93
Total:	**19**	**112.18**

Mission Data

Stage of Project Cycle	**No. of Persons and Specialty**		**Performance Rating**	
Month/Year			**Implementation Progress**	**Development Objective**
	Count	**Specialty**		
Lending	*17*	TTL-Lead Economist (1), Manager (1), Senior Financial Sector Specialist (1), Sr. Advisor (2), Lead Private Sector Development Specialist (1), Lead Microfinance Specialist (1), Senior Economist (1), Senior Finance Officer (2), Counsel (2), Team members (5)	-	-
Supervision	*11*	TTL-Lead Economist (1), Senior Financial Specialist (1), Sr. Advisor (2), Lead Private Sector Development Specialist (1), Senior Financial Specialist (1), Senior Economist (1), Team members (5)	S	S

Appendix 2. Egypt banking sector financial soundness Indicators
(in percent, end of fiscal year[1])

	2005	2006	2007	2008	2009	2010	2011 *June*
1. Capital Adequacy Ratio	13.7	14.7	14.8	14.7	15.1	16.3	16.0
2. Equity to Assets	6.1	6.3	5.5	6.2	6.4	6.7	6.4
3. Nonperforming Loans to Total Loans	26.5	18.2	19.3	14.8	13.4	13.6	11.0
4. Provisions to Nonperforming Loans	51.0	76.2	74.6	92.1	100.4	92.5	93.6
5. Return on Average Assets	0.6	0.8	0.9	0.8	0.8	1.0	1.0
6. Return on Average Equity	10.2	14.3	15.6	14.1	13.0	14.3	14.3

[1] *Fiscal year ends at June 30th for public sector banks, and December 31st for other banks.*

Source: Central Bank of Egypt

Appendix 3. List of Persons Met

Ministry of Finance
Ms. Amina Ghanem, Deputy Minister for International Relations

Ministry of Investment
Mr. Mahmoud Mohieldin, former Minister (currently Managing Director of the World Bank)
Ms. Mona A. Zobaa, Undersecretary, Head of Investment Policy Department

Central Bank of Egypt
Ms. Lobna Helal, Sub Governor, Banking Reform
Mr. Gamal Negm, Sub Governor, Banking Supervision
Mr. Tarek Raouf, Sub-Governor, Payment Systems
Mr. Tarek Fayed, Assistant Sub Governor, Banking Supervision
Ms. Rafahia Hussein Roshdy, Assistant Sub Governor, Banking Supervision
Mr. Farag Abdul Hameed Farag, Assistant Sub Governor, Banking Supervision
Ms. Ehab Rafik Abou Ali, Manager, Banking Reform
Dr. Ghada Abd Al-Hadi Kandil, Consultant, Banking Reform
Ms. May Abunalga, Consultant, Banking Supervision
Mr. Mohamed Aboumoussa, Consultant, Banking Supervision
Mr. Ahmed Faragallah, Head of Payment Systems Department

Egyptian Financial Supervisory Authority
Dr. Zia Ahmed Bahaa El Din, Chairman
Dr. Ashraf Kadry El Sharkawy, Deputy Chairman
Dr. Adel Moneer Rabeh, Deputy Chairman
Dr. Ali Al-Ashry, Assistant Chairman
Mr. Mohamed Amiri, Assistant Chairman
Mr. Walaa El-Husseiny, Adviser

National Bank of Egypt
Mr. Hisham Okasha, Deputy Chairman
Mr. El Sayed Elkosayer, Board Member
Mr. Wael Abou Ali, General Manager
Mr. Michael Makkar, Head of Strategy & Planning

Banque Misr
Mr. Mohamed Naguib Ibrahim, Vice Chairman
Mr. Mohamed Abbas Fayed, Vice Chairman
Dr. Suzan Hamdy, General Manager
Mr. Khaled Mustafa, General Manager

Insurance Holding Company
Mr. Mahmoud Abdallah, Chairman
Mr. Mohammed Omran, Vice Chairman
Ms. Zeinab Ishak, Vice Chairman
Mr. Mohamed Ahmed Elshater, AML Specialist

Misr Life Insurance Company
Mr. Sadek Hassan Sadek, Chairman & Managing Director
Mr. Hisham Ramadan, Vice Chairman

National Societe Generale Bank (NSGB)
Mr. Mohamed El Dib, Chairman & Managing Director
Mr. Tarek Fayed, Assistant Managing Director

Delta Financial Investments
Ms. Neveen El Tahri, Co-Chairperson and Managing Director

I-Score - The Egyptian Credit Bureau
Mr. Mohamed Rafaat El-Houshi, Managing Director

USAID
Ms. Ingi M. Lotfi, Senior Economist

Annex B. Guatemala Financial Sector Adjustment Loan (Loan No. IBRD-71300)

Principal Ratings

	*ICR**	*ICR Review**	*PPAR*
Project Name (No. IBRD-71300)			
Outcome	Satisfactory	Satisfactory	Satisfactory
Risk to Development Outcome	Moderate	Moderate	Moderate
Bank Performance	Highly satisfactory	Highly satisfactory	Highly Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory

* The Implementation Completion and Results Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (OED) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Appraisal	Mariluz Cortes	Danny Leipziger	Donna Dowsett-Coirolo
Completion	Yira J.Mascaró	Lily L. Chu	Jane Armitage

1. Background and Context

1. The Bank's 2002 Financial Sector Adjustment Loan (FSAL) to Guatemala responded to a crisis that had been brewing in the country's weak financial system since 1998. The crisis was brought to a head by traditional problems: election-related macroeconomic imbalances, a deterioration of export prices, and a severe hurricane. The government that took office in 2000 tightened monetary and fiscal policy and resolved some small, weak banks, at substantial cost to the Central Bank of Guatemala (BGUAT). These measures and the prospect of continued stable macro policies and a financial reform that would be supported by the IMF, the FSAL, and the Inter-American Development Bank (IDB) led to a capital inflows and a higher country rating, which in turn allowed the government to resume borrowing in international markets. However, a financial reform was necessary to resolve the underlying problem.

Guatemala's Financial Sector and the 1998-2002 crisis

2. Guatemala's financial sector crisis of 2000-2002 reflected the impact of variations in fiscal and monetary policy and external price and climatic shocks on the weak financial system. In the run-up to the end-1999 elections, the government pursued expansionary fiscal and monetary policies that contributed to a credit boom. During the same period, the rural sector suffered from substantial damage from Hurricane Mitch (November 1998) and large declines in the prices of coffee (the main export) from the high levels of 1996 and 1997. The wider current account deficit and the later capital outflows were financed by using proceeds from privatizations, government external borrowing, and Bank of

Guatemala (BGUAT) sales of international reserves. Nonetheless, the exchange rate depreciated.

3. Faced with a deteriorating macroeconomic situation, stabilization began in the last quarter of 1999, following election of a new president. Restraint in government expenditures reduced the fiscal deficit by more than one percent of GDP; open market operations slowed the growth of credit sharply. Capital returned from abroad, the exchange rate appreciated, and international reserves rose. After receiving a favorable external bond rating, the government successfully issued \$325 million of 10 year Eurobonds in November 2001, to refinance short term debt coming due at the end of 2001 and in 2002. However, the stabilization policy, the slowdown in the world economy, and further declines in coffee prices led to a further decline in GDP growth in 2001and a widening of the current account deficit, as well as pressures on a weakened financial sector. These problems limited the prospects for reducing poverty and supporting the Peace Accords. Guatemala requested an IMF Stand-by (approved in April 2002) and support for financial reform from the World Bank (following the recommendation of the 2000 Financial Sector Assessment Program, FSAP) and the Inter American Development Bank.

4. In 2000, Guatemala's onshore financial sector was small relative to Central American comparators, bank-centered, had limited foreign presence, and contained numerous small banks; many of the banks were considered under-capitalized and under-provisioned although reported figures suggested these were not issues. Guatemalan onshore banks' credit to the private sector and deposits, as percentages of GDP in 2000, were only about 60 percent of Honduras' or the average for Costa Rica, El Salvador and Honduras. Guatemala's 31 onshore banks accounted for almost 90 percent of the onshore financial system's assets. Foreign banks and subsidiaries accounted for less than 5 percent of bank assets. Twenty-two of the banks accounted for only 25 percent of bank assets. Other parts of the system, insurance companies, and finance companies, were small and remain small.

5. Many of the onshore banks were part of onshore-offshore financial conglomerates. The other onshore parts of the conglomerates were small relative to the banks. However, the offshore banks were in some cases thought to be large. Their size probably reflected a number of regulations on onshore banks, such as the prohibition on dollar deposits and loans that only ended fully in 2001. The conglomerates' offshore banks, which were unregulated, unsupervised, and provided no information to the bank supervisors, Funds, profits and losses, could flow easily between onshore and offshore banks under the same ownership. Hence the size of deposits and private sector credit from the banking system, not to mention the size of the banking sector and exposures, were generally considered to be understated, perhaps substantially.

6. The monetary and financial system had significant weaknesses in the mid-1990s that were exposed by the crisis. Monetary and financial policy was overly influenced by political pressures. Banks were undercapitalized taking into account the probable understatement of non-performing loans and the low levels of provisioning. Banks, and the whole financial conglomerates, were over-exposed to related parties. Offshore banking contributed to the obscurity of bank activities.

7. These problems reflected the lack of an adequate legal and regulatory monetary and financial sector framework. The legal framework was inadequate for conduct of monetary and financial policy, including the setting of objectives for policy, the autonomy of the central bank, and the risks to the central bank from unlimited exposure to lender of last resort facilities and illiquidity of banks in the payments system. The prudential regulation and supervision framework and the authority for intervention and resolution of failed banks was inadequate, particularly in light of the offshore component of the bank groups. Guatemala also was not in compliance with international norms regarding Anti-Money Laundering. Finally, Guatemala lacked a credit information system that could be used to assess risk and exposure, and that could enable increased access to credit.

8. The financial sector crisis began with excessive credit growth in 1998 in the context of the 1996 Peace Accords and high commodity prices—in 1998 private credit from banks grew over 27 percent December on December. The credit boom was fueled initially by some capital inflows and then loose monetary policy in the run-up to elections. Institutionally, the credit boom reflected the banks' weak credit risk analysis and the lack of restraint by capital requirements that were poorly enforced because of the weakness in regulation and supervision and the complications of the offshore banking connections. Deposits began to decline in mid 1999 and capital outflows developed, to some degree between the onshore and offshore banks, reflecting political uncertainties.

9. By mid-1999, banks' illiquidity, banks' problem loans and insolvency of borrowers and banks were worsening.[1] These problems reflected the fall in coffee prices, the devastation of Hurricane Mitch, and the pre election slowing of growth, then the 1999 fall of private bank deposits. In mid-2000, the Bank and the IMF responded to government request for a FSAP, which was followed in 2002 by an IMF Standby and the Bank FSAL.

10. This analysis of the financial crisis suggests that it was largely related to traditional macroeconomic issues related to developments in the national economy and politics and deteriorations in the terms of trade, as they affected a weak financial system. This analysis correspondingly suggests the lesser importance of the impact of direct contagion from the rest of the world's upsurge in banking problems in 1997-99 (Laeven and Valencia 2008) and the general slowing of capital flows from industrial to developing countries.[2] Contagion would appear important only to the extent it affected Guatemalan offshore banks and eventually limited the authorities' ability to finance a widening current account and fiscal deficits.

[1] Three small banks had outstanding liabilities with the BANGUAT that were several times their book capital at various times. Other banks' illiquidity was alleviated by deposits from the public sector from time to time. Reported non-performing loans (which were probably understated by "evergreening" and which had very low coverage in provisions) had reached nearly 10 percent at end 2000.

[2] In particular, the crisis was preceded by a decline in the current account deficit in 1997 that remained high in 1998. Both deficits were more than financed by capital inflows; reserves actually rose in both years. Only in late 1999, with the continuation of the increased current account deficit, a decline in international reserves, depreciation of the exchange rate, and the uncertainty of the elections that led to deposit declines, did the capital account decline. Guatemalan onshore banks' foreign liabilities were higher in mid-1999 than at the beginning of 1997.

11. The 1999-2000 financial crisis never became systemic—for example, it was not considered systemic in the recent enumeration of systemic crises (Laeven and Valencia 2008). This outcome probably reflects the results of the elections, the prospect of financial reforms supported by the international financial institutions; the return of capital outflows, the easing of international credit markets; and the improvement in Guatemala's country rating. All of these factors permitted a roll-over of short-term debts coming due at the end of 2001 and in 2002 into ten-year debt. But the weak financial system, the fundamental problem that posed future risks, still needed correction.

12. The crisis starkly illustrated the various problems in the system that were noted above, raised in the 2000 FSAP, and were common worldwide in the 1990s. The <u>reported</u> capital of the onshore banks was substantially above the required minimum of 10 percent of risk—weighted assets. However, provisioning adequately for even the reported non-performing loans (NPLs) of nearly 10 percent would have left many banks undercapitalized. And NPLs were probably under-reported by rolling over ("ever-greening") of weak loans and transfer of NPLs offshore, which were not included. A survey indicated related-party lending accounted for at least 25 percent of loans, a figure that was probably underestimated because of the lack of unique identification of related parties and excludes the even higher level of related party lending in the non-bank parts of the conglomerates and the offshore lending to the same related parties. At least three banks were chronically illiquid in the clearing mechanism; the BGUAT was legally responsible for covering these illiquidities and these banks correspondingly had accumulated obligations to BGUAT, in some cases several times their book capital. In some instances, public sector and social security deposits had been made to help these banks, which were then used to repay BGUAT. In 2001, three of these banks were finally intervened. To reduce risks of a bank run, BGUAT paid off the depositors—the banking industry had declined to set-up a deposit insurance fund as was permitted under the 1999 savings protection law. Two other weak banks were later merged with government owned mortgage bank that was capitalized with an injection of government funds.

The 2002 FSAL and Other Financing from International Financial Institutions.

13. The 2002 Guatemala FSAL was a US$150 million loan of three $50 million tranches for support of financial reform in Guatemala. The loan was based on the FSAP of 2000 and supported the financial reform program initiated by the Guatemalan government that took office in 2000. Expected closure date was in June 2004. The loan was accompanied by a US$5 million Bank financial technical assistance loan (FTAL).

2. Objectives, Design, and Relevance

14. The loan's stated development objective was **"to assist the Guatemalan Government to implement its financial sector reform program, aimed at bringing about a stronger and better functioning banking sector, able to withstand external shocks and to increase prudent lending to the private sector, opening access to groups and enterprises largely excluded from bank financing (micro, rural, and small and medium enterprise financing)"**. The overall objective of the loan was not revised.

15. The loan's development objective was underpinned by six policy areas:

i. *Maintain a supportive macroeconomic policy framework*

ii. *Reform the legal framework for monetary and financial policy*

iii. *Reform the financial sector legal framework* — to strengthen the regulation of financial groups on- and off-shore, create an orderly exit mechanism, enhance credit risk management, and prudently increase lending and thereby increase access to finance;

iv. *Reform of banking supervision* — through more autonomy of the Superintendency of Banks (SIB), improve the SIB's legal and institutional capacity to supervise financial groups, and move banking sector regulation towards international standards ;

v. *Enactment of legislation to prevent money laundering, reduce illegal activities and comply with international norms;*

vi. *Consolidation of the banking system* — through the restructuring or closure of insolvent banks and through mergers and acquisitions.

16. The loan documents also indicate the need for financing from international financial institutions and financial reforms to reduce the risk of a deeper financial crisis in 2002. Such a crisis would have limited future GDP growth and poverty reduction and required large government spending for resolution of the financial system that would have crowded-out social spending.

3. Relevance of Objectives and Design

17. **Relevance of Objectives.** Under the 1998 Country Assistance Strategy (CAS), prior to the FSAL, the Bank's assistance had focused on reducing poverty through assistance to education and infrastructure and improving governance, in order to support the 1996 Peace Accords that ended 26 years of civil conflict. The 2002 CAS Progress Report accompanied the Board Presentation of the FSAL and an accompanying Financial Sector Technical Assistance Loan (FTAL); its objectives for the period until the next full CAS (in 2005) continued the 1998 CAS focus on poverty reduction and supporting the Peace Accords. The FSAL was important to macroeconomic stability by addressing a key vulnerability and helping avoid a bank crisis that would reduce growth and add to poverty. The overall FSAL project development objective (PDO) –the strengthening of the financial sector to withstand shocks and increase prudent lending — was thus highly relevant to achieving the goal of reducing poverty in the 1998 CAS. Preventing a full-blown financial crisis would avoid a negative feedback from the financial sector onto growth and poverty, as has occurred in countries hit by financial crises. It would also avoid the typical reduction in fiscal space that occurs in a financial crisis, when the Ministry of Finance is forced to provide resources to the financial sector. The CPS for the period 2009-2012 (presented in mid-2008) continued to support the objective of enhancing fundamentals to promote macroeconomic stability, which included strengthening financial

supervision and risk management; it also included Promotion of Stable Sustainable Growth and Productivity, which included increased financial services for rural households; and Expansion of Opportunities for Vulnerable groups. The objectives of the 2009-2012 CAS did not include avoidance of a banking crisis that had been a concern of the 2002 FSAP and an underlying objective of the previous CAS. As discussed below, the results of the operation helped avoid a financial crisis in Guatemala in late 2007 and early 2008, while the global financial crisis did not lead to a financial sector crisis in Guatemala. Relevance of objectives is rated ***high***.

18. **Relevance of Design.** The policy areas related to the financial sector listed above comprised a highly relevant project design to strengthen the financial sector to withstand shocks and increase its prudential lending, through which it would open access to credit, which was the overall objective. These six policy areas had been recommended in the 2000 FSAP. Their relevance has been proven in the resiliency of Guatemala's the financial system in the 2006/7 "mini" crisis and the 2008/9 global financial crisis (see below). Relevance of design is rated ***high***.

4. Implementation

19. The first FSAL tranche was released on loan effectiveness based on the prior Congressional approval of four major financial sector reform laws. The main conditions for disbursement of the second and third tranches were: continued macroeconomic stability, passage of the regulations for implementing the four laws, strengthening of the BGUAT, improving bank regulation and supervision, carrying out whatever bank resolution transactions were necessary, implementation of the Anti-Money Laundering Law, and operation of the credit information system. As discussed below, the tranche conditions were met with two waivers and two partial waivers, which were not important. The third tranche was released on December 30, 2006 and the loan was closed in March 2007. The closing date of the loan was first extended from November 2004 to December 31, 2005 as a result of delays in meeting the second tranche conditions, which were ultimately met. There was one waiver of tranche conditions in November 2004, which was appropriate as discussed below. Thereafter, the government and parliament initially felt that incurring the additional external debt and the conditions for the third tranche might not be needed. However the failure of a bank in October 2006 made it clear that the funds would be needed. Hence, the FSAL was extended to March 2007 and the accompanying FTAL was extended to 2009.

20. The IMF approved a precautionary Stand-by of US$100 million in April 2002 (which was not drawn-upon, although the IMF regularly reported on progress) and the Inter-American Development Bank approved a US$200 million supporting financial sector reform in May 2002 that was not directly linked to the Bank loan by parallel conditions.

5. Achievement of the Objectives

Policy Areas

Maintaining a supportive macroeconomic policy framework

21. Macroeconomic stability indicators were satisfactory during the course of the FSAL (Appendix B-2). This is not surprising given Guatemala's traditional orientation toward macroeconomic stability and the IMF Stand-by that was on-going during the FSAL. As shown in Table B.1, the fiscal deficit remained under 2 percent of GDP. Credit growth remained low except in 2006, the last year of the loan; it returned to less than double digit levels in 2007. The outcome of these policies, in the context of domestic and international developments, was quite stable. Inflation remained under double digits and declined during the course of the loan. The current account did rise slightly, as a percentage of GDP, but this was in the context of rising capital inflows, which offset the current account deficit and produced a rise in international reserves and a slight appreciation in the exchange rate.

Guatemala--Selected Macroeconomic Indicators (1998-2009).

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP growth [a]	5.0	3.8	3.6	2.3	2.2	2.5	3.2	3.3	5.4	6.3	3.3	-0.3
Fiscal Deficit [b]	-2.2	-3.3	-2.2	-1.9	-1.0	-2.6	-1.1	-1.7	-1.9	-1.7	-1.8	-3.1
Credit Growth [a]	27.3	9.9	5.8	8.0	4.6	*	9.3	5.4	24.1	13.3	9.7	-3.4
Inflation in Prices Y/Y [a]	4.9	6.0	7.6	8.0	5.5	7.4	8.4	6.4	6.5	12.6	1.9	4.9
Current Account [b]	-5.4	-5.6	-5.5	-6.0	-5.3	-4.2	-4.9	-4.5	-5.0	-4.2	-4.5	-0.6
Current Account [c]	-1.0	-1.0	-1.0	-1.3	-1.2	-1.0	-1.2	-1.4	-1.6	-1.7	-1.8	-0.2
International Reserves, year-end [c]	1.3	1.2	1.7	2.3	2.3	2.8	3.4	3.7	3.9	4.1	4.4	4.8
Exchange rate [d]	6.8	7.8	7.7	8.0	7.8	8.0	7.7	7.6	7.6	7.6	7.5	7.5

[a] percent per year [b] percent of GDP [c] billion dollars [d] Quetzales per dollar, year-end
*Series revised.
Sources: IMF, World Bank.

Reform of the legal framework for monetary and financial policy

22. The Central Bank Law and the Monetary Law were two of the four laws passed by Congress in April 2002 and were a prior action of the FSAL first tranche disbursement. These laws had been recommended in the 2000 FSAP as reforms of the existing complex and overlapping laws, and the Bank and the IMF supported the government in drafting the laws. The Team Leader of the FSAP and the Country Director made presentations to Parliament on the need for the laws, which played an important role in their passage. The main results of the Central Bank Law were to increase the Central Bank's autonomy, the statement of price stability as the objective of the Central Bank, and the formalization and limitation the lender of last resort facility to short term, collateralized loans. Although not part of the law, the BGUAT also began to strengthen the payments system and move to a

Real Gross Time Settlements (RTGS) payments system in 2002; it became operative in 2006 and is undergoing further improvement. The Monetary Law modernized monetary legislation, particularly in exchange policy, making the currency convertible and allowing for the free movement of capital.[3]

23. Perhaps the most important result of this legislation was the control of risks to/losses by the BGUAT through the tightening of the lender of last resort facility and the beginning of the RTGS payments system. Prior to the new law, the unrestricted liability of the BGUAT as a lender of last resort and guarantor of the payments system had led to large unwarranted creation of money, often at the wrong time. It also created subsidies for owners of weak banks and large losses to the BGUAT that could later hinder its ability to carry out monetary policy. Under the new system, the BGUAT no longer has any legal risk from the payments system because of the RTGS and had made no lender of last resort loans from 2002 until recently. The reforms also led to the Ministry compensating the BGUAT for its net annual losses from its monetary operations, and amendments to the Bank Law have now made this an annual legal obligation. The waiver of the loan condition to completely recapitalize BGUAT for past losses, which had been rejected by the Congress, was unimportant as the Congress's proposed recapitalization would have been a notional account--a 100 year non-interest bearing, non-tradeable bond. The setting of price stability as a target was desirable; it may have had an impact on the decisions of the Monetary Board, which decides on monetary policy but its composition still includes representatives of groups that might have been interested in excessive monetary creation. In addition, as in other countries, the objective of price stability was later interpreted as a reason to sterilize the purchases of foreign exchange that were made to prevent an exchange rate appreciation. This policy implied costs to the BGUAT because of a negative spread on earnings from its international reserve holdings relative to its liabilities created for sterilization; it may also have contributed to payments from the Ministry of Finance to BGUAT.

Reform the financial sector legal framework

24. The principal reforms of the legal framework for regulating and supervising financial groups were undertaken under the Banking and Financial Groups Law, a third financial reform law passed in April 2002, with its regulations issued under the FSAL's tranches. The law set norms for bank licensing; provided for regulation and supervision of offshore banks and the consolidated supervision of bank groups on- and off-shore; and established a stronger bank regulatory framework including capital rules. The law also established the framework for better bank governance and the disclosure and dissemination of information by the banks and the financial conglomerates, as well as the framework for moving to international accounting standards. In addition, the Law set-up bank resolution procedures and exit mechanisms and a) a Fund for Protection of Savers (FOPA), which provided for moderate deposit insurance (20,000 Quetzales or under US$3000) for deposits[4] that were financed by fees on banks, and b) a fund to support bank resolution, for example takeovers of weak banks by stronger banks, in processes similar to those used by the Federal Deposit Insurance Corporation (FDIC) of the US. Both funds

[3] In 2001, bank deposits and loans in foreign exchange were permitted.
[4] See Demirgüç-Kunt, Karacaovali, and Laeven, (2005).

were initially capitalized using fund related to the FSAL. The law also set-up the basis for credit information system that can be used by banks to assess clients and for risk management and exposures to related parties by supervisors; a system that is now fully functioning. The FTAL played an important support role to this sub-objective, in particular in the drafting and set-up of the deposit insurance system, the bank resolution system, and the credit information system. In addition, the Bank Supervision Law, a fourth financial reform law passed in April 2002, strengthened banks' credit risk management as discussed below. Finally, as part of the supported reforms to increase access, an insurance law and a secured transactions moveable property law were presented to the congress and both have been passed. A Microfinance (non-bank financial institutions, NBFI) Law was also presented to the congress but still was not passed as institutions in the microfinance sector were diverse and were concerned that a new law would overly favor one segment or another of the institutions. In 2011, the Superintendent of Banks drafted another version of the law, which included the possibility of mobile banking, for submission to the Parliament that took office after the 2011 election.

25. Although the Parliament has not passed the Microfinance Law that was submitted under the FSAL, small scale and micro lending and small depositors' access to deposits have grown substantially. Within the banking sector, BanRural (Banco de Desarollo Rural) has expanded dramatically, to become the 3rd largest bank in the country. BanRural, which started about 12 years ago, is owned 18 percent by the Government and 82 percent by co-ops, it also has some subordinated credits in its capital. It has well over half of Guatemala's bank branches, with 72 percent in rural areas in all parts of the country, all connected by internet. It has about 600,000 loans on its books (equivalent to about 5.5 percent of GDP in value, which is a large ratio for a bank focused on small scale and micro finance) and 2.7 million deposit accounts (Guatemala's total population is about16 million). Performance on its loans has been good and it has 200 percent provision of NPLs. It now not only offers banking services but various types of insurance. BanRural has also set up an internal system of information on micro-credits and has been trying to get other banks to contribute to it. In the non-bank sector, Savings and Loan Cooperatives, which on average serve somewhat smaller borrowers than the banks, have also grown rapidly, nearly doubling in lending between 2004 and 2008 and account for about the same amount of micro-credits as banks. Micro-finance institutions that do not take deposits can operate without the Microfinance Law; at end-2011, there were 23 such institutions with over 200,000 loans that had an average loan size of US$ 529 and totaled US$ 104 million,. The total loans of these microfinance institutions rose 23 percent compared to 2010.

26. The Banking and Finance Law made major steps to strengthen bank supervision, create consolidated supervision that included offshore members of a group, and set-up a modern bank resolution framework. All of the reforms were recommended in the 2000 FSAP. The previous lack of consolidated supervision of off-shore members of a group had long been recognized as a problem. Similarly, the lack of deposit insurance and a more modern bank resolution framework had made exit difficult and led to losses by the BGUAT that had had to carry out closures when a bank's illiquidity in the payments system had been too large. Since the passage of the law, the Superintendency has been able to license offshore banks owned by Guatemalans, collect information from them, and

supervise them and their operations as part of a financial group. The bank resolution framework and the deposit insurance were used in the exit of two banks. All of these developments indicate the importance and success of this law and the FSAL's support to the reform.

27. The Banking and Finance Law and the FSAL had less direct effect on access to credit. The credit information system (put into full operation soon after a partial waiver in the third tranche of the FSAL) has helped banks and financial companies to identify loan risks and has been widely used by them. SIB has also used the system to assess risks in banks and, more recently, systemic risks. SIB also can use it to assess concentration of a bank's lending by a bank, but the regulation on this issue has only been strengthened recently. However, the value of the system depends heavily on the uniqueness of the identification of borrowers in the system, which may be an issue.

28. Regarding the usefulness of the credit information system for expanding access to microfinance, the size of the borrowers that are included in the system is large relative micro-borrowers, as is often the case with systems designed for use of the central bank and banks. This reduces its usefulness for this group of borrowers. Some of the larger microfinance nongovernmental organizations (NGOs) use a credit information system that pre-dates the bank-focused credit information system.

29. A NBFI law was submitted to congress in 2006, but still has not passed. This situation leaves these institutions without a good legal framework. The cooperatives, which are major lenders to micro-borrowers, are covered under the cooperative law but experience in other countries has shown this is an undesirable approach for such financial activities.

30. The Insurance Law, which was submitted to Congress during the FSAL, was finally passed in 2008. It will help the financial system move away from its bank-domination, and it allows foreign insurers to operate in Guatemala. The Law of Moveable Property (Collateral), also submitted to Congress under the FSAL, was passed in two parts, October 2007 and September 2008. It will help borrowers use the collateral of moveable property for loans. However, much of its effect will depend on the quality of the collateral registry and the ability to enforce collateral through the judicial system, both of which are still issues.

Reform of banking supervision

31. The Banking Supervision Law, together with the Banking and Finance Law discussed above, were major factors in improving supervision of the financial sector. The Banking Supervision Law was a fourth financial reform law passed in April 2002, with its regulations and the carrying out the action plans of the Superintendency of Banks regarding risk-based supervision and consolidation as conditions of the FSAL's tranches. The law defined and extended the functions of the Superintendency of Banks, increased its autonomy, increased its power to sanction non-compliance, and provided greater protection for the supervisors. These two Laws formed the basis of much stronger supervision of banks and opened the possibility of consolidated supervision, including offshore banks. Again, these improvements were all recommended by the 2000 FSAP.

The FTAL provided technical assistance for improving the quality of supervision under these laws, including consolidated supervision and the beginnings of risk-based supervision.

32. There are various indicators of the improvement in supervision. Data are now available on offshore as well as onshore banks and conglomerates. The FSAP Update of 2005 noted an improvement in supervision, but that substantial further improvement was needed. Moreover, effective improvement in supervision is difficult to judge, since the actual enforcement of supervisory results has a political, as well as a technical component. In this regard, Guatemala performed well in 2006 and 2007, notably in its actions against Banco Café, which were related to its offshore activities and that finally resulted in its closure in 2006; and Banco Comercio, which was closed in 2007.

Enactment of legislation to prevent money laundering, reduce illegal activities and comply with international norms

33. In December 2001, Guatemala enacted an Anti-Money Laundering Law. The law established the creation of an Anti-Money Laundering (AML) Unit in the Superintendency of Banks. By the end of 2002, the unit became operable and the Financial Action Task Force (Review Group for the Americas) indicated that Guatemala met all its 25 qualification criteria. In 2004, Guatemala was taken off the list of GAFI's non-cooperative countries. Although the Anti-Money Laundering Law was passed before the FSAL, it helped to improve its effectiveness by support for the four major laws, which provided the basis for offshore supervision. The FTAL provided technical assistance, training and funds for hardware acquisition to the Anti-Money Laundering Unit.

Consolidation of the banking system

34. In part, the weakness of the Guatemala's banking system prior to 2002 reflected the large number of banks (31), many of which were small, as noted above. The decline in the number of banks since then has reflected closures by the Government/SIB of Guatemala and, in the last three years, exits of banks by takeovers[5], although there have been no runs nor formal measures to force consolidation, for example, by raising minimum capital requirements as has been done in such countries as Egypt and Pakistan. The decline in the number of banks reflected the end of niche banking and the increased competition, according to bankers in Guatemala. There have also been two takeovers of small banks by well-known foreign banks, as way of entry into Guatemala.

35. The government had initiated closure of some weak banks prior to 2005 and merged two other weak banks into the government owned mortgage bank. After the bank resolution procedures and the resolution and deposit insurance funds were established, with support of the FSAL, two more banks were intervened and resolved in 2006/2007 by measures envisaged under the new Law—in one case disbursal of deposits among some other banks, in the other a transfer of deposits and assets to the largest bank in the system,

[5] In three cases, Bank Capitalization Fund has provided resources to help cover the minimum capital requirements for banks taking over other financial institutions, thus contributing to the consolidation of the financial system.

in both cases with support from the deposit insurance fund and, to a smaller degree, the bank resolution fund. Both resolutions were done reasonably rapidly.

36. The latter two bank resolutions indicated the success of the new approach. They also indicated the need to strengthen risk-based and consolidated supervision further. In addition, they indicated the need to ensure sufficient funding of the deposit insurance system, which was recapitalized in this case by funds from the Government, an increase in premiums, and secured loans from some banks. [6]

37. Since the failure of the two banks in 2006/7, the number of onshore banks has continued to decline, to 18 in December 2009. This decline has occurred although there have been no bank runs, even in the 2008/2009 crisis. The share of the largest 3 banks has almost doubled since 2001.

Outcomes

38. The FSAL's support substantially strengthened the BGUAT, the payments system, bank regulation and supervision, the resolution framework for weak banks, and anti-money laundering policies. These results were noted in the 2005 FSAP Update, which also pointed out much remained to be done. In 2006-2007, two weak banks were intervened before a major run developed and resolved using the new bank resolution framework supported by the FSAL and FTAL, without generating a systemic financial crisis. This result reflected the FSAL's support in strengthening the Superintendency of Banks (SIB), the new bank resolution framework and the capitalization of the bank resolution and deposit insurance institutions that were needed to carry out this best practice intervention and resolution Reported capital to risk weighted ratios in the remaining banks at that time exceeded the legal minimum of 10 percent; much higher than the adjusted ratio at the time of preparation of the FSAL. Reported average NPLs were about 5 percent compared to 8 percent in 2002. Although these figures represented a substantial improvement, they may still have overstated the quality of the system because of the low ratios of provisioning to NPLs and the rolling-over ("evergreening") of weak loans. Bank credit to the private sector had increased somewhat, but it still remained only about 28 percent of GDP and its annual growth was quite variable (Table B.2), with some of the rapid growth related to increased consumer lending, in which the banks had little experience.

39. The financial system also appears to have been resilient to the 2008-2009 crisis. Partly this resiliency reflects the financial system's lack of exposure to complex derivatives and synthetic instruments,[7] as well as the lack of mortgage lending, but it also reflects the maintenance of high liquidity and limited leveraging. In 2009 and 2010, reported average capital remained about 15 percent of risk weighted assets, well above the 10 percent required minimum. Reported NPLs in 2009 and 2010 were less than 3 percent

[6] The deposit insurance agency (FOPA) is funded by fees paid by the banks, which are all members. The need to resolve two banks almost immediately after FOPA was set up meant that it had not built up sufficient assets to pay-off depositors. The gap in available funds was covered by a loan from the banks that was repaid from future deposit insurance fees—the loan is now almost completely paid off.

[7] There may have been some exposure in offshore parts of the conglomerates and their owners.

with much higher provisioning than in the past because of strengthened regulations on provisions. Bank deposits continued to grow and credit growth declined only marginally.

40. However, the international crisis had two important, indirect, traditional effects. First, the slow-down in the industrial countries led to a slowdown in Guatemala's exports and remittances, and a drop in GDP growth, all of which are likely to increase NPLs. So far, reported NPLs have not increased much and on average, provisions are reported to fully cover all NPLs (Annex Table 1). Second, the decline in foreign credit lines to Guatemalan banks, may have contributed somewhat to the reduction in credit growth. However, banks' net foreign borrowing had traditionally been small relative to domestic deposits as a source of credit. A more important factor in the decline in credit growth after 2007, according to Guatemalan banks and producers, was the slow-down of the economy, which led to a corresponding decline in demand for credit.

41. According to these outcomes and the reported data by the Superintendency (SB), the banking system now appears to be more resilient to international crises, a resiliency in which the FSAL played a role by supporting consolidation and the strengthening of prudential standards and supervision. No bank has failed since 2007; the weak/niche banks have been taken over by national banks or new foreign entrants. Although credit to the private sector has declined slightly relative to GDP, the system-wide reported average capital to risk weighted assets exceeded 15 percent in 2009. Reported NPLS are under 3 percent (Annex Table 1), and their provisioning is much higher in 2009 than in 2007. According to views expressed by bankers and businessmen in Guatemala, banks' risk analysis has improved, in part because of the credit information bureau supported by the FSAL. The strengthened BGUAT has taken a more active monetary policy role, by easing the availability of liquidity facilities, easing reserve requirements, and lowering the policy interest rate. Supervision seems to have improved according to comments from banks and businessmen in Guatemala. The World Bank made DPLs in September 2008 ($200 million) and April 2009 ($350 million) aimed at poverty reduction and improvement in governance and fiscal management; they also included support for further strengthening of bank regulation and supervision and reforms of debt management that would contribute to deeper debt markets. The IMF also supported Guatemala with a precautionary $935 million Stand-by in April 2009, which has not been drawn upon.

6. Ratings

OUTCOME

42. Actions under the operation's six policy areas related to the financial sector contributed substantially to the overall development outcome sought by the operation of "bringing about a stronger and better functioning banking sector, able to withstand external shocks and to increase prudent lending to the private sector, opening access to groups and enterprises largely excluded from bank financing". Overall, the achievement of the operation's development outcome (efficacy) is rated by this review ***substantial***. The relevance of objectives is rated ***high***, while the relevance of the design of the operation is rated ***high***. Based on these ratings for efficacy and for relevance of objectives and design, this review rates the Overall Outcome of the FSAL ***Satisfactory***.

RISK TO DEVELOPMENT OUTCOME

43. The risk to the Developmental Outcome after the closure of the loan were anticipated by the possible failures in issuing regulations for the new laws, and then implementing them. These risks were mitigated by conditioning the tranche releases on the new regulations and performance of the SBI in implementing its plans for improvement and by providing support through the FTAL. A second risk was that some banks would be forced into failure materialized after the loan's closure in March 2007. Two banks actually failed at the end of 2007 and the beginning of 2008, after the loan's closure. However, the support of the FSAL permitted the Government to provide enough resources to resolve these banks under new procedures, as outlined in the FSAL. Guatemala's financial system did not experience a crisis after these two bank failures nor in the global crisis after October 2008. Risk to development outcome is rated ***moderate***.

MONITORING AND EVALUATION

44. **Design.** The policy areas and the associated actions in the Policy Matrix and tranches for the FSAL were an effective tool in monitoring the main program results. The actions under the policy areas were carefully synchronized with tranche releases to implement the reforms needed to obtain the overall objective. These actions were generally observable quantitatively and made a clear "results framework", which was linked to the funding of the FSAL tranches and were not affected by exogenous factors. For example, the legal framework for monetary and financial policy was reformed by passage of the four laws that were prior conditions of the FSAL; the passage of the regulations that were needed to implement the laws was a second tranche condition. The strengthening of the financial sector legal framework; to regulate financial groups, create an orderly exit mechanism, develop a credit information bureau, enhance credit risk management, and increase lending and encourage access to finance were also directly observable and part of the tranche conditions. Data on off-shore banks was included in the Superintendent's published reports; the deposit insurance and bank resolution institutions were created and performed well in the 2006/7 crisis discussed below. A credit registry was created that is widely used and praised by the banks. The amount of lending to the private sector is directly reported. Similarly, the passage of an Anti-Money Laundering law was directly observable and part of the prior conditions of the FSAL. The consolidation of the financial system was directly observable in the decrease in the number of banks, which was partly the result of the intervention and resolution of two banks by deposit insurance and resolution institutions that had been created and supported by the FSAL under tranche conditions. Only the qualitative target for improving supervision was not directly observable.

45. It should be noted that in the results framework (?) increased access to finance was treated as a result of the increase in prudent financial sector growth. The substantial growth of a bank focused on small depositors and borrowers has provided a major increase in access to finance, as well as the growth of co-ops, which were not part of the loan. The tranche conditions also included the submission of a draft non-bank

intermediary law to parliament—such institutions also often provide access to finance.[8] However, this law was not approved by Parliament. In fast disbursing loans at the time of the operation, loan conditions related to laws were always the submission of draft laws to Parliament; in contrast to the current approach to DPLs in which the loan is based on prior actions such as actual passage of law.

46. Three quantitative outcome indicators were added to the FSAL in 2005, one year after the project's original, projected closing date, in response to Bank-wide changes in the reporting of DPL performance. These indicators were: consolidated supervision of all financial groups, increase in banks' profitability (as an indicator of their soundness), and improvement in the quality of the banks' portfolio. They were all achieved, as shown in Appendix B-2.

47. It should be noted that although these three indicators are relevant as standard ways to measure a banking system's strength and its supervisory framework, unlike the six policy areas, their quality is heavily dependent on the unobservable variable of the improvement in supervision quality, as well as exogenous factors. Numerous countries have reported better supervision of banks, better rates of return, and better quality of bank portfolios, only to experience a crisis that revealed substantial problems that were either not recognized by the supervisors or on which action had not been taken. Even if the quantitative measurements are correct, these indicators have potential shortcomings, for example, profits can be raised by undertaking risky lending and non-performing loans are a lagging indicator of a banking system's health because loans initially grow faster than "overdue loans" a process that can be continued for some time by overdrafts and "evergreening" of overdue loans. Moreover, these quantitative indicators are not directly related to elements under control of the government, unlike the policy areas/indicators. However, this problem did not represent a major shortcoming in the original project design, because the quantitative indicators were added only after the original forecast closure of the project, in response to a change in Bank monitoring procedures.

48. **Implementation and Utilization.** During supervision missions, the Policy Matrix and appropriate sections of the legal agreement served as the primary M&E tool. The information and data from supervision missions on compliance with tranche releases, as well as political changes that could have potentially affected the pace and quality of implementation, and updates on financial sector performance, were effectively used by the Bank to monitor the operation, make decisions about technical assistance needs and funding, and rate the progress of the operation. Based on these considerations, the overall quality of the M&E framework is rated ***substantial***.

BANK PERFORMANCE

49. Quality at entry. As elaborated above, the Bank's adjustment operation was well designed to support a number of necessary financial sector reforms identified in and based on the analytic work of the FSAP. Risks associated with the FSAL were clearly identified

[8] Also, the meaning of access to finance has changed substantially since 2002; it now includes access to deposit and money transfer services, as well as credit, which was the main focus of access to finance in 2002.

at appraisal and spelled out in the Program Document as well as means of mitigating them that were effective. An appropriate M&E framework was designed (see above). Quality at entry is rated by this review ***highly satisfactory***.

50. Quality of supervision. Project Status Reports (PSR) and Implementation Status Reports (ISR) were completed on schedule, including back-to-office reports produced by supervision missions prior to the introduction of ISRs. The supervision missions were appropriately scheduled. Overall, the performance of the Bank was supportive, involved, and actively engaged. The Bank's support included: (i) intensive post-FSAP technical assistance to the Government in drafting financial sector legislation in coordination with the IMF and the Inter-American Development Bank; (ii) active engagement with the Guatemalan Congress to ensure understanding and support for the reforms; (iii) coordinated technical assistance through the technical assistance loan to the Central Bank of Guatemala and SIB, to implement the reform program; (iv) implementation workshops; and (v) frequent supervision missions (11 in total) that clearly spelled out the status of the loan and made only a few waivers in conditions as were appropriate. The Bank provided intensive assistance to the BGUAT and the SIB in implementing the new bank resolution mechanism. The authorities praised this assistance and requested the extension the FTAL to receive further Bank assistance. Quality of supervision is rated ***highly satisfactory***. According to these ratings, overall Bank performance is rated ***highly satisfactory***.

BORROWER PERFORMANCE

51. The achievement of the FSAL's development objectives was the result of the strong and continued commitment to the financial sector reforms at key levels of government and through two administrations, as well as by the SIB. The FSAP recommendations were accepted by government and were appropriately incorporated into the Loan's reform program. At the same time the authorities diligently sought Congressional approval for the new financial sector framework and the FSAL and FTAL. The first set of laws quickly received Congressional approval. However, the laws on Insurance and Movable Property took some time to be approved and Congress has thus far resisted passage of a Microfinance Institution Law. The Ministry of Public Finance and the Monetary Board along with the implementing agencies (BGUAT and SIB) performed satisfactorily in strengthening banking supervision and regulatory oversight, and in the resolution of failed banks even at the expense of affecting entrenched financial interests. Improvements in supervision by SIB have been somewhat slower than desired, but are gradually taking effect, notably in response to the 2008/2009 crisis. Borrower performance is rated ***satisfactory***.

7. Lessons Learned

52. **The quality of the technical analysis and the interaction between AAA, Lending, and Technical Assistance and the government is crucial to a loan’s success**, particularly in the financial sector. The 2002 FSAL policy conditionality was based on the findings of the 2000 FSAP and further technical analysis conducted during preparation. The high quality of the technical analysis in these two instruments was crucial to engage the government’s commitment to the reform agenda during preparation of this operation. This included interactions between the FSAP team leader and the Country Director with

the Parliament. High quality technical analysis and advice was also carried out during supervision. This continued technical and policy dialogue with the authorities and their technical teams was important to maintain the authorities' ownership and commitment to the FSAL development objectives during the course of two administrations. The high quality of TA under the FTAL was critical in setting up the deposit insurance and bank resolution agencies and in setting up the legal authority to carry out bank resolution, which was tested in 2006/2007.

53. **Policy based operations may require strong Bank technical assistance efforts as part of the process, particularly in the financial sector**. The FTAL provided crucial technical assistance to strengthen the capacity of BGUAT and SB, to implement the reform actions supported by the FSAL. Supervision missions of both loans also provided timely technical assistance and advisory services to the implementing agencies including after the failure of the fourth largest bank during the second half of 2006. This intense level of technical assistance efforts is often crucial for the success of policy-based operations, but the needed resources are not always available to Bank teams, if there is no parallel technical assistance loan. Although "free" TA may be available from non-Bank sources, the coordination with Bank financed institutions can be too slow and complex to achieve the best results for the country. Even if there is a technical assistance loan, it cannot be used to fund Bank staff, which sometimes are the best qualified to provide the technical advice needed for effective implementation of the loan conditions. Mechanisms are needed to fund this type of Bank-provided technical assistance in ways that do not impinge on the usually limited preparation and supervision budgets.

54. **Multi-tranched financial sector adjustment operations are effective instruments to support major financial sector reforms**. The success of the FSAL/FTAL shows that a multi-tranched adjustment operation can be very effective in cases of major financial sector reforms that involve the enactment of new basic legislation and its regulations, and the institutional strengthening of the agencies in charge of implementing the reforms, particularly agencies that carry out bank resolution. A multi-tranched adjustment operation can support the process of reform at different stages and respond to unforeseen challenges that could derail the reform process. Programmatic loans may also be effective in supporting reform programs, but may not be able to provide the hand-holding necessary to obtain the best results from major reform processes.

Appendix 1. Basic Data Sheet

Guatemala Financial Sector Adjustment Loan (Loan No IBRD-71300)

Key Project Data (US$ 150 million)

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	350.0	150.0	100
Loan amount	150.0	150.0	100
Cofinancing	200.0	–	–
Cancellation	–	–	–

Project Dates

	Original	*Actual*
Initiating memorandum	9/10/201	10/12/2001
Negotiations	–	5/7/2002
Board approval	4/1/2002	6/25/2002
Signing	–	–
Effectiveness	12/18/2002	–
Closing date	6/30/2004	3/30/2007

Staff Inputs (staff weeks)

Stage of Project Cycle	*Staff Time and Cost (Bank Budget Only)*	
	No. of Staff Weeks	*USD Thousands (including travel and consultant costs)*
Lending		
FY02	27	165.04
FY03		208.93
FY04	1	12.36
FY05	–	–
FY06	–	–
FY07	–	–
Total:	**28**	**166.31**
Supervision/ICR		
FY02	–	–
FY03	5.5	41.47
FY04	17.85	111.76
FY05	2.28	43.54
FY06	7.35	55.73
FY07	11.5	110.42
Total:	**44.48**	**362.94**

Mission Data

Stage of Project Month/Year	Count	Specialty	Performance Rating: Implementation Progress	Performance Rating: Development Objective
Lending				
	7	TTL (1), Sector manager (1), Regional Financial Services Advisor (1), Lawyer (1), Team members (3)	–	–
Supervision				
	7	TTL (4), Country Economist (1), Team members (2)	S	S

Appendix 2. Additional Data

Banking Indicators

End of	2001	2002	2003	2004	2005	2006	2007	2008	2009	6/2010
Number of Banks		31	29	28	25	24	21	19	18	
NPLs % of Gross loans [a]	8.1	7.9	6.5	7.1	4.3	3.4	2.6	2.3	2.3	2.8
Statutory Capital to Risk Weighted Assets % [a]	14.1	14.9	15.6	14.5	13.7	13.6	13.8	13.6	15.4	15.1
Capital to Assets %	9.3	8.8	8.2	7.2	6.3	6.6	7.1	7.4	8.7	9.3
Rate of Return on Equity	11.6	8.5	12.2	15.3	15.2	15.0	16.8	16.3	15.7	18.1

[a] Anecdotal estimates suggest that substantial under-estimates of NPLs and under-provisioning of NPLs existed before 2004, meaning that capital was substantially over-estimated.
Source Superintendente de Bancos Guatemala, IMF. Article IV Consultations.

Appendix 3. List of Persons Met

Government	
Bank of Guatemala	Edgar Barquin Duran, President (and former head of the Superintendency of Banks) Julio Suarez, Vice President Waleska Marilu Garcia Corzo, Subdirectora, Analysis Bancario y Financiero
Superintendency of Banks	Guadalupe Barral Caballero, Coordinatora de Proyectos de Asistencia Tecnica, Unidad de Asuntos Internacionales (former interlocutor on the 2004 FSAL) Other Staff of the Superintendency
Ministry de Finance	Alfredo del Cid, Ministro Mayra Palencia Prado, Director Public Credit
Ministry of Economy	Abel Francisco Cruz, Vice Ministro
Superintendency of Tax Administration (SAT):	Manfredo Chocano, Manager of Planning and Institutional Development.
Private Banks	
Citibank:	Carlos Prera Estrade Vice President Risk Management
Banco Industrial:	Luis Jorge Sifontes, Vice President Correspondent Banking
Banco G&T Continental:	Erwin Prera Soria, Corporate Manager, Finance Roberto Ortega Herrera Manager
BanRural:	Aram Sergi Walter Garcia, Asst. to the President (formerly in Superintendente Bancaria)
Coordinating Committee of Associations of Agriculture, Commerce, Industry and Finance	Carlos Amador, President Juan Antonio Busto President Chamber of Industry

Annex C. Morocco Financial Sector Development Policy Loan (Loan No. IBRD-73500)

Principal Ratings

	*ICR**	*ICR Review**	*PPAR*
Outcome	Satisfactory	Satisfactory	Satisfactory
Risk to Development Outcome	Negligible to Low	Negligible to Low	Negligible to Low
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Highly Satisfactory	Highly Satisfactory	Highly Satisfactory

* The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (OED) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Appraisal	Samir El Daher	Hossein Razavi	Theodore *0*. Ahlers
Completion	Catherine Burtonboy	Zoubida Allaoua	Mats Karlsson

1. Summary

Economic developments

1. In the decade prior to the 2005 loan, Morocco implemented successful stabilization programs and pursued prudent economic, fiscal, monetary and debt management policies, and financial sector reforms. These stimulated economic growth while maintaining price stability. The ambitious program of structural reforms covered many areas and included trade facilitation, customs reform, telecom privatization, agriculture and public sector modernization, and financial sector liberalization.

2. The successful privatization of several state enterprises attracted foreign direct investment, which coupled with strong and steady flows of remittances from Moroccans abroad and tourism receipts, led to a significant increase in international reserves. An active debt management strategy helped reduce debt servicing payments and lowered interest and exchange rate risks. The public debt fell from 76 to 47 percent of GDP between 2000 and 2008.

3. The policies adopted after 2004 contributed to a significant acceleration of economic growth, creating employment opportunities for a rapidly expanding labor force. Per capita income almost doubled over the decade, while unemployment fell from 14 to slightly below10 percent. Growth also became less volatile and less dependent on agriculture. The investment rate increased sharply from 25 to more than 35 percent of GDP, raising some concerns about the efficiency of investment and the relative role of housing and the construction sector.

4. Although the Moroccan banking sector was not directly impacted by the global financial crisis, the economy suffered from the retrenchment of capital flows and the decline of receipts from exports, tourism and remittances. However, Morocco was able to manage well the adverse effects of the global financial crisis and to preserve a reasonable growth performance. This was helped by strong agricultural production performance that benefited from favorable weather conditions. The current account of the balance of payments shifted into a deficit of more than 5 percent of GDP in 2008. The poor export performance was linked to the contraction of export markets, but also reflected the low diversification of exports and an underlying problem of lack of competitiveness.

5. The authorities adopted several stimulus packages to support the incomes of different groups and stimulate public investment, especially in infrastructure, by both the general government and the large number of public enterprises. These resulted in a sharp deterioration of public finances from an annual surplus of 0.4 percent of GDP in 2008 to a deficit of over 4.5 percent in 2010. With inflationary pressures low, the central bank lowered its key policy rate and gradually reduced reserve requirements from 15 percent in December 2008 to 8 percent in October 2009.

6. Moroccan banks did not hold toxic assets and did not rely on wholesale funds to support their lending, but they had expanded their financing of infrastructure, housing and small and medium enterprises (SMEs). At the same time, microfinance institutions engaged in a rapid increase of microcredit that was funded by borrowing from banks, with microcredit growing at an average rate of 84 percent between 2004 and 2007. Growing difficulties emerged in two of these areas. Microcredit suffered from high levels of nonperforming loans, rising from less than 2 percent before 2007 to 12 percent in September 2009, while the real estate sector experienced an abrupt fall of sales of housing units targeted to nonresident, mainly European, buyers. The central bank took steps to ensure the resiliency of the banking system by raising the minimum capital adequacy ratio from 8 to 10 percent of risk-weighted assets in 2008, encouraging mergers of microfinance institutions, introducing a regional real estate price index, and indicating its intent to raise the capital adequace rate (CAR) to 12 percent for institutions with significant risk concentrations in real estate or other sectors.

7. Bank credit experienced a significant slowdown, with its growth rate falling from nearly 30 percent in 2008 to less than 18 percent in 2009. This was a welcome correction to the very rapid growth of preceding years. Economic recovery and the resumption of faster credit growth will depend on global developments and especially on economic prospects in Europe. The tight conditions in the real estate market are for the time being affecting the financial prospects of property developers. It is unclear if any of the banks will suffer significant increases in non-performing loans (NPLs). The supervisory authorities are closely monitoring developments in this area.

Morocco's Financial Sector

8. The financial sector of Morocco is better balanced than those of other countries in the region. Insurance companies and pension funds are well established and have accumulated assets corresponding to nearly 40 percent of GDP. Mutual fund assets amount to 25 percent of GDP. Eliminating substantial double counting, because both

insurance companies and pension funds invest extensively in mutual funds, the assets of institutional investors exceed 50 percent of GDP. However, despite the relatively strong presence of institutional investors, the financial system continues to be dominated by the commercial banks, which account for 55 percent of total financial assets (after the elimination of double counting). Compared to other countries in the region, Morocco is an outperformer. It is a regional leader in lending to SMEs and microcredit, the spread of life insurance, the development of mutual funds, and the presence of properly funded pension plans.

9. Morocco has always had large private banks that are prudently managed and operate with adequate capitalization and high profitability. Private banks represented 65 percent of total banking assets in 2008, up from 62 percent in 2003. The large private banks are universal banks with extensive interests in asset management and insurance. The government wields significant influence in the CPM group thanks to statutory provisions and control of more than 50 percent of the Banque Centrale Populaire (BCP), a large bank and the apex for eleven regional mutual banks. The CPM group is one of the three largest Moroccan banks with a 22 percent market share but its model of operation is very similar to that of the large private banks. A negative aspect of the prudent and conservative management of the large commercial banks has been their neglect of financial inclusion and the limited access to financial services by low-income groups. In contrast to the commercial banks, several other public sector banks have tended to be specialized in particular economic sectors and have suffered from high levels of NPLs, large losses, and inadequate capital.

10. Over the past 20 years, the Moroccan authorities have taken a long series of measures to reform the structure and functioning of the financial system. Most of these measures were supported by Bank operations, such as the Financial Sector Development Project of 1991, the Financial Markets Modernization Loan of 1995 and the Contractual Savings Development Loan of 1997. Early reforms included the removal of direct controls on bank credits, interest rates and compulsory bank investments in treasury bills, the adoption of indirect methods of monetary control, and the opening of the government bond market to nonbank investors. They also included several measures to stimulate the expansion of insurance business and the promotion of capital markets. These reforms were implemented on a gradual and incremental basis and did not affect the overall stability of the financial system.

11. However, several other measures that had been identified in these operations had not been fully implemented at the time of preparation of the 2005 Financial Sector DPL. These measures included the restructuring of the specialized public banks, the corporatization and partial privatization of BCP (the largest commercial bank that is under public control), the strengthening of insurance regulation and supervision, and the reform of the pension system to ensure its long-term sustainability.

12. The 2002 Financial Sector Assessment Program (FSAP) underscored that future challenges included improving the competitiveness of public banking institutions, developing the insurance and capital markets, strengthening the long-term balance of the pension system, modernizing the payment system, and pursuing the strengthening of the supervisory framework. It also noted that geographic coverage in banking services

remained low, with a small percentage of households holding bank accounts, while access to financial services for low-income groups was limited. Government still played an important role in the financial system through direct and indirect control of a large share of around 36 percent of domestic financial assets. These included 12 percent represented by the CPM group, 7 percent by the other public sector banks, 5 percent by the Caisse des Dépôts et de Gestion (CDG), and 12 percent by the public pension funds.

13. The authorities indicated their intention to disengage gradually from the financial sector and foster an enabling environment for the emergence of an efficient financial industry, led by the private sector, that would serve more effectively the country's development and growth objectives. To achieve this goal they took steps to improve the legal, regulatory, and supervisory framework and strengthen enforcement capacity in the financial sector. The ongoing restructuring of the public financial institutions was a prerequisite to improving the overall efficiency of the Moroccan financial sector.

2. Objectives and Design

14. The 2005 Financial Sector DPL was a two-tranche operation for an amount of EUR 166.3 million (equivalent to USD 200 million) to support continuing financial sector reform in Morocco. The loan was based on the findings of the 2002 FSAP and supported the government's program. The main development objective of the government's program and the 2005 Financial Sector DPL was **"to strengthen the enabling legal and institutional environment for financial intermediation and risk management and to increase the role and participation of the private sector in the provision of financial services"** (Loan and Program Summary). According to the Operational Policy Matrix, the operation encompassed three policy areas:

i. *Strengthening the legal, regulatory and supervisory framework of the financial sector* — by implementing an effective and modern legal, regulatory and supervisory framework, in line with international standards, across the banking, insurance, and securities markets so as to improve financial intermediation and risk-taking behavior, and foster a more efficient mobilization of savings;

ii. *Restructuring of state-owned financial institutions* — particularly by addressing the stock of non-performing assets of weak public financial institutions and streamlining their role and activities in the financial sector;

iii. *Enhancement of the financial sector's infrastructure, transparency and integrity* — by modernizing the payment system, improving the integrity of the financial sector through better anti-money laundering policies, and enhancing the quality of financial information in upgrading accounting and auditing standards.

3. Relevance of Objectives and Design

15. **Relevance of Objectives.** The operation furthered the strategic objective of the 2005-08 Country Assistance Strategy (CAS) of improving competitiveness and the investment climate and contributed to the attainment of the CAS outcome of strengthening a growth-oriented financial sector. It addressed the high level of non-performing loans in

public financial institutions, a weakness that had persisted for many years and had not been successfully resolved under previous operations. It also aimed at strengthening the legal and regulatory environment for financial sector operations and significantly upgrading the financial sector infrastructure. In addition, the loan promoted several governance-related objectives of the CAS, by increasing the autonomy of the banking sector supervisor while ending existing conflicts of interest between its supervisory and shareholding roles, extending banking supervision to the banking operations of a major public sector institution with a dominant presence in asset management, promoting greater autonomy of the insurance and capital market supervisors, and enhancing the quality of financial information available to investors. The Bank's support, which drew on the lessons of previous operations and the analytical findings of the 2002 FSAP, was highly appreciated by the authorities. The Bank's insistence on a pragmatic and sustainable resolution of the long standing financial problems of several public financial institutions was found particularly useful. Relevance of objectives is rated by this review ***high***.

16. **Relevance of Design.** The design of the operation as a two-tranche loan reflected both the Bank's and the authorities' assessment that the reform program represented a consistent package of mutually reinforcing measures that could be implemented over a 12 to 18 month timeframe. In this context, the first tranche aimed at locking in a set of basic policy measures, such as the adoption of new bylaws for the central bank and a new banking law, and at the same time supporting the reform momentum. The second tranche conditions covered measures that required more time for preparation.

17. The scope of the supported reform program was sufficiently broad and covered most of the policy issues identified in the 2002 FSAP. Two omissions concerned the absence of measures to strengthen the long-term balance of the pension system and the lack of any specific measures to promote financial inclusion. The authorities have for many years been studying the long-term sustainability of the pension system, with extensive Bank support. Over time, they have taken many steps to resolve specific problems, such as the insolvency of the railways pension fund or the challenge of enhancing the investment management of the assets of the national social security institution. However, government thinking and deliberations have not yet reached the stage where decisive action can be taken in addressing the long-term balance of the overall pension system. Since government ownership of the reform agenda is an essential factor of ultimate success, Bank staff did not insist on including pension reform measures in this operation, which is anyway quite complex.

18. On financial inclusion, no specified action was contemplated at the time of loan preparation. Morocco is a leader in microfinance in the MENA region. Microcredit operations are undertaken by specialized institutions that primarily rely for their funding on commercial banks. A rapid gain in outreach was under way at the time of loan preparation that obviated the need for the inclusion of special measures in this operation. But shortcomings in governance and internal controls and inadequate information on the total debt of borrowers created significant portfolio problems in microcredit operations in subsequent years. Measures to rectify these problems and strengthen the sustainability of access to finance have been included in the 2009 Financial Sector DPL. Based on the above considerations, relevance of design is rated by this review ***substantial***.

4. Implementation

19. The loan became effective on December 20, 2005 when the first tranche of USD 130 million equivalent was released. The release was based on conditions that were met prior to Board presentation and included the adoption by Parliament of the new bylaws of the central bank and the new law on credit institutions as well as several other conditions that required ministerial decisions or agreements to take specified actions.

20. The second tranche for the remainder of the loan amount was released on June 30, 2007 when the loan was closed. This was within the 12 to 18 months period indicated in the project document. Release of the second tranche was based on conditions that required implementation of several specified actions or results, such as the launching of a new RTGS payment system, liberalization of insurance premiums, and full compliance of CIH with prudential requirements as well as several other conditions that required ministerial decisions or adoption of draft laws.

5. Achievement of Objectives (Efficacy)

Policy Areas

Strengthening the legal, regulatory and supervisory framework of the financial sector

21. This policy area encompassed banking, insurance, and the securities markets. In the banking sector, the enactment of the new bylaws of the central bank and the new banking law increased the autonomy of the central bank and strengthened its authority to intervene in troubled banks. The central bank continued to expand its supervisory capacity, implemented a new bank rating system (similar to CAMEL)[9], and prepared a handbook of procedures for the treatment of financially troubled commercial banks. The rating system is used to target the on-site inspections and that about 25 groups are being monitored more tightly, of which 10 are in real estate financing. The new framework introduced consolidated supervision of related entities and made progress toward the adoption of risk-based supervision and Basle II capital standards. The scope of banking supervision was broadened to include the banking operations of the CDG that were not previously subject to any regulatory oversight, while both the Crédit Immobilier Hôtelier (CIH) and Credit Agricole du Maroc (CAM) were required to comply with the same prudential requirements as the commercial banks. The Banque Al Maghrib (BAM) has significantly improved its supervisory practices and has included stress testing and macroprudential simulation exercises among its supervisory tools. An important decision in 2008 increased the minimum capital adequacy ratio from 8 to 10 percent of risk-weighted assets to ensure the resiliency of the banking system, while the central bank indicated its intent to raise the capital adequacy rate (CAR) further to 12 percent for institutions with significant risk concentrations in real estate or other sectors. All commercial banks are compliant with the CAR. It is too early to judge the success of the 12 percent requirement. Of course, a higher minimum CAR across the board does not address the risk of institutions with particular exposure in potentially volatile sectors, such

[9] The CAMEL rating system is based upon five critical elements of a bank's operations: Capital (C), Asset quality (A), Management (M), Earnings (E), Asset and Liability Management (L).

as real estate, and therefore needs to be complemented with monitoring of risks associated to such exposures. A regional real estate price index was introduced to monitor the exposure of banks to real estate risks, while mergers of microfinance institutions were encouraged to address growing problem loans in microcredit.

22. In the insurance sector, the liberalization of insurance premiums was completed with the lifting of controls on motor insurance premiums. The promulgation of an implementing regulation of the new Insurance Code that covered the diversification and valuation of assets, solvency rules, the calculation of technical provisions, and recourse to reinsurance brought the regulatory and supervisory framework into greater compliance with International Association of Insurance Supervisors (IAIS) standards. Revised accounting standards for the insurance sector were adopted. All insurance companies except three complied with solvency and prudential requirements, while restructuring plans were adopted for the remaining three. Action plans were prepared for the reform of labor funds, the insurance of work-related accidents, and the introduction of insurance mechanisms for natural disasters and political risks. However, little progress has been made in increasing the autonomy of the insurance regulator and this goal has been included in the 2009 Financial Sector DPL.

23. In the area of securities market regulation and supervision, six new laws expanded the powers of the regulator and applied new rules to the stock exchange, the central securities depository (Maroclear), mutual funds, public offerings, and repurchase agreements. The surveillance and investigative powers of the regulator were significantly reinforced. Guidelines were issued about how to deal with insider information and the system of sanctions for violations was modified to provide for a greater range and gradualism of penalties. Licensing of mutual fund companies is now granted by the regulator and not the Minister of Finance, although the licensing mechanism continues to be focused on the mutual fund product rather than the management company. The regulator was also given adequate powers to stipulate detailed regulations through circulars that have legal force and are issued after broad consultation. The regulator was granted budgetary autonomy, allowing expansion of human, technical and financial resources necessary for undertaking on-site inspections and investigations of financial misconduct (such as insider trading, market manipulation, false information, and mishandling of quotations). However, formal autonomy was not granted prior to the 2009 DPL and as in the case of the insurance sector, this has been included in the objectives of the 2009 DPL.

Restructuring of state-owned financial institutions

24. This covered three formerly specialized public financial institutions: the Banque Nationale pour le Développement Economique (BNDE), the Crédit Immobilier et Hôtelier (CIH), and the Crédit Agricole du Maroc (CAM) - successor to the Caisse Nationale de Crédit Agricole (CNCA). These institutions had long suffered from large NPLs and had received between 1998 and 2004 MAD 6.6 billion in direct or indirect transfers from public funds and MAD 9 billion in preferential financings.

25. The restructuring of BNDE followed a two-track approach that involved the government, CDG, and CAM. CDG took over BNDE, recognized accumulated losses,

which according to the loan document were estimated at 2.8 billion MAD, and sold the performing loans and part of the branch network to CAM. The government and CDG, as shareholders, agreed at the outset on a burden sharing formula whereby the government covered 70 percent of the restructuring costs against 30 percent for CDG. The BNDE was absorbed into the investment banking arm of the CDG.

26. The restructuring of CIH entailed the recognition of large losses from non-recoverable NPLs, a substantial recovery of debts from connected borrowers, a recapitalization from existing shareholders, a transfer of public sector shareholdings to CDG, and the introduction of the French Caisse Nationale des Caisses d'Epargne (CNCE), later merged into Banque Populaire Caisses d'Epargne (BPCE), as a strategic investor. The new shareholding structure is based on a new management company that holds 68 percent of the equity capital of CIH, while 12 percent is held by two insurance companies and the remaining 20 percent has been placed with the public. CDG has 65 percent of the management company, implying that its net stake in CIH amounts to 44 percent; the French BPCE holds 35 percent of the management company or 24 percent of CIH. A new governance structure has been established with an audit committee that is composed of representatives of CDG and BPCE.

27. The restructuring resulted in a new strategy that defines CIH as a family bank in direct competition with commercial banks in the offer of deposit facilities and other financial services and the granting of consumer and especially housing loans. CIH has been able to comply with prudential requirements since the end of 2006 and operates with a high CAR that reflects both the recovery of bad debts and the profitability of current operations. However, CIH still suffers from large volumes of NPLs, the resolution of which continues to face difficulties, although they are covered by substantial provisions. Another weakness is its continuing high exposure to the real estate sector, which accounted in 2009 for 70 percent of total assets and 87 percent of total loans. On the other hand, total own funds exceeded 10 percent of total assets, while the CAR amounted to nearly 16 percent of risk-weighted assets.

28. The Crédit Agricole du Maroc's restructuring proceeded on several fronts. Its legal status was changed to that of a joint-stock company, allowing entry of private investors. New management was appointed and a new strategy was adopted, aiming to reduce in the long run the share of agricultural loans from 60 to 30 percent of the loan portfolio. CAM acquired the bulk of BNDE's branch network in an effort to increase its capacity to collect savings and lower the cost of its resources. The capital of the bank was negative in 2003 when its NPLs amounted to 40 percent of the loan portfolio. However, in 2010 its own funds amounted to over MAD 4 billion, while the NPLs were below10 percent and were well provisioned. The old agricultural bonds (bons CNCA) that were compulsorily held by commercial banks were for the most part converted on a voluntary basis into subordinated debt that is counted as part of Tier-2 capital. CAM is now in compliance with prudential requirements. A new public foundation has been created for channeling subsidized loans to small farmers. This is managed by CAM but the credit risk is assumed by the foundation.

Enhancement of the financial sector's infrastructure, transparency and integrity

29. The modernization of the payment system included the launching in September 2006 of the Real Time Gross Settlement system (RTGS) for large value payments and the use of check imaging and other electronic payment instruments for small-value payments, such as standing credit and direct debit orders, to replace paper-based payment methods. A national committee for the payment system to improve the regulatory framework and the national coverage and processing efficiency of all payment instruments was established in April 2006. In 2008 the RTGS processed over 110 thousand transactions for a total value of 276 billion USD. The check clearing system handled 27 million checks for a value of more than 900 billion MAD. The retail payment system also utilized 5 million debit cards. No data are reported on the use of credit cards. A new law on anti-money laundering was adopted in April 2007. The law defines money laundering offences and sets out preventive measures for parts of the financial sector and designated nonfinancial business and professions. A Steering Committee was appointed to implement the Accounting and Auditing Action Plan. Companies making public offerings are now mandated to publish audited consolidated financial statements prepared in compliance with international norms (IFRS).

Outcomes

30. The basic outcome of the operation has been a much stronger framework for financial sector regulation and supervision. A key factor in this has been the greater autonomy that has been conferred on the central bank for the conduct of monetary policy, supervision of the banking system, and intervention in financially troubled banks. The operation has also successfully addressed the long-standing NPLs and weak capital positions of several key public financial institutions. Credit to the private sector expanded during this period, rising from 49 percent of GDP in 2004 to 78 percent in 2008, while NPLs declined from 19 to 6 percent of total loans and provisions increased from 59 to 74 percent of NPLs. This was probably very close to the required level of provisions. NPLs and provisions of the formerly specialized public sector banks continued to be much higher than those of ordinary commercial banks, although they also experienced considerable improvement. Reforms supported by the operation have thus been effective in promoting sound expansion of credit to the private sector, despite some excessive concentration of lending in the real estate sector. Lending to SMEs amounted in 2008 to 24 percent of total loans, which is very close to the average prevailing in high income OECD countries.

31. Considerable progress has been made in adopting international best practices in the supervision and regulation of the insurance sector and securities markets and in upgrading the financial sector infrastructure, including the modernization of the payment system, the greater transparency and integrity of financial reporting, and the improvement of accounting and auditing standards. The new framework is expected to stimulate a greater role and participation in the financial sector by the private sector, supporting the objective of the government to gradually disengage from the sector. Evidence suggests that the profitability of the banking sector has improved, along with its greater contribution to the financing of the economy. The banks, including the old commercial banks and the restructured formerly specialized public sector banks, improved, on an

aggregate basis, their ROAs from close to 0.80 percent in 2003-4 to close to 1 percent in 2007-9, while their ROEs rose from around 10 percent to around 15 percent. Their equity ratio remained around 7.5 percent, but their CAR strengthened from less than 10 percent to 12 percent. At the same time, the share of bank assets in state-owned banks further declined, to less than 24 percent in 2008, from 26 percent in 2004.

6. Ratings

OUTCOME

32. Achievements under the operations three policy areas thus contributed substantially to the overall development outcome sought by the operation: "strengthen the enabling legal and institutional environment for financial intermediation and risk management and [to] increase the role and participation of the private sector in the provision of financial services". Overall, the achievement of the operation's development outcome (efficacy) is rated by this review ***substantial***. The relevance of objectives is rated ***high***, while the relevance of the design of the operation is rated ***substantial***. Based on these ratings for efficacy and for relevance of objectives and design, this review rates the Overall Outcome of the 2005 Financial Sector DPL as ***Satisfactory***.

RISK TO DEVELOPMENT OUTCOME

33. The risk to development outcome is rated **Negligible to Low**. The government views the development and higher efficiency of the financial sector as a central part of its policy priorities and has repeatedly shown its continued commitment to pursue the financial sector reform agenda. Adopting risk-based supervision and solvency rules in both banking and insurance are high on the list of future goals, while readiness to address constructively new regulatory and supervisory challenges is clear by the sustainability of the reform effort that has now extended over more than 15 years.

MONITORING AND EVALUATION

34. **Design.** The project adopted several indicators that were intended to measure the progress towards achieving the development objective and ensure that all the required steps were met. The main indicators were the following:

- Enactment of the new bylaws of the central bank
- Enactment of the new banking law
- Compliance of CIH with the prudential requirements
- Level of provisioning of NPLs
- Share of state ownership in the banking sector
- Number of companies preparing audited consolidated financial statements
- Number of new life insurance contracts
- Value of new life insurance contracts

35. Some indicators were related to outputs (enactment of laws and bylaws) rather than outcomes, with uncertain linkages to the achievement of the operation's development objective. Other indicators were related to outcomes, such as the compliance with

prudential rules of CIH and the attainment by all banks of a specified level of provisioning for NPLs. Some indicators, such as the number and insured value of life insurance contracts, were less meaningful, since the number and value of contracts could be increased with hard selling practices that would not necessarily demonstrate either sound practice or desirable progress. This was equivalent to adopting an indicator in banking that focused on the number and value of new credits without paying due attention to their quality.

36. **Implementation and Utilization.** M&E implementation was facilitated by the excellent collaboration and open dialogue with the authorities. Data and information on the selected indicators were provided on a regular basis. Both the Ministry of Economy and Finance and the Bank Al Maghrib regularly publish extensive economic and financial data, including a detailed annual report on banking supervision and bank performance. These permitted a comprehensive assessment of the pace and achievements of the reform program. Based on these considerations, the overall quality of M&E is rated ***substantial*****.**

BANK PERFORMANCE

37. **Quality at entry.** The project was designed in close cooperation with the authorities and took into account both technical and political factors. The policy reform agenda was based on the recommendations of the 2002 FSAP, the accounting and auditing ROSC, and the IMF Article IV consultations, all of which advocated a strengthening of the financial sector legal and regulatory framework and an effective restructuring of the ailing public financial institutions. Extensive high level consultations were also held with market participants from all segments of the financial sector and professional associations.

38. Implementation risks and mitigation mechanisms were extensively discussed. The project document noted that a main risk could be strong social and political opposition that could weaken the government's resolve to pursue its macroeconomic reform program. To mitigate this risk, the macroeconomic program would be closely monitored and consultations would take place if any further actions would be required to maintain the economy on a sustainable path.

39. Many measures under the financial sector reform program were centered on changes in the legal, regulatory, and supervisory framework, which did not require large public outlays, or on technological improvements, such as those pertaining to the payment system, where large private sector operators would be sharing in the investment costs. Other associated risks related to the government's ability to finalize the legal texts within the specified timeframe and more importantly to enforce the strengthened legal framework. These risks were mitigated through the preparation of all implementing regulations within the relevant timeframe and by the provision of appropriate technical assistance by the Bank as well as other development partners, such as in particular the European Union. The ongoing commitment of the authorities was, of course, of crucial importance in this respect.

40. The restructuring of the public financial institutions entailed, however, large fiscal outlays. In the case of the CIH, the associated risks were mitigated by the government's acceptance and commitment that the affected institution needed to resolve its non-

performing loans and to submit its business plans and operations to a rigorous "market test". Participation by a foreign strategic investor was a significant risk-mitigating factor. Special emphasis was also placed on sharing the burden of the restructuring costs with connected delinquent borrowers, who needed to be pressed into clearing their arrears with the restructured institutions.[10] In the case of CAM, the government as sole shareholder had to play a key part in its restructuring and in ensuring its compliance with prudential rules. An action plan that involved the opening of capital to private investors was adopted but a large fiscal burden remained a significant risk and depended on the commitment of the government to the success of the restructuring plan. Based on the above considerations quality at entry is rated ***satisfactory.***

41. **Quality of supervision.** Implementation support included a high level of coordination with the IMF, which provides technical assistance to the banking supervision department of the central bank. The very good design of the operation along with the ample availability of detailed and extensive data facilitated implementation support of the project and permitted an accurate evaluation of the pace and achievements of the reform program. Analysis of the substantial information and data produced by the authorities (Ministry of Economy and Finance and the Bank Al Maghrib) on the pace of progress of reforms allowed management to reduce the number of supervision missions and the cost of the operation. Quality of supervision is rated ***satisfactory.*** According to these ratings, overall bank performance is rated ***satisfactory***.

BORROWER PERFORMANCE

42. The Borrower's performance is rated **Highly Satisfactory**. This is based on the strong commitment of the authorities to the reform program, their excellent cooperation with the project team, and their willingness to discuss the progress of the project and provide detailed data on different aspects of its implementation. The 2002 FSAP recommendations were fully accepted by the authorities and were incorporated in the design of the project. All disbursement requirements were complied with ahead of project closing. The central bank covered effectively all actions that concerned the regulation and supervision of the banking sector and the modernization of the payment system, while the Ministry of Finance was responsible for all reform actions affecting the nonbank sector.

7. Lessons Learned

43. The most relevant lesson of this project is perhaps the importance of the ownership of the reform program by the authorities and their strong commitment to its success. This is underscored by the second component of the operation concerning the restructuring of the ailing specialized public financial institutions. The serious problems faced by these institutions had been identified in previous Bank operations in the mid-

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[10] The 2005 loan document reports that the CIH had a negative worth of 1.1 billion MAD in 2004. There was a nominal capital of 3.3 bn and reserves of 0.4 bn, which implies that loan losses after provisions amounted to 4.8 bn. NPLs equaled 5.3 bn, implying that provisions were only 0.5 bn. The nominal capital and reserves were reduced to 0.3 bn, implying that shareholders absorbed 3.4 bn of the losses, leaving presumably 1.4 bn for the GOM. New capital was raised from existing shareholders for 1.9 bn. However, the shareholders were for the most part public bodies. The NPLs have been fully provided now but they are not written off because judicial practice favors their reporting on the balance sheet.

1990s but at that time the authorities were inclined toward regulatory forbearance in the hope that a recovery in their financial fortunes would resolve their problems. Ten years later and following the findings of the 2002 FSAP report, the authorities accepted the need for decisive action and committed to undertake a fundamental financial and operational restructuring of these institutions. With regard to the CIH, which was the most important of the three institutions, the loan included as first tranche conditions agreements by various public entities to settle their non-performing loans, by the state to honor its guarantees of CIH loans to the tourism sector, and by existing shareholders to rebuild its capital base. These were all pre-requisites that led to opening its capital to a strategic partner. Two of the three institutions were converted into universal banks, developed new strategic business plans and were able to comply with prudential requirements within the specified timeframes. The third was effectively closed down as a development bank and was absorbed into the investment banking arm of CDG.

44. An equally strong commitment has been shown in the area of banking supervision. The new bylaws of the central bank and the new banking law, which were essential first steps, were followed by a major effort to strengthen the effectiveness of banking supervision. This included the promulgation of implementing regulations, a large expansion in the number of skilled supervisors, continued training of staff to match the growing complexity of banking operations, and a significant increase in the minimum capital adequacy ratio. A major emphasis was also placed on improving the corporate governance of banking institutions and upgrading their risk management systems in preparation for the introduction of risk-based supervision and Basel II capital standards.

45. The new approach has contributed to improved credit risk management by banks but has not eliminated the risk of overly high expansion of credit, growing exposure to particular sectors, such as real estate, and exposure to systemic risks arising from exogenous events. The Moroccan banks did not suffer large losses from the global financial crisis because they did not hold toxic assets and did not rely on wholesale funds to support their lending. But they expanded at a very rapid pace their financing of housing, among other sectors, and faced the risk of growing NPLs in the future resulting from the abrupt fall of sales of housing units targeted to nonresident buyers. Because the banks followed conservative lending policies and insisted on relatively low leverage levels by the property developers they financed, they were not, at least initially, impacted heavily from the collapse of housing sales. However, NPLs from property developers may increase in the future if economic recovery in Europe is overly slow. As already noted, the central bank took steps to ensure the resiliency of the banking system by raising the minimum CAR from 8 to 10 percent and the commercial banks responded by slowing down the rate of credit expansion, which also allowed them to maintain their loan-to-deposit ratio well below100 percent, but these actions were taken somewhat late in the process.

46. Credit to the private sector was growing very fast in Morocco before 2008 and the slowdown in credit expansion that occurred in that year was welcome by both the authorities and the banks. Microcredit expansion was also very rapid but suffered from high levels of nonperforming loans because of shortcomings in governance and internal controls and inadequate information on borrowers. Measures to rectify these problems, such as the creation of a credit bureau, were included in the 2009 FS DPL.

The scope of the operation was sufficiently broad and covered most of the policy issues identified in the 2002 FSAP. The balance between banking, insurance and capital market reforms also seemed appropriate given the much greater importance of the banking sector. However, both insurance and capital market business are growing in Morocco and are more advanced than in other countries in the region. Two omissions concerned the absence of measures to strengthen the long-term balance of the pension system and the lack of any specific measures to promote financial inclusion. The first of these two issues is highly complex and would require a dedicated operation when the authorities are ready to tackle it. The second was not addressed in the 2005 operation because Morocco was already making significant progress in this area. Promoting sustainable access to finance was the main focus of the 2009 FS DPL. This reflected the difficulties that were encountered in microcredit expansion in 2008.

47. Other lessons are the high quality of the underpinning technical analysis (CAS, FSAP and Accounting and Auditing ROSC) that provided the base for the policy dialogue and technical discussions during preparation and implementation of the project and the extensive and effective cooperation among the government, project and country office teams.

Appendix 1. Basic Data Sheet

Morocco Financial Sector Development Policy Loan No. IBRD 73500

Key Project Data (amounts in US$ million)

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	200.0	200.0	100
Loan amount	200.0	200.0	100

Project Dates

	Original	*Actual*
Initiating memorandum	3/17/2005	3/17/2005
Negotiations	4/4/2005	4/4/2005
Board approval	12/15/2005	12/15/2005
Signing	–	–
Effectiveness	12/20/2005	12/20/2005
Closing date	6/30/2007	6/30/2007

Staff Inputs (staff weeks)

Stage of Project Cycle	*Staff Time and Cost (Bank Budget Only)*	
	No. of Staff Weeks	*USD Thousands (including travel and consultant costs)*
Lending		
FY04	14	116.66
FY05	28	200.15
FY06	13	99.73
Total:	**55**	**416.54**
Supervision/ICR		
FY06	1	7.25
FY07	7	55.75
FY08		5.60
Total:	**8**	**68.6**

Mission Data

Stage of Project	No. of Persons and Specialty		Performance Rating	
Month/Year			Implementation Progress	Development Objective
	Count	Specialty		
Lending				
	3	Senior Regional Financial Sector Advisor (1), Lead Financial Specialist (1), Senior Program Assistant (1)	–	–
Supervision	*3*	Senior Regional Financial Sector Advisor (1), Senior Financial Specialist (1), Senior Program Assistant (1)	HS	S

Appendix 2. Additional data

Morocco Financial structure

	2003	2005	2007	2008
I. Banks	**80.6**	**87.8**	**108.4**	**113.9**
Private	66.9	74.3	90.7	96.1
Public	12.7	12.1	15.6	14.8
Offshore	1	1.5	2.1	3
II. NBFIs	**65.1**	**74.9**	**87.2**	**91.4**
Insurance companies	16.1	16.1	17.8	17.3
Pension funds	14.8	19.3	20.9	24.4
Mutual Funds	7.1	8.2	10.7	11.8
Caisse de Dépôt et de Gestion	9	9.6	9.6	9.1
Other [1]	11	13.5	17.4	17.1
III. MFIs	**0.2**	**0.3**	**0.9**	**0.8**
IV. Total assets (I + II + III)	**145.9**	**163**	**196.5**	**206.1**
I. Banks	**55.2%**	**53.9%**	**55.2%**	**55.3%**
Private	45.9%	45.6%	46.2%	46.6%
Public	8.7%	7.4%	7.9%	7.2%
Offshore	0.7%	0.9%	1.1%	1.5%
II. NBFIs	**44.6%**	**46.0%**	**44.4%**	**44.3%**
Insurance companies	11.0%	9.9%	9.1%	8.4%
Pension funds	10.1%	11.8%	10.6%	11.8%
Mutual Funds	4.9%	5.0%	5.4%	5.7%
Caisse de Dépôt et de Gestion	6.2%	5.9%	4.9%	4.4%
Other [1]	7.5%	8.3%	8.9%	8.3%
III. MFIs	**0.1%**	**0.2%**	**0.5%**	**0.4%**
IV. Total assets (I + II + III)	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source:

Financial Indicators

		2002	2003	2004	2005	2006	2007	2008	2009
	Number of branches				2,223	2,447	2,748	3,138	
S02CGP0	Number of Branches Per 100,000 Adults, Commercial Banks								
S08BSK0	3 Bank Asset Concentration (%)	63.2	63.9	67.6	66.3	65.6	69.3	68.7	87.4
S06IFS0	Domestic Bank Deposits / GDP (%)	63.5	65.0	66.3	72.6	77.0	85.0	84.8	83.4
S01IFS0	Private Credit / GDP (%)	48.3	48.7	49.2	53.3	56.9	68.8	75.5	78.0
S03IFS0	Credit to Government and SOEs / GDP (%)	19.1	17.9	16.1	16.3	15.9	14.5	14.3	17.1
S09IFS0	Private Credit to Deposits (%)	76.0	74.8	74.1	73.4	73.8	80.9	89.0	93.5
S07IFS0	Lending-Deposit Spread (%)	8.58	8.78	7.90	7.98				
S01BSK0	Net Interest Margin (%)	4.04	4.03	3.59	3.47	3.46	3.15	3.04	2.66
S05BSK0	Cost to Income Ratio (%)	57.2	56.5	55.5	55.0	52.7	46.8	45.9	43.8
S06BSK0	Return on Assets (%)	0.58	0.83	0.82	0.19	1.16	1.07	1.07	0.98
S07BSK0	Return on Equity (%)	6.3	9.6	9.6	2.4	15.2	15.2	15.4	13.5

		2002	2003	2004	2005	2006	2007	2008	2009
S03FSI0	NPLs to Total Gross Loans (%)		18.7	19.4	15.7	10.9	7.9	6	5.5
S04FSI0	Provisions to NPLs (%)		54.9	59.3	67.1	71.2	75.2	75.3	74.1
S02FSI0	Bank Capital to Assets (%)		7.6	7.6	7.7	7.4	6.9	7.3	7.6
S01FSI0	Regulatory Capital to Risk-Weighted Assets (%) (CAR)		9.6	10.5	11.5	12.3	10.6	11.2	11.8
S03WDI0	Stock Market Capitalization / GDP (%)	21.3	26.4	44.0	45.7	75.2	100.4	74.0	69.2
S01WDI0	Stock Market Turnover Ratio (%)	10.7	6.5	9.1	15.9	35.3	42.1	31.1	45.7
S01AXC0	Insurance Premiums (Life) / GDP (%)	0.90	0.72	0.57	0.62	0.71	0.95	0.95	0.91
S02AXC0	Insurance Premiums (Non-Life) / GDP (%)	1.51	1.56	1.54	1.53	1.50	1.55	1.56	1.59
S03NBF0	Insurance Company Assets / GDP (%)		16.1	15.7	16.1	15.9	19.0		
S02NBF0	Mutual Fund Assets / GDP (%)		14.2	16.0	16.4	22.4	21.4	23.5	26.4
S01NBF0	Pension Fund Assets / GDP (%)		15.0	17.0	19.0	20.0	21.0		

Notes: 1/ Includes finance companies (including leasing and factoring companies);
Sources: Ministry of Finance, Central Bank of Morocco

Microcredit

	2004	2005	2006	2007	2008
Number of clients (1,000)	460	628	1,246	1,353	1,280
Number of clients / Working age population (%)	2.50%	3.30%	6.50%	7.00%	6.50%
Number of clients / Number of poor (%)	5%	7%	15%	17%	15%
Portfolio outstanding (million MAD)	890	1,550	3,400	5,589	5,683
Portfolio outstanding / Credit to households (%)	1.00%	1.50%	2.90%	3.60%	3.20%

Appendix 3. List of Persons Met

Government	**Title**
M. Nouaman Al Aissami,	Chef de la Division du Crédit, Ministère de l'Economie et des Finances, Direction du Trésor et des Finances Extérieures
M. Thami Yahyaoui, Adjoint du	Directeur, Ministère de l'Economie et des Finances, Direction des Assurances et la Prévoyance Sociale
M. Lotfi Boujendar	Chef de la Division des Régimes de Retraite, Ministère de l'Economie et des Finances, Direction des Assurances et la Prévoyance Sociale
M. Mohammed El Alaoui El Abdallaoui	Directeur, La Caisse Marocaine des Retraites
M. Saïd Laftit	Secrétaire Général Caisse de Dépôt et de Gestion
Private Sector	
Mr. Karim El Aynaoui	Director, Bank al Maghrib
Mr. Abderrahim Bouazza,	Head of Banking Supervision, Bank al Maghrib
Ms. Hiba Zahoui	Banking Supervision, Bank al Maghrib
M. Ismail Douiri	Co-Chief Executive Officer, Attijariwafa Bank
Mr. Sekkat	Directeur General, Crédit Immobilier et Hôtelier
M. Karim Tajmouati	Membre du Directoire, Crédit Agricole
M. Fouad Chikri	Directeur, Crédit Agricoler
M. Abdelkerim Sahbeddine	Directeur, Fédération Marocaine des Sociétés d'Assurance et de Réassurance
M. Abdeljalil Taboubi	Sous Directeur, Fédération Marocaine des Sociétés d'Assurance et de Réassurance
M. Mounir Ferram, Directeur Délégué	Confédération Générale des Entreprises du Maroc

Annex D. Pakistan Banking Sector Restructuring and Privatization Project No. IDA-35710 & No. IDA 40310 FSLT 72700)

Pakistan Banking Sector Restructuring and Privatization Project No. IDA-35710

Principal Ratings

	*ICR**	*ICR Review**	*PPAR*
Banking Sector Restructuring and Privatization Project *(No. IDA-35710)*			
Outcome	Satisfactory	Satisfactory	Satisfactory
Risk to Development Outcome	Negligible to Low	Negligible to Low	Negligible to Low
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Highly Satisfactory

* The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (OED) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	*Task Manager/Leader*	*Division Chief/ Sector Director*	*Country Director*
Banking Sector Restructuring and Privatization Project *(No. IDA-35710)*			
Appraisal	Joseph Pernia	Marilou Jane D.Uy	John Wall
Completion	Kiatchai Sophastienphong	Joseph Pernia	John Wall

1. Background

48. The banking system in Pakistan was on the verge of a major crisis in the mid nineties with an exceptionally high level of non-performing loans and significant liquidity issues. The system at that time was dominated by state owned banks which had a history of poor governance and a lack of financial and banking discipline. The state owned banks accounted for 90 percent of all bad loans which was not surprising as the state banks accounted for about 80 percent of the assets of the banking system. There was a history of significant political interference in the management and operations of the state owned banks which greatly interfered with the financial intermediation process at these banks and in turn lead to as situation where many borrowers did not expect to repay loans from these state owned banks. The legal framework and court system were ineffective in the process of resolving non-performing loans. Banks were overstaffed and over branched and the labor unions wielded significant powers, which wase not conducive to running an effective and efficient operation. Faced with this scenario and in an effort to prevent a banking crisis the State Bank of Pakistan and the Ministry of Finance commenced the process of designing and implementing a “home grown” bank reform program. This program aimed to strengthen governance and financial discipline across the banking sector. It focused on bank regulators, markets, the courts, bank owners by enhancing the authority and ability of the central bank to supervise banks and enforce regulations,

promoting market discipline, improving the legal and judicial process for enforcing financial contracts, and initiating corporate governance reforms in the NCBs and development financial institutions (DFIs).

49. The Banking Sector Ajustment Loan (BSAL) was successful in helping the government with the implementation of the reform agenda. The bank assisted this program in 1997 with the BSAL, which contained a number of short term measures designed to stem the flow of bad loans; curtail loss making and conserve the assets of Nationalized Commercial Banks (NCB) s and DFIs; the strengthening of prudential regulations; and bringing financial disclosure standards up to international levels. The program also supported the strengthening of the legal and judiciary process as well as major improvements in corporate governance at state banks which included an amendment to the law which insulated the appointment process from political interference as well as enhancing the autonomy of the board and management of these entities. By the end of 1999, when the program concluded, the banking sector had recorded significant improvements by most benchmarks. The NCBs had stemmed losses making through a retrenchment program which resulted in 30 percent of the workforce leaving and the closure of 500 loss making branches. The level of non-performing loans though still high at 22 percent had started to stabilize due to improved lending practices and intensified loan recovery and work out of problem loans. The new banking court system resulted in nearly 50 percent of default cases being processed through the courts at an unprecedented pace. New boards and management had been put in place at most of the NCBs and these were moving ahead with an aggressive agenda aimed at reforming these institutions. Steps had been taken to strengthen the supervisory and regulatory capacity of the State Bank of Pakistan. However while the BSAL was successful in assisting with the first level of reforming and restructuring the sector and the institutional framework the agenda was far from complete.

50. Privatization of the NCBs had not occurred for a number of reasons including: weak market conditions; the country's deteriorating foreign investment climate; weakening resolve due to changes in government; and the weak overall condition of the balance sheets of the NCBs, which did not attract any buyers. So despite the significant improvements, in excess of 80 percent of the banking system was still owned directly by the state and there was a serious risk that the improvements recorded in the first stage of the reform program could be lost until a number of these banks could be successfully privatized. Feedback from the market at that time indicated that quality acquirers were reluctant to dedicate substantial management time as well as assume the political and social risks of the further restructuring necessary to bring the operating and financial structures of the NCBs closer to international norms.

51. The banking sector in Pakistan has remained resilient in the face of domestic and international shocks but the deteriorating macroeconomic environment since late 2007 has adversely impacted bank profitability and loan quality. Rising non performing loans and loan losses have adversely impacted earnings and profitability but overall bank profitability has remained satisfactory during this period. SBP has estimated that some smaller distressed banks with a total market share of 6.4 percent will need to raise additional capital or merge with stronger banks. Non-performing loans reached a low of 6.9 percent in 2006 but have since increased to 14 percent in September 2010 largely due

to the downturn in the economic environment. However banks in Pakistan continue to maintain a high level of provisions against non performing loans amounting to 70 percent.

52. The banking system continues to be very liquid but banks have been increasing their investment in government paper since 2008 due to low demand for credit and the increased levels of credit risk in the economy. Liquid assets amounted to 33.6 percent of assets in September 2010 which compares to 27.5 percent at the end of 2008. The levels of return on assets (ROA) and return on equity (ROE) across the system have declined since 2006 but were still strong in September 2010 with an average ROA of 1.6 percent and an average ROE of 16.2 percent.

53. The State Bank has become an effective, strong, and respected regulator of the system as a result of various measures taken during the banking reform program. Prior to 1997 the State Bank was largely ineffectual, with weak systems, poorly skilled staff, lack of technology and understanding of the risks involved in the sector. A series of Governors have been at the State bank since 1997 and they have on a consistent basis built up the capacity of the institution through a combination of recruitment and training, installation of new systems and processes and restructuring the organization to remove the emphasis on the traditional transaction side of the business. As a result, the State Bank has been successful in supervising and regulating the system. No banks have failed during this period. Minimum capital levels have been increased to Rupee 700 billion. And further increases are planned. There are 38 licensed banks. However there is a heavy concentration of the system with the six largest banks. Amongst the top ten banks there are no issues with capital or liquidity.

54. The banking sector totally dominates the financial system in Pakistan and accounts for about 93 percent of total financial assets. The banking sector has demonstrated impressive growth up to 2008 but nevertheless financial sector penetration remains low with only 14 percent of the population using formal financial services and approximately 50 percent using neither formal nor informal financial services.

55. Growth in private sector credit has not reached the levels anticipated or desired. The banks' operations were designed primarily to assist the privatization of the NCB and to shift the structure of the market from one which had been dominated by state owned loss making and inefficient banks to private sector profitable and well managed banks. In addition, the banks' operations supported the strengthening of the State Bank of Pakistan (SBP) and the removal of certain imbalances both legal and structurally in the system. Overall they were designed to create an effective financial intermediation mechanism in Pakistan which would be largely private sector owned. While the structure of the system should facilitate increased lending to the private sector a number of factors have militated against that: (i) inflation rates have been running in excess of 20 percent and this has resulted in very high interest rates; (ii) the state is borrowing ever increasing amounts from the system and is in effect beginning to crowd out the private sector. State borrowing from the banking system, including treasury bills, amounts to about 34 percent of the system's assets; (iii) banks expanded their lending portfolios in the years post privatization up to 2007 and as a result suffered some losses from increased non performing loans. This has resulted in a more cautious lending approach by the main banks; and (iv) banks are in a position to generate very attractive returns from investing in treasury bills. Interest rates

on treasury bills in the first two months of 2011 are 14.5 percent which provides the larger banks with a margin of at least 9 percent and little incentive to pursue lending to the small and medium enterprise sector and consumers which is much more risky and carries a much higher administrative cost.

56. Capital Markets have not developed to any significant extent in Pakistan. The banking sector still represents about 93 percent of the financial system. The stock exchange suffered a crisis in 2008 and the market was closed for a number of months. The insurance and pension fund sectors have not been developed to any extent and there are no longer term funding sources, which is a major impediment to the provision of project and term finance as well as for the development of the mortgage market. The regulation of this sector comes under the SECP and they do not appear to have the same institutional capacity and focus as the SBP.

57. The authorities in Pakistan had made significant progress in implementing their "Home Grown" Reform program since 1997, which had been supported by BSAL. The banking sector had improved by most benchmarks. NCBs had stemmed operating losses and had made significant progress with restructuring and downsizing their operations. The level of non- performing loans stabilized due to improvements in the credit and risk process and a much improved loan recovery and work out process. All of these measures helped the banking system to record improvements in capital adequacy, asset quality, efficiency, and profitability However the banking system remained largely under state ownership and control and if the government did not continue with the next phase of the program which was to focus primarily of the steps necessary to prepare NCBs for privatization there was a significant risk that the progress achieved in the first phase could have been lost. In September 2000 the bank was requested by the government to help revive and continue the implementation of the reform program by focusing on bank privatization as the next critical set of steps in the process. The government at that time had concluded that the best way to insulate the financial intermediation process from political interference was to privatize all NCBs and to reduce the number of specialized financial institutions and privatize them also if possible. This was a major step and the government committed to trying to privatize Habib Bank and United Bank within the tenure of the government as well as taking major steps towards preparing the National Bank of Pakistan for privatization and to reduce the development financial institutions to three.

58. The Bank Sector Restructuring and Privatization Project (BSRP) was prepared in this context, in 2001, in order to assist the government with the next stages of its bank reform program. The first steps in the process took place following a request from the Minister of Finance in September 2000 for bank assistance in reviving the implementation of the bank reform program. The first phase of this program had been successful and the government was committed to moving ahead with next phase but needed bank financing to support the program.

2. Objectives and Design

59. The development objective of project (according to the Project Appraisal Document) was to help the Government continue implementation of its banking reform

program aimed at **"achieving a competitive private banking system that operates under a strong regulatory framework, is supported by an effective banking court system, and intermediates resources independently of vested interests and in response to price signals".** The main focus of the project was on the further measures necessary to prepare the NCBs for privatization as well as taking steps to restructure some of the DFIs. The project also included some policy reforms which were designed to facilitate bank restructuring and to put in place some measures to strengthen and build a sustainable banking system. These were especially important in order to give the banks when privatized an opportunity to grow and develop into strong and successful financial institutions. The project thus encompassed three main policy areas:

i. *Bank restructuring* — through continued rationalization of staff and branches at the NCBs as well as the amalgamation of the NDFC into the National Bank.

ii. *Bank privatization* — through the completion of the sale of the remaining government shareholding in the Muslim Commercial Bank and the sale of the government's 49 percent shareholding in Allied Bank as well as by preparing United Bank and Habib Bank for privatization and making initial progress on the preparation of National Bank for sale.

iii. *Policy reform* — by addressing a number of serious impediments to the overall development and strengthening of the banking system including liberalizing branch openings, harmonizing the taxation policy of banks with the corporate sector, strengthening the loan recovery act and reforming the National Savings Scheme and the Foreign Currency Deposit regulations.

3. Relevance of Objectives and Design

60. **Relevance of Objectives.** The project was planned to help the government with the second stage of the operational restructuring of the NCBs in preparation for their privatization. At the same time it was prepared with the aim of improving corporate governance of the partially privatized banks by divesting the remaining government shareholding and allowing complete control to the private sector owners. In addition, it was to promote measures designed to develop the healthy part of the banking system by liberalizing bank branching, contracting the weaker part of the system which included amalgamating of the largest development financial institution into one of the NCBs. In addition the project was designed to help with the deepening of the banking market by reducing taxation on financial intermediation and the cost of loan recovery by facilitating foreclosure on loan collaterals. The project's objectives were fully aligned with the government's strategy and the Bank's Country Assistance Strategy (CAS) with Pakistan. While the government had developed the plan the bank came in strongly with measures to support implementation of the plan. The authorities viewed the bank's intervention as being helpful and being of significant help in achieving the desired objectives. The relevance of objectives is rated ***high.***

61. **Relevance of Design.** The project encompassed a complementary set of mutually reinforcing reforms aimed at bank restructuring, privatization, and policy reforms conducive to a more transparent and competitive environment for the operation of

commercial banks. The policy content was thus highly relevant, as well as the design of the disbursement in association of the fulfillment of key milestones. The loan was structured to be utilized as reimbursement for the cost of the severance packages being paid out to NCB and NDFC staff. This was an appropriate design as it provided an incentive to move ahead with the restructuring and ensured that the finance was available to meet the cost of the retrenchment. The program had to be adjusted on two occasions. The first was to allow the inclusion of Allied Bank under the project. This bank had earlier being privatized but due to a poor mechanism for privatization at that time the privatization failed and the bank was renationalized. It therefore required to be restructured and prepared for privatization again which would require resources and support. This was included as a revision to the BSRP and again this was taking into account the overall objectives of government as well as making sure that this bank would be managed under the same process. Relevance of design, taking into account the project's restructuring, is rated by this review as ***substantial***.

4. Implementation

62. The loan, of a commitment amount of $300 million, became effective in December 2001 with an expected implementation period of three years. The project was structured to be disbursed based on fulfillment of conditions which were set out. The first tranche of US$100 million which had been allocated to National Development Finance Corporation (NDFC) was disbursed upon effectiveness of the loan because the conditionality in relation to NDFC was met as a board condition. The remainder of the loan was structured to be disbursed when certain targets in relation to reductions in branches and staff of the NCBs were achieved.

63. **Project Restructuring.** The project had to be restructured on two occasions by the Bank, with no modification in its development objective. This arose because the disbursements allocated against some of the NCBs were not needed as some of the banks had been privatized before reaching that particular stage of the process. The first amendment to the loan agreement in February 2003 changed the allocation of US$ 50 million which had earlier been earmarked for staff retrenchment at Habib Bank to a staff retrenchment scheme for Allied Bank. This arose because the second phase of the Habib Bank restructuring did not take place before privatization. As a result of the progress made in the first phase of the restructuring the bank was privatized and consequently there was a saving in the staff retrenchment cost.

64. Thus, the loan agreement was amended to include Allied Bank in the definition of an NCB so as to facilitate disbursements to assist in the financing the restructuring of this bank.[11] The market for banks was strong during this period, as strategic investors were aware of the significant changes taking place in the restructuring of the sector in Pakistan which would eventually result in a market which had been earlier totally dominated by

[11] A share of 51 percent of Allied Bank had previously been sold in 1991-1993 through an Employee Ownership Plan. Following that, the Banks Nationalized Act of 1974 did not apply to the bank. However, for a number of reasons, including poor governance and the acquisition of a significant proportion of the bank by some of the bank's major defaulters, the state bank had to intervene in 2001 and the bank was nationalized again.

state owned banks becoming a largely privately owned banking market. As a result, the government was able to privatize Allied Bank without having to complete the rationalization program. All of this meant that the US$200 million earmarked to be disbursed against specific retrenchment targets had not been disbursed. The loan agreement was amended for a second time to allow disbursement of the balance to the government as a reimbursement for the costs incurred earlier by the government in the recapitalization of NCBs in advance of privatization. The use of loan proceeds retroactively to pay for state-owned bank recapitalization was appropriate. as the government, in parallel, undertook reforms to operationally restructure these banks with the aim of privatizing them, while strengthening bank supervision. Operational restructuring included reforming the boards and management of these banks as one of the first steps. As a result of this and the overall market conditions the privatization of United and Habib Banks proceeded more quickly than planned. In fact, it was not envisaged that these banks would have been privatized during the term of this loan.

65. The restructuring of the project also changed the financial side of the project. This resulted in the amount disbursed for retrenchment being reduced to US$ 211 million. However the overall project cost increased from US$540 million at time of appraisal to US $609 million and this was mainly due to a significant increase in the cost of the NDFC amalgamation with National Bank of Pakistan and to the capital injections which the Government provided to the NCB's in advance of privatization. A further US$115 million of the bank's funds was used to reimburse the Government for these capital injections. This resulted in 70 percent of the bank's funds being used for severance as compared to a planned 100 percent.

5. Achievement of Objectives (Efficacy)

Policy Areas

Bank Restructuring

66. Three key sets of targets were pursued under this policy area:

- Branch Rationalization of the NCBs
- Staff Rationalization of the NCBs
- Amalgamation of NDFC into the National Bank

67. Specific targets were set for branch and staff reductions at the NCBs as well as for an improvement in the cost income ratio to 65 percent. The NCBs were to reduce their branch networks by 1,800 branches (40 percent) and the staff number by 25,635 (50 percent). Significant progress was made with each of these targets: 1,487 branches were closed and the staff number reduced by 11,083. These were below target because the early privatization of United Bank and Habib Bank (in 2002 and 2004, respectively) discontinued the restructuring agenda for these banks—as discussed above (see restructuring of the project).

68. That said, overall the government showed serious intent in relation to these targets and made significant progress in the rationalization and retrenchment process before the

privatization of the two of these entities. This progress helped to facilitate privatizations at an earlier stage than was anticipated when the loan was being put in place. NDFC was amalgamated with the National Bank of Pakistan in December 2001. Although the specific targets as set down were not fully achieved, the reasons for this are reasonable and positive in the overall framework of the restructuring of the state banks restructuring and privatization.

Bank privatization

69. The main targets pursued under this policy area were the following:

- Bona fide attempt at fully divesting the government's remaining shareholding in Muslim Commercial Bank at market prices
- Sale of the government's 49 percent share ownership in Allied Bank to a qualified strategic investor
- Substantial progress in the sale of United and Habib Banks
- Initial progress in preparing the National Bank for sale.

70. The targets sought were important and were designed to conclude some smaller privatizations and to make significant progress in preparing some of the major NCBs for privatization. The government successfully sold its shareholding in Muslim Commercial Bank and reduced its shareholding in Allied Bank to 11.9 percent. Habib Bank and United Bank were successfully privatized during the time frame of the project, which was much better than anticipated. A sale of 51 percent of United Bank was concluded in October 2002 and for Habib Bank in February 2004. This was largely due to a combination of factors; firstly, the restructuring process had commenced prior to 2001. New boards and management had been put in place and significant progress had been made under their leadership combined with strong government support, secondly the market conditions were more favorable towards Pakistan and the financial sector at that time and this enabled a quicker than anticipated sale to strong shareholders. Both banks have gone on to perform very well post privatization and even though the government still has a minority position and some representation at board level there has been no evidence of any interference in the operations and management of these banks post privatization.

71. United Bank had been loss making prior to its privatization. Since then the bank has significantly improved its performance and recoded an return on equity (ROE) of 17 percent in 2008 and a return on assets (ROA) of 1.4 percent. Habib Bank has improved its ROE from 8.6 percent prior to privatization to 20.7 percent in 2008 and its ROA improved from 0.3 percent to 2 percent during the same period.

72. Of the shares in National Bank of Pakistan 23 percent were sold through a combination of an Initial Public Offering and a market sale in tranches between November 2001 and November 2003. This particular component was satisfactorily completed and more than anticipated was achieved with the privatization of the NCBs largely completed which resulted in 80 percent of the country's banking assets being in the Private Sector. This was one of the key objectives of the "Home Grown" banking reform program drawn up by the government in 1997.

Policy reform

73. The main reforms sought under this policy area were the following:

- Liberalization of bank branching policy
- Revision of tax policy for banking sector and initial reduction in the level of taxation
- Amendment to the Loan Recovery Act 1997 to facilitate the foreclosure of loan collaterals
- Reform of the National Savings Schemes
- Reform of the Foreign Currency Deposit Scheme

74. These reforms were an important part of BSRP because they addressed a number of issues which were seriously impeding the growth and development of a strong and competitive banking market. All the measure set out as objectives to be achieved were completed. The opening of bank branches was liberalized which was beneficial in particular to foreign owned banks which prior to that had been restricted to a small number of branches. The State Bank of Pakistan now reviews banks policies in relation to expansion of branch network based on the CAMEL rating of the bank. For banks with a good CAMEL rating the bank is free to expand its branch network. Banks with weaker CAMEL ratings have to meet more stringent requirements and may not receive permission until some key issues are addressed. This is very much in line with international practice in this area. As the project was launched, banks had a tax rate of 41 percent and the corporate rate was 35 percent. During the project the rate on banks was gradually reduced to come into line with the corporate tax rate. The complete alignment of the tax rate on banks with that of the corporate sector was concluded after the project closed. The Loan Recovery Act of 1997 was amended and this greatly facilitated foreclosure by banks on collateral.[12]

75. The National Savings Scheme was reformed. It was causing wide scale disintermediation because it was paying higher returns than banks and these returns were tax exempt. It had grown to about half the size of the banking system and effectively the state though this mechanism was absorbing funds that would otherwise have been available for the banking system. The reform of the system involved reducing the interest rate and linking the rate to comparable government securities as well as removing the tax advantage. Institutional investors were also debarred from investing in the scheme under the reform measures.

76. The foreign currency deposits scheme was also amended. All of these policy issues which were essentially part of the second generation of policy reforms and were

[12] This revision has been challenged twice in the High Court. On the first occasion the High court upheld the position but on the second occasion the High Court accepted the challenge. It is now the subject of an Appeal in the Supreme Court. Essentially the law is being challenged because it allows banks to foreclose on property without having to refer to the Courts in advance. If the Supreme Court upholds the second decision of the High Court then banks will have to obtain a court ruling in advance of any foreclosure on property. This will add an extra layer to the process and delay proceeding somewhat but overall it should not have any material impact on the recovery of bad loans.

designed to improve the banking environment and to remove some distortions in the market. The policy components of BRSP were satisfactorily achieved and had the desired impact on the banking sector.

Outcomes

77. This project was very successful in terms of achieving the objectives identified. Due to the success of the policy reforms and operational restructuring measures the privatization of the two large NCBs, Habib Bank and United Bank was concluded earlier than projected as well as the re-privatization of Allied Bank. Also the government sold its shareholding in the Muslim Commercial Bank and off loaded 23 percent of its shareholding in National Bank of Pakistan. The program was not specifically designed to achieve the privatization of United and Habib Banks, which was intended for the next phase. However, due the success of the restructuring and reform measures which were favorably received by the financial markets it was possible for the government to achieve the privatization of the United and Habib Banks as well as the other privatizations which were scheduled during this phase of the program. At the end of this phase and on completion of the program in 2004 nearly 80 percent of the banking sector assets were controlled by private sector banks. One large bank National Bank remained under government control. A first step had been taken on its privatization with 23.2 percent of the shares disposed of through an IPO. This reform program supported by the project has fundamentally changed the structure of the banking market in Pakistan, from one that had been previously been dominated by state owned banks to a market in which private sector participation surpassed 80 percent. The institutional development programs had enhanced these banks before privatization and the new owners were taking steps to continue the process. Corporate governance and the regulatory environment had been strengthened. The state bank has put in place new systems and procedures including a modernization program designed to ensure that it became an effective and strong regulator. As a result of tighter supervision, and policy reforms that improved foreclosure laws; taxation policy for banks; branching; and regulations for national savings and foreign currency deposits, the capacity of the banking system to extend credit to the private sector and its resilience to shocks have improved.

6. Ratings

PROJECT OUTCOME

78. The actions undertaken under the three policy areas contributed to the substantial achievement of the development objective of "achieving a competitive private banking system that operates under a strong regulatory framework, is supported by an effective banking court system, and intermediates resources independently of vested interests and in response to price signals". Overall, the achievement of the operation's development outcome (efficacy) is rated ***substantial***. The relevance of objectives was rated ***high***, while the relevance was design was rated ***substantial***. Based on these ratings for efficacy and for relevance of objectives and design, this review rates the overall project outcome as ***Satisfactory***.

RISK TO DEVELOPMENT OUTCOME

79. As a result of the government's "Home Grown" banking reform program of 1997 which has been successfully implemented the banking sector in Pakistan is largely privatized with in excess of 80 percent of the banking assets in private sector banks. These banks are continuing to perform well despite the global financial crisis of 2008 and the political instability in Pakistan and neighboring countries and the disastrous flooding which affected the country in 2010. This is due to a number of factors: (i) the banks are well capitalized; (ii) the banks are highly liquid; (iii) the State Bank has been transformed into a very strong and effective regulator and supervisor of the system; and (iv) political interference in the private sector banks is not in evidence, despite the fact that the government still holds a significant minority ownership in a number of the former NCBs and they have the right to appoint board members to these institutions. The results of this process, which commenced in 1997, are evident today. Pakistan has a well developed and functioning banking system even after all the events both globally and locally. The evidence to date strongly supports the sustainability of these measures and it is likely that this will continue. One anticipated outcome of the reforms which has slowed is the availability of credit to the consumer and business sectors. There are a number of reasons for this, none of which are directly related to the reform program; (i) the economy has slowed significantly with GDP dropping to about 4 percent in 2010 and even lower projected for 2011 from 6.4 percent in 2003; (ii) inflation has been reduced from 25 percent in mid 2008 but continues to be running high at about 15 percent in the second half of 2010, which has resulted in interest rates of 20 percent and over; and (iii) inefficiencies in the operation and performance of the energy sector with continuous power outages make it increasingly difficult for business to run profitable. Overall, the Risk to Development Outcome is rated as **Negligible to Low**.

MONITORING AND EVALUATION

80. **Design**. The project adopted several indicators that were intended to measure progress towards achieving the development objective and ensuring that all the required steps were met. The main indicators were the following:

- Reduction of the cost/income ratio of the NCBs to 0.65
- Rationalization of the branch network of the NCBs by reducing the number of branches by 40%
- Staff rationalization in the NCBs by reducing the headcount by 50 percent
- Amalgamation of National Development Finance Corporation (NDFC) into National Bank of Pakistan (NBP)
- Bona fide attempt at fully divesting the government's remaining shareholding in Muslim Commercial Bank (MCB) at market prices
- Sale of the government's 49% shareholding in Allied Bank Limited (ABL) to a qualified strategic investor
- Substantial progress in the sale of United Bank Limited (UBL)
- Substantial progress in preparing Habib Bank Limited (HBL) for sale
- Initial progress in preparing National Bank of Pakistan for sale
- Liberalization of bank branching policy

- Revision of the tax policy for the banking sector and initial reduction in the level of taxation
- Amendment to the Loan Recovery Act of 1997 to facilitate foreclosure on loan collaterals
- Reform of the National Savings Schemes (NSS)
- Reform of the Foreign Currency Deposit Scheme

81. Overall this was an appropriate set of indicators. Some were specific and more easily measured while others referred to substantial progress which was more difficult to quantify. However the two indicators which referred to substantial progress were those in relation to the sale of Habib Bank and United Bank. In both these cases the indicator was more than fulfilled during the project as 51% of the shares of both of these banks was disposed of.

82. **Implementation and Utilization.** The implementation of this project was greatly assisted by the " Home Grown" Plan which the government had developed for the industry in 1997 and which was strongly supported by the authorities. The indicators were strong and aligned to the project objectives and were monitored on a regular basis. Many of the key indicators were achieved earlier than anticipated which again was due to the strong commitment as well as good design of the project. The results of this project lead to a reformed and privatized banking sector as well as reforms to loan recovery, taxation and branch banking policy. Based on all these factors and especially the pace and success of the various reform measures the overall quality of M&E is rated **substantial**.

BANK PERFORMANCE

83. **Quality at entry.** The responsiveness of the bank to the government's request was timely and the approval process was managed efficiently in a cost effective and timely manner. The design of the program was relevant and addressed in a very complementary manner key policy reforms that removed important distortions from the banking system so that the restructured and privatized banks could operate efficiently. Quality at entry is rated ***satisfactory*.**

84. **Quality of supervision.** The bank closely supervised the operation and responded to a request to restructure the project on two occasions to accommodate additional aspects which could not have been anticipated at the outset. The Bank's responsiveness supported the fulfillment of the objectives set down. Quality of supervision is rated ***satisfactory***. Based on these ratings, overall Bank performance is rated ***satisfactory***.

BORROWER PERFORMANCE

85. This was a case of a loan supporting a "home grown" bank reform program where the borrower was both committed and in charge of the implementation. As the borrower had a strong commitment to the projects decisions were made promptly and there was a strong push behind the implementation of all aspects of the program which the various implementation agencies also performed well. The overall performance of the borrower was ***highly satisfactory.***

Banking Sector Development Policy Program No. IDA 40310 FSLT 72700

Banking Sector Development Program *(No. IDA 40310 FSLT 72700)*			
Outcome	Highly Satisfactory	Satisfactory	Moderately Satisfactory
Risk to Development Outcome	Negligible to Low	Negligible to Low	Negligible to Low
Bank Performance	Highly Satisfactory	Highly Satisfactory	Moderately Satisfactory
Borrower Performance	Highly Satisfactory	Highly Satisfactory	Satisfactory

* The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The ICR Review is an intermediate Independent Evaluation Group (OED) product that seeks to independently verify the findings of the ICR.

Key Staff Responsible

Project	***Task Manager/Leader***	***Division Chief/ Sector Director***	***Country Director***
Banking Sector Development Program *(No. IDA 40310 FSLT 72700)*			
Appraisal	Mudassir Khan	Simon Bell	John Wall
Completion	Kiatchai Sopastienphong	Simon Bell	John Wall

1. Background

86. Pakistan had made significant progress in reforming its financial sector over the previous decade. Fundamental change had taken place through the implementation of the "home grown banking reform program", the first phase of which had been supported by the Banking Sector Adjustment Loan (BSAL). The reforms carried out in the first phase were aimed at addressing the fundamental causes of the problems in the banking sector. The reforms introduced during this phase included controlling the abuse of public sector banks by vested interests by changes in laws and governance; strengthening the regulatory framework and structure; resolving imbalances in interest rates by reforming the National Savings Scheme; improving the environment for enforcement of legal contracts; operational restructuring at public sector banks and introducing greater transparency and disclosure of information on public sector banks. These reforms greatly improved the operations and structure of public sector banks but the sector was still dominated by government owned banks and privatization efforts had slowed. As a result the government initiated a second phase of restructuring and reform which was designed to prepare the sector for privatization. The reform measures in this phase were supported by the Banking Sector Restructuring and Privatization Project reviewed in the previous section.

87. The reforms undertaken in the first two phases of the bank reform were estimated to have cost the government about US$2 billion or 2.8 percent of GDP. These costs included capital injections for the banks, voluntary retirement programs, branch closures and also other costs involved in restructuring the banks in advance of privatization. In view of the high cost incurred by the government and the fact that banking sector reform was also an important feature of the CAS it was felt that a further bank program should support the costs which the government had incurred in the re-capitalization of the banks. The earlier bank operations had supported operational restructuring in order to facilitate privatization. The bank had linked any funding towards the re-capitalization of the banks to successful privatizations. Reform of the corporate governance structure was considered

the most critical for sustainability of the complete reform program and to ensure that it could not be reversed. The Government at this stage had already completed the required actions on corporate governance and privatized three banks to foreign and local investors. In addition they had taken steps to further strengthen the regulatory and supervisory structure of the banking system, improving transparency and disclosure and preventing the possible use of the banking system for money laundering. As a result of all of this it was decided to proceed with the Banking Sector Development Program (BSDP).

88. The preparation of BSDP took place in a different background to the earlier operations. A Financial Sector Assessment Program (FSAP) had been carried out in early 2004; the overall assessment was quite positive and the findings highlighted the banking sector reforms that had been implemented, providing an essential foundation for the recovery of the financial sector. The FSAP highlighted in particular the transformation of a predominantly state owned and weak banking system into a healthier, market based system which was predominantly private sector owned. It. also highlighted the improved financial and liquidity position of the banks and made a number of recommendations, including: the National Bank of Pakistan should be privatized as well as a continuation of the sale of minority positions in other banks, further steps should be taken to strengthen the legal structure and the supervisory capacity of the State Bank of Pakistan, capacity for stress testing should be developed by SBP as well as a recommendation to tighten the provisioning standards.

2. Objectives and Design

89. BSDP was a Development Policy Loan, structured on a prior action policy matrix, with a commitment amount of USD 300 million, blended as a USD 100 million credit from IDA and a USD 200 million loan from IBRD. The development objective of the operation was to support the government of Pakistan towards **"improving [banking] sector governance through privatization of UBL, HBL and resolution of ABL, further strengthening the regulatory and supervisory environment for banking, improving transparency and disclosure, and preventing possible use of the banking system for money laundering"** (Loan and Program summary). The operation was designed around four policy areas (Operational Policy Matrix):

i. *Improving banking sector governance through privatization*

ii. *Develop effective regulatory and supervisory capacity at State Bank of Pakistan*

iii. *Promote transparency and disclosure of the banking system*

iv. *Prevent the possible use of the banking system for money laundering, financing for terrorism, and transfer of illegal/ill-gotten money*

90. The operation was approved in January 2005 and was declared effective on January 18th 2005 and disbursed into an account of the Ministry of Finance at the State Bank of Pakistan. The operation was closed in July 2005. This was a single tranche operation with all conditions met at approval.

3. Relevance of Objectives and Design

91. **Relevance of Objectives**. BSDP followed on from two earlier bank programs which were specifically focused on supporting aspects of the "home grown" banking reform program of the government. The objectives of financial sector reforms were aligned with the CAS and the Poverty Reduction Support Paper (PRSP) for Pakistan. The operation was designed to support the continued development of the sector through bank privatization and strengthening of the regulatory framework. The operation was broadly grounded on the recommendations of the 2004 FSAP, despite missed opportunities noted below (see relevance of design). Based on these considerations, the relevance of objectives is rated by this review as ***substantial***.

92. **Relevance of Design.** The privatization of Habib Bank and United Bank were included as a prior action in the BSDP, but were also stated as an outcome of the previous BSRP project. The recapitalization of HBL and UBL had been conducted at a total cost to the government of US$ 805 million (Project Appraisal Document, Table 2, World Bank, 2004). Essentially, the government was provided with recapitalization support (of up to US$ 300 million) for results already achieved. However, as noted in the Project Appraisal Document, the Bank had explicitly linked any re-capitalization support to state-owned banks to their successful privatization, which in view of the success to date was not unreasonable, especially as the government had incurred the cost of recapitalization earlier than anticipated.

93. As noted, an opportunity may have been missed with BSDP to continue with future enhancements to the banking and financial sector. The privatization of the National Bank of Pakistan was never completed even though this had been mentioned in earlier programs as a bank which was being prepared for privatization. The capital markets and non-bank financial institution (NBFI) sector were not developed and the regulation and supervisory structure for this sector was not adequately addressed. A development plan for this sector would have been an important step towards further developing the financial markets in Pakistan.

94. In fact, the 2004 FSAP recommended that the Government and State Bank of Pakistan develop a strategy to privatize the remaining public sector commercial banks (especially the National Bank of Pakistan) as well as continuing divestiture from the capital of other banks. In addition, it focused on the need to develop a more robust stress testing mechanism as well as the need to review and strengthen the provisioning requirements of banks. There was an opportunity to commence the process of developing the NBFI sector and developing the capital market. All of these issues could have been included under BSDP, it would have required a multi-tranche operation with disbursements linked to achievement of specified actions, or as a series of programmatic operations, with follow-up loans to support the broader financial sector reform agenda outlined in the FSAP. Based on these considerations, the relevance of design is rated by this review as ***modest***.

4. Achievement of Objectives (Efficacy)

Policy Areas

Improving banking sector governance through privatization

95. The main targets pursued under this policy area were the following:

- Privatization and hand over of United Bank
- Privatization and hand over of Habib Bank
- Merger/sale and handing over of Allied Bank to a qualified private sector group
- Qualified bankers appointed to board and management of National Bank of Pakistan
- Issuance of detailed guidelines under "FIT and Proper Tests (FPT) for the appointment of Board of Directors, Chief Executive Officers and Senior Management of banks.

96. Specific outcome indicators were set down against each of the above actions. On the privatization of United Bank, Habib Bank, and Allied Bank, the main task was to ensure that the banks were privately owned and managed and adequately capitalized in compliance with State Bank of Pakistan regulations. Of the shares in United Bank, 51 percent were disposed of in October 2002, 51 percent of Habib Bank was disposed in February 2004 and Allied Bank was handed over to a private sector group in August 2004. All of these banks continued to perform successfully in the market post privatization and have enhanced their operations and financial capacity. Professional managers were brought into National Bank of Pakistan and Fit and Proper Tests introduced for appointment of senior bankers was introduced in 2003.

97. As the privatization of Habib Bank and United Bank had already been achieved under BRSP, the Bank's development policy credit did not have a material impact on privatization of state-owned banks. However, based on the understandings between the Bank and the government for the support to the financial sector reform program, the successful privatization of the two banks was the precondition for the financing by the Bank of the recapitalization cost incurred by the government in earlier phases. The provision of this financing through the BSDP prior action on the privatization of the two banks marked the successful completion of this part of the financial sector reform program. The BSDP also focused on institution-building issues and further strengthening of the State Bank of Pakistan.

98. Practice of directed lending to preferred sectors and interest rate subsidies no longer in evidence in private sector banks. This practice appears to have ceased amongst the private sector banks. However, the state still owns a number of specialized development banks in the agricultural and other sectors and it is likely that these entities are used for both directed and subsidized lending. In addition the state still owns the majority of NBP which is one of the largest banks in the country with an extensive branch network and a large deposit base. The governance and operational structure of this bank differs from the banks which have been privatized and provides opportunities for

government to exercise more influence over the bank's lending and other policies. This is one of the significant gaps in the privatization of the banks in Pakistan. It was envisaged that this bank would have been privatized as part of the reforms of the sector. However, the privatization of NBP was not concluded and as the bank is a systemic bank it is important that its governance structure is in line with the private sector banks.

99. Private sector banks had put in place a strong management and governance structure and were taking positive steps to develop their business platforms. Access to credit improved for consumers and business. Consumer credit expanded from nearly zero in the mid 1990's to about 12 percent of all bank credit in 2003. However the state is absorbing an ever increasing proportion of the available funds from the banking system which is running at 34 percent in 2011. In addition the high interest rate environment as well as the poor energy supply position makes it increasingly difficult for smaller businesses to grow and prosper and be in a position to borrow money for expansion.

Develop effective regulatory and supervisory capacity at State Bank of Pakistan

100. The main reforms pursued under this policy area were the following:

- Introducing a new system of monitoring, surveillance and supervision, Institutional Risk Assessment Framework (IRAF)
- Introduction of separate sets of regulations for corporate, SME, consumer finance, micro finance, NBFCs and insurance companies
- Issuance of guidelines on risk management for banks/DFIs

101. This policy area was deemed to have been substantially achieved as a result of the following actions, all of which had been taken before the loan was approved. A Risk Assessment Framework was introduced by the SBP in early 2004 and this assisted the latter in taking a more proactive approach to institutions which were showing signs of distress. Separate guidelines were introduced for various segments of the market in 2003. These stipulated the reserve requirement for different types of lending both secured and unsecured. In addition, an effective system of risk management was introduced for banks by the SBP in August 2003. This brought about a clearer focus on the key risks of the business as well as encouraging banks to put in place an appropriate system to measure the various risks and also to introduce an overview and monitoring system for taking corrective action where necessary.

102. The State Bank has become an effective and strong and respected regulator of the system as a result of various measures taken during the banking reform program. Prior to 1997, the State Bank was largely ineffectual with weak systems, poorly skilled staff, and lack of technology and understanding of the risks involved in the sector. A series of Governors have been at the State Bank since 1997 and have on a consistent basis built up the capacity of the institution through a combination of recruitment and training, installation of new systems and processes, and restructuring the organization to remove the emphasis on the traditional transaction side of the business. As a result, the State Bank has been successful in supervising and regulating the system. No banks have failed during this period. Minimum capital levels have been increased to Rupee 700 billion. And further increases are planned. There are 38 licensed banks. However there is a heavy

concentration of the system with the six largest banks. Amongst the top ten banks there are no issues with capital or liquidity. However, a number of smaller banks are below the minimum capital requirement and do not meet the minimum capital adequacy ratio. SBP anticipates that some of these banks may amalgamate or be acquired by larger banks which would resolve this issue. However there is a need for the SBP to put a time limit on this process and to develop a contingency plan which could be implemented in the event that some banks fail to meet the capital requirement.

103. The State Bank of Pakistan monitors and tests the system on a regular basis. It carries out regular on site and off site examination of the system as well as reviewing the overall system on a continuous basis through the regular flow of information which it has from the banks. It is focused on evaluating bank's internal control and risk management systems and in this context are keeping pace with regulatory and supervisory developments elsewhere. However, it is of some concern that with some of the smaller banks which do not meet the minimum capital requirements restructuring is not being more actively pursued. The State Bank of Pakistan is hopeful that some mergers or other mechanisms will resolve this issue. The FSAP update, which took place in 2008, also highlighted this issue.

104. Banks are well provisioned against non-performing loans which though increasing in recent years are well down on the levels which existed prior to 1999. Non-performing loans reduced from a level of 22 percent in 1999 prior to the privatization of the NCBs to a low of 6.9 percent in 2006. However, since that time the level of non-performing loans has increased due deterioration in the economic and political situation in Pakistan. In addition some sectors such as textiles have also suffered from a downturn in the global economy. On top of that the rapid expansion in consumer and SME credit in period from 2000 to 2007 has resulted in some problems emerging part of which were due to poor credit assessment standards and the absence of a credit bureau during this period. Non-performing loans in September 2010 have increased to 14 percent. However banks in Pakistan maintain a high level of provisions against these loans which amounts to about 70 percent. It is expected that non performing loans will decline over the next two years especially if there is an upturn in economic activity. In any event, the bank's credit assessment standards have been strengthened and a credit bureau is now in place which is particularly helpful for the consumer market. There continues to be an absence of a satisfactory properly registration mechanism which makes it difficult to ensure who is the titled owner of property which creates uncertainty in the value of collateral. The issue here is largely due to the unsatisfactory nature of the present system with some records duplicated and the lack of a fully automated reliable system. The Asian Development Bank has been assisting with some work in this area. Again it is something that could have been addressed if there had been further bank operations as it is clearly an impediment to the expansion and development of the credit market especially the home loan sector.

105. The strengthened system has withstood local and international shocks in recent years. The banks' programs which supported the restructuring and privatization of the banking sector as well as strengthening of the regulatory framework and capacity of the State Bank have greatly improved the capacity of banks in Pakistan to withstand the impact of the global financial crisis, as well the various local issues, both political and flooding. The banking sector in Pakistan has not had any major issues following the global

financial crisis, partially because the banks in Pakistan did not have significant exposures outside the country and they were not active in trading or investing in derivatives and other off-balance sheet type instruments. Non-performing loans have increased since 2007, but the banks are well provisioned against the potential loss and are actively involved in resolving these loans. In addition, the main banks in Pakistan are well capitalized and liquid, which has been a further cushion in the more difficult operating environment since 2008.

Promote transparency and disclosure of the banking system

106. The State Bank of Pakistan was required to put in place a clear and consolidated instruction on financial disclosure. This was to ensure that information would be disclosed on a consistent and transparent basis across the system. A new disclosure requirement was put in place in January 2004 and this has had the effect of improving transparency and compliance with regulations. In addition, the SBP publishes a quarterly banking system review and also has developed a five year plan for the sector which is published and widely discussed.

Prevent the possible use of the banking system for money laundering, financing for terrorism, and transfer of illegal/ill-gotten money

107. The objective here was designed to ensure that it would be become increasingly difficult for terrorists and others with illegal monies to utilize the banking system for transferring or holding the funds. Guidelines were issued in March 2003 and a system was put in place to monitor adherence to these guidelines.

5. Ratings

PROJECT OUTCOME

108. Actions in the policy area concerning transparency and disclosure of the banking system and prevention of using the banking system for money laundering, financing for terrorism contributed substantially to the development objective of "improving [banking] sector governance through privatization of UBL, HBL and resolution of ABL, further strengthening the regulatory and supervisory environment for banking, improving transparency and disclosure, and preventing possible use of the banking system for money laundering". Based on the Bank's approach to the financing of bank balance sheet restructuring in Pakistan, the privatization of HBL and UBL, which had been achieved under a previous operation (BSRP), opened the way for BSDP to finance part of the cost of recapitalization incurred by the government. This contributed substantially to the overall objective of the financial reform program of improving banking sector governance through bank privatization. The contribution of achievements under the policy area of developing effective regulatory and supervisory capacity of the State Bank of Pakistan was also substantial in view of the overall resilience of the banking system. Overall, the achievement of the operation's development outcome (efficacy) is rated ***substantial***. The relevance of objectives was rated ***substantial***, while the relevance was design was rated ***modest***. Based on these ratings for efficacy and for relevance of objectives and design, this review rates the overall outcome as ***Moderately Satisfactory***.

RISK TO DEVELOPMENT OUTCOME

109. As a result of the government's "Home Grown" banking reform program of 1997 which has been successfully implemented the banking sector in Pakistan is largely privatized, in excess of 80 percent of the banking assets in private sector banks. These banks are continuing to perform well despite the global financial crisis of 2008 and the political instability in Pakistan and neighboring countries and the disastrous flooding which affected the country last year. This is due to a number of factors; (i) the banks are well capitalized, (ii) the banks are highly liquid, (iii) The State Bank has been transformed into being a very strong and effective regulator and supervisor of the system (iv) political interference in the private sector banks is not in evidence despite the fact that the government still holds a significant minority ownership in a number of the former NCBs and has the right to appoint board members to these institutions. The results of this process which commenced in 1997 are evident today. Pakistan has a well developed and functioning banking system even after all the events both globally and locally. The evidence to date strongly supports the sustainability of these measures and it is likely that this will continue. One anticipated outcome of the reforms which has slowed is the availability of credit to the consumer and business sectors. There are a number of reasons for this, none of which are directly related to the reform program; (i) the economy has slowed significantly with GDP declining to about 4 percent in 2010 and projected even lower for 2011 from 6.4 percent in 2003; (ii) inflation has reduced from 25 percent in mid 2008 but continues to be running high at about 15 percent in the second half of 2010 which has resulted in interest rates of 20 percent and over; and (iii) inefficiencies in the operation and performance of the energy sector with continuous power outages make it increasingly difficult for business to run profitable. Overall, the Risk to Development can be rated as **negligible to low**.

MONITORING AND EVALUATION

110. **Design**. The project was based on a number of prior actions and associated outcome indicators which were set down. The outcome indicators related to the privatization of HBL and UBL were not relevant as the privatization had been achieved in the earlier phase of the reform program. The indicators related to the compliance of both banks with SBP prudential regulations were however relevant. Outcome indicators also focused on further developments of an effective regulatory and supervisory system and enhancing the capacity of the State Bank of Pakistan. Indicators to assess transparency and disclosure as well as anti money laundering were also set down. These were significant and important for the overall assessment of the development and enhancement of the financial sector.

111. **Implementation and Utilization**. Due to the design of the project based on a set of prior actions and associated outcome indicators that largely focused on privatizations which had already been completed and some further strengthening of the capacity of the banking regulator which had also been completed the overall quality of the M&E is rated as ***modest***.

BANK PERFORMANCE

112. **Quality at entry.** This was the third in a series of operations which had been designed to support the first generation of banking reforms. During this process the bank had established a good working relationship with the government and also had acquired a strong knowledge of the key issues in the reform process. While the earlier operations were designed to prepare the banks for privatization and to strengthen the legal and regulatory framework this operation was designed to assist the government in funding the re-capitalization of the state banks which had been already carried out as a pre condition to successful privatization. This was in line with the Bank's policy in Pakistan to link support for recapitalization to successful bank privatization. However, the operation missed opportunities to further reforms in the financial sector, including as highlighted in the 2004 FSAP. A stronger focus of BSDP on objectives which had not been already achieved could have brought enhanced results for the overall financial markets in Pakistan. Based on these considerations, quality at entry is rated by this review *moderately satisfactory*.

113. **Quality of supervision.** The Bank continued to support the implementation of the government's reform program during the effectiveness of the operation. However, there was no follow up on financial sector operation by the Bank despite the unfinished agenda in the banking and non banking sectors. There was limited work by other development partners such as ADB. Overall, the quality of supervision is rated *satisfactory*. Based on the ratings for quality at entry and supervision, overall Bank performance is rated ***moderately satisfactory***.

BORROWER PERFORMANCE

114. This was a unique case of a loan supporting a "home grown" bank reform program where the borrower was both committed and in charge of the implementation. As the borrower had a strong commitment to the projects decisions were made promptly and there was a strong push behind the implementation of all aspects of the program which the various implementation agencies also performed well. The overall performance of the borrower is rated **satisfactory.**

6. Lessons learned

115. The key lesson from these two projects was the importance of the commitment of the authorities to the reform program, which was most evident prior to and during the Banking Sector Restructuring and Privatization Project. Without this strong and effective commitment, such significant results could not have been achieved. Reforming and privatizing a largely state-owned banking sector is challenging, especially as there are many competing interests involved. The system was dominated by state owned banks which had a history of poor governance and a lack of financial and banking discipline. The state-owned banks accounted for 90 percent of all bad loans which was not surprising as the state banks accounted for about 80 percent of the assets of the banking system. The legal framework and court system was ineffective. Banks were overstaffed and over branched and the labour unions wielded significant powers which were not conducive to running an effective and efficient operation. Faced with this scenario, and in an effort to prevent a banking crisis, the State Bank of Pakistan and the Ministry of Finance

commenced the process of designing and implementing a “home grown” bank reform program in 1997.

116. The objective of this program was to strengthen governance and financial discipline across the banking sector. It focused on bank regulators, markets, the courts, bank owners by enhancing the authority and ability of the central bank to supervise banks and enforce regulations, promoting market discipline, improving the legal and judicial process for enforcing financial contracts, and initiating corporate governance reforms in the NCBs and DFIs. Without such a well developed and structured road map the authorities would not have succeeded in totally reforming the system over the next seven years. The government accepted the need to drastically reduce the number of branches and staff of these large state owned banks in order to make them more attractive for privatization. Once they set out to implement a retrenchment program it gave a clear signal to the markets that they were committed and that it would be possible to drastically overhaul the sector. Due to this strong commitment and favourable market conditions as well as strong support from the bank the reform and privatization program moved ahead more quickly than planned.

117. An equally strong commitment was shown by the authorities in relation to banking regulation and supervision. Prior to 1997 the capacity of the State Bank as regulator and supervisor of the system was largely ineffectual with weak systems, poorly skilled staff, lack of technology and understanding of the risks involved in the sector. The authorities recognised that successful banking reform could not be achieved and maintained without a radical reform of the banking regulatory and supervisory framework. The Government supported a series of Governors in building up the capacity of the State Bank through a combination of recruitment and training, installation of new systems and processes and restructuring the organization to remove the emphasis on the traditional transaction side of the business. As a result of all of this the State Bank has been successful in supervising and regulating the system. No banks have failed during this period and Pakistan has managed to maintain a stable and operational banking system during the global financial crises.

118. A further positive aspect of the reform measures which were strongly supported by the bank was the ability of the banking sector in Pakistan to withstand the worst impact of the international and local crises. The banking sector has performed well during the international financial crisis and also has withstood the impact of the uncertain political environment in its region as well as the severe shocks in Pakistan especially from the flooding in 2010. This is largely due the fact that the main banks were successfully privatized with good quality owners who have continued to ensure that the banks are managed and controlled effectively as well as maintaining strong balance sheets with a solid capital position, good levels of liquidity and a high level of provisions against non performing loans. In addition the State Bank of Pakistan has continued to perform strongly as the regulator and supervisor of the system.

119. In summary, through the Banking Sector Restructuring and Privatization Project and—to a lesser extent—the Banking Sector Development Program, the Bank was successful in assisting the government with the transformation of what was a predominantly state-owned, poorly performing banking sector into a largely privately-

controlled banking sector that is performing to a high standard when measured in terms of financial and operational performance. The banking sector has successfully overcome the global financial crisis of 2008 as well as the political upheaval in the region. However, in view of the government's commitment to reform, the Bank could have built a stronger momentum after the completion of these operations to assist Pakistan in addressing remaining gaps in the financial system which limit its efficiency and capacity to mobilize finance for development and poverty reduction. These gaps include: (i) developing of a longer term funding market which includes the insurance and pension fund sectors; (ii) the regulatory and supervisory regime for the non banking sector; (iii) a capital market development plan. In addition the government needs to conclude its privatization of state owned banks especially the National Bank of Pakistan, which is still one of the largest banks in the country and a systemic bank.

Appendix 1. Basic Project Data Sheet

Banking Sector Restructuring and Privatization (Loan No. IDA--35710)

Key Project Data (US$300 million)

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	540.0	609.0	112.81
Loan amount	300.0	326.78	112.81
Cofinancing	240.0	282.38	112.81
Cancellation	–	–	–

Project Dates

	Original	*Actual*
Initiating memorandum	3/6/2001	3/6/2001
Negotiations	4/1/2001	4/1/2001
Board approval	10/23/2001	10/24/2001
Signing	9/1/2002	9/1/2002
Effectiveness	10/24/2001	10/24/2001
Closing date	12/31/2004	12/31/2004

Staff Inputs (staff weeks)

	No. Staff Weeks	*US$(‘000)*
Identification/ Preparation	18.2	82.2
Appraisal	42.3	173.351
Supervision	39.59	159.741
Completion	23.2	89.565
Total	123.29	504.857

Mission Data

Stage of Project Cycle Month/Year	No. of Persons and Specialty (e.g. 2 Economists, 1 FMS, etc.)		Performance Rating	
			Implementation Progress	Development Objective
	Count	Specialty		
Identification/ Preparation February 2001	*3*	TTL (1), Team Member (2)	S	S
Appraisal/Negotiation			S	S
May 2001	*3*	TTL (1), Team Member (2),		
July 2001	*3*	TTL (1), Team Member (2)		
Supervision			S	S
September, 2002	*3*	TTL (1), Team Member (2)		
March, 2003	*3*	TTL (1), Team Member (2)		
October 2003	*3*	TTL (1), Team Member (2)		
February 2004	*4*	Senior Financial Sector Specialist (1); Senior Financial Management Specialist (1), Financial Analyst (1); Lead FS Specialist (1);		
Completion April 2005	*5*	Senior Financial Sector Specialist (1); Team Member (1); Senior Financial Management Specialist (1), Financial Analyst (1);	S	S

Banking Sector Development Policy Program (Loan No. IDA-40310 FSLT-72700)

Key Project Data (US$ 300 million)

	Appraisal estimate	***Actual or current estimate***	***Actual as % of appraisal estimate***
Total project costs	300.0	299.0	100
Loan amount	300.0	300.0	100
Cofinancing	350.0	–	–
Cancellation	–	–	–

Project Dates

	Original	***Actual***
Initiating memorandum	9/18/2004	9/18/2004
Negotiations	11/02/2004	11/02/2004
Board approval	1/13/2005	1/13/2005
Signing	–	–
Effectiveness	1/18/2005	1/18/2005
Closing date	7/31/2005	7/31/2005

Staff Inputs (staff weeks)

	No. Staff Weeks	***US$***
Identification/ Preparation	7.98	31,890
Appraisal	9.11	46,056
Supervision	4.33	10,710
Completion	8.52	54,780
Total	29.94	143,436

Mission Data

Stage of Project Cycle Month/Year	No. of Persons and Specialty		Performance Rating	
			Implementation Progress	Development Objective
	Count	Specialty		
Identification/Preparation February 2004	*4*	Task Team Leader, Sr. Financial Sector Specialist, Senior Financial Management Specialist and Financial Analyst	-	-
Appraisal/Negotiation November 2004	*4*	Task Team Leader, Sr. Financial Sector Specialist, Senior Financial Management Specialist and Financial Analyst	-	-
Supervision July 2005	*2*	Task Team Leader and Financial Analyst	-	-
Completion November 2005	*6*	Task Team Leader, Sr. Financial Sector Specialist, Private Sector Development Specialist, Financial Analyst, Junior Professional Associate and Team Assistant	-	-

Appendix 2. Additional Data

Cost to Income Ratio of Selected Banks:

Position as of September 30, 2010	
Bank	**Cost/Income Ratio (percent)**
NBP	46
HBL	44
UBL	41
All Banks	54

Pakistan Financial Soundness Indicators for the Banking Sector, 1999-2003 (commercial banks)

(in percent)	Dec-99	Dec-00	Dec-01	Dec-02	Sep-03
Capital Adequacy					
Regulatory capital to risk-weighted assets	12.2	11.4	11.3	12.6	13.1
Tier I capital to risk-weighted assets	10.3	9.8	9.7	9.7	10.9
Capital to total assets	5.0	4.9	4.6	6.1	6.2
Asset composition and quality					
NPLs to gross loans	22.0	19.5	19.6	18.0	16.1
Provisions to NPLs	46.6	53.9	53.2	58.3	63.0
NPLs net of provisions to capital	117.4	96.7	100.7	54.5	41.8
Earnings and Profitability					
ROA (after tax)	-0.3	0.0	0.0	0.8	1.4
ROE (after tax)	-6.2	-0.3	-0.3	13.8	22.1
Net interest income to gross income	54.3	61.2	68.9	67.4	58.2
Noninterest expenses to gross income	76.9	71.6	62.7	57.3	50.4
Personnel expenses to noninterest expenses	57.0	54.3	52.6	51.4	50.1
Non-interest income to total income	17.6	16.5	14.5	18.1	30.9
Liquidity					
Liquid assets to total assets	38.7	37.5	39.9	47.0	48.6
Liquid assets to total deposits	48.2	48.0	50.3	60.2	59.4

Pakistan Financial Soundness Indicators, 2007- 2011 (Commercial and Specialized Banks)

	2006	2007	2008	2009	2010	2011
Capital Adequacy						
Capital to risk weighted assets	12.7	12.3	12.2	14.0	14.0	14.6
Tier 1 Capital to risk weighted assets	10.0	10.0	10.1	11.6	11.8	12.6
Capital to Total Assets	9.4	10.5	10.0	10.1	9.8	9.6
Asset quality						
Non-performing loans to total loans	6.9	7.6	10.5	12.6	14.7	16.2
Non-performing loans net of provisions to Capital	9.7	5.6	19.4	20.4	26.1	25.7
Provisions to Non-Performing Loans	77.8	86.1	69.6	69.9	66.7	66.8
Earnings & profitability						
Return on Assets (Before Tax)	3.1	2.2	1.2	1.3	1.7	2.2
ROE (Av. Equity & Surplus) Before Tax)	35.2	22.6	11.4	13.2	16.7	23.4
Net Interest Income to Gross Income	70.9	68.2	70.3	72.4	74.7	75.7

	2006	2007	2008	2009	2010	2011
Liquidity						
Liquid Assets to Total Assets	31.9	33.6	28.2	32.7	35.0	44.4
Liquid assets to Total Deposits	42.7	45.1	37.7	44.5	45.9	58.4
Loans to Deposits	74.6	69.7	75.2	67.7	61.4	53.6

Source: State Bank of Pakistan

Appendix 3. List of Persons Met

Government Officials	
Dr. Waqar Masood	Secretary Finance
Ms. Nazrat Bashir	Secretary, Ministry of Finance
Mr. Shahid Kardar	Governor, SBP
Banking Officials	
Mr. Siraj Uddin Aziz	Chairman Pakistan Banks Association and President Bank Alfalah
Mr. Zakir Mahomood	President, HBL
Mr. Shaukat Tarin	Executive Director, Silk Bank
Mr. Mahmood Mandviwala	Standard Chartered Bank, Karachi
Mr. Tufail Ahma	Standard Chartered Bank, Karachi
Mr. Naeem	Standard Chartered Bank, Karachi
Mr. Naveed Khan	President Falsal Bank and VP Overseas Chamber of Commerce & Industry
Mr. Kamran Y. Mirza	CEO, Pakistan Business Council
Mr. Mansur-Ur-Rehman	Banking Ombudsman, Banking Mohatasib Pakistan
Mr. Zubyr Soomro	CEO Hikmah Consulting (ex CM Citibank)
Dr. Ishrat Hussain	Dean IBA & former Governor SBP
Mr. Sibtain Fazal Halim	Secretary, EAD
Mr. Nadeem ul Haq	Dy. Chairman, Planning Commission
World Bank Officials	
Rachid Benmassaoud	Country Director

Annex E. References

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Annex F. Borrower Comments: Egypt

Central Bank of Egypt

Deputy Governor

June 19th, 2012

Mr. Ali M. Khadr
Senior Manager
Independent Evaluations Group
Country, Corporate and Global Evaluations
The World Bank

Subject: Egypt First Financial Sector Development Policy Loan (Loan No. IBRD-73910); Egypt Second Financial Sector Development Policy Loan (Loan No. IBRD-75280) - Draft Project Performance Assessment Report of Financial Sector Lending Operations

Dear Mr. Khadr,

Reference to your letter dated May 30th, 2012 enclosing subject report, kindly be advised that the Central Bank of Egypt has substantial comments on the content of the draft report including factual errors. Accordingly, we do not approve the distribution and disclosure of the current report.

We will communicate all our comments in writing by the close of business day, Thursday, June 21st, 2012.

Thanking you for your cooperation.

Sincerely,

Lobna Hilal
Deputy Governor

Cc:
Mr. Merza H. Hasan, Executive Director
Mr. David Craig, Country Director for
Mr. Loic Chiquier, Director, Financial and Private Sector Development
Ms. Poonam Gupta, Country Program Coordinator
Ms. Caroline Heider, Director General, Independent Evaluation Group, World Bank
Mr. Simon C. Bell, Sector Manager, Finance and Private Sector Development
Dr. Sahar Nasr, Lead Financial Economist Social & Economic Development

Central Bank of Egypt

Deputy Governor

June 21st, 2012

Mr. Ali M. Khadr
Senior Manager
Independent Evaluations Group
Country, Corporate and Global Evaluations
The World Bank

Subject: Egypt First Financial Sector Development Policy Loan (Loan No. IBRD-73910); Egypt Second Financial Sector Development Policy Loan (Loan No. IBRD-75280) - Draft Project Performance Assessment Report of Financial Sector Lending Operations

Dear Mr. Khadr,

As a follow up to my letter dated June 19th, 2012, kindly find attached our comments on subject report. A marked up soft copy including more detailed comments and corrections to factual data has been also forwarded to your e-mail.

As communicated in your letter dated May 30th, we expect to receive a final draft reflecting all our comments before approving its distribution and disclosure.

Thanking you for your cooperation.

Sincerely,

Lobna Hilal

Lobna Hilal
Deputy Governor

Cc:
Mr. Merza H. Hasan, Executive Director
Mr. David Craig, Country Director
Mr. Loic Chiquier, Director, Financial and Private Sector Development
Ms. Poonam Gupta, Country Program Coordinator
Ms. Caroline Heider, Director General, Independent Evaluation Group, World Bank
Mr. Simon C. Bell, Sector Manager, Finance and Private Sector Development
Dr. Sahar Nasr, Lead Financial Economist Social & Economic Development

Annex F

Comments on WB's

Project Performance Assessment Report of

Financial Sector Lending Operations

1- Although the report assessment covers a period beyond the 2 DPL's and their ICR's, the data used is out of date.

2- The report contains some information that lacks accuracy and factual information.

3- The report did not highlight the major developments that took place during the past three years, thanks to the reforms that started since 2004.

4- The Egyptian banking sector managed to withstand several real-life stress tests which started with the global financial crisis in 2008, followed by the Euro sovereign debt crisis and finally the economic and financial implications of the January 25th Revolution in 2011.

5- The following table reflects a tangible translation of improvements that took place in the sector's financial performance (e.g. Asset Quality, Solvency) since the inception of the reforms and during stressed periods:

Egypt: Banking Sector Financial Soundness Indicators

(In percent; end of fiscal year [1])

	2005	2006	2007	2008	2009	2010	2011
							June
1. Capital Adequacy Ratio	13.7	14.7	14.8	14.7	15.1	16.3	16.0
2. Equity to Assets	6.1	6.3	5.5	6.2	6.4	6.7	6.4
3. Nonperforming Loans to Total Loans	26.5	18.2	19.3	14.8	13.4	13.6	11.0
4. Provisions to Nonperforming Loans	51.0	76.2	74.6	92.1	100.4	92.5	93.6
5. Return on Average Assets	0.6	0.8	0.9	0.8	0.8	1.0	1.0
6. Return on Average Equity	10.2	14.3	15.6	14.1	13.0	14.3	14.3

[1] Fiscal year ends at June 30th for public sector banks, and December 31st for other banks.

+ As Per Latest Fiscal Year End

6- Egyptian banks enjoy a high capital adequacy ratio (CAR) that exceeds minimum regulatory ratio as well as Basel II requirements (as shown in the above table), which acts as a strong buffer for any adverse economic conditions. On the other hand the banking sector will implement Basel II standards by year 2012/2013, which will take into account necessary requirements regarding CAR calculations along with regulatory discretions.

7- The successful reforms had a positive impact on deposits growth even during stressed periods where total deposits increased from EGP 650 billion in 2007 to EGP 981 billion in 2011 (51%, increase), reflecting confidence in the Egyptian Banking Sector.

8- Loans increased from EGP 354 billion in 2007 to EGP 490 billion in 2011 (38%, increase), of which loans extended to private sector increased by EGP 125 billion compared to EGP 11 billion for State-owned Enterprises (SOEs) loans.

9- Legacy SOE NPLs has been completely resolved by a 60% cash payment in 2006 and a 40% debt / asset swap in June 2010.

10-Loans to SOEs are extended on full assessment of borrower and project viability with full-fledged analysis of cash flow repayment capacity. Moreover, the majority of these loans are financed through syndicated loans with the participation of both State-owned Banks (SOBs) and private banks, pricing is based on market norms and commensurate the risk profile of these loans.

11-State-owned banks (SOB) witnessed major operational restructuring through the appointment of competent management teams that succeeded in upgrading the overall governance structure including but not limited to; risk management and internal control environment, in addition to upgrading IT and MIS systems. The restructuring also encompassed financial aspects which had a strong impact on strengthening SOBs solvency and improving its asset quality. NPLs improved to reach 10.1% in 2011 through conducting major restructuring and settlement agreements of both private sector and SOE NPLs; which has positively reflected on banks' profitability, that increased from EGP 554 billion in FYE 2005 to EGP 2,706 billion in FYE 2011 (388% increase).

The provision gap that amounted to EGP 55 billion in 2003 was fully covered in June 2011 through the settlement of NPL's (both private and state-owned), capital gains realized from the sale of non-core investments (including investments in Joint Venture Banks) and the real operational profits realized by the commercial SOBs throughout this period.

12-The two largest commercial banks National Bank of Egypt (NBE) and Banque Misr (BM) were recapitalized through the proceeds of the DPL I and DPL II loans and the Central Bank of Egypt (CBE) established a specialized unit that monitors the performance of all SOBs against an agreed upon budget as well as quantitative and qualitative targets. Their performance is monitored and evaluated against other private sector peers, with the purpose of making sure that those banks do not relapse and that they gradually are at par with leading private sector competitors.

13-In response to the improved performance of banking sector, capacity-building program was conducted to raise banking supervision capabilities, which includes but not limited to; more assertive, and proactive supervision; providing training programs for supervisors; as well as restructuring banking supervision units, aiming to move towards risk based supervision in addition to establishment of two new units focusing mainly on financial stability, namely macro-prudential and regulations unit to address any systemic risks and respond to changes and developments facing the sector. Moreover new supervisory tools and techniques were introduced to act as early warning signals to safeguard the sector from any unforeseen or potential risks such as stress testing (ongoing stress testing performed on banking sector reflected its ability to withstand severe shocks and maintaining acceptable profitability and solvency levels), internal bank's rating as well as monitoring large corporate clients on industry/sector level to proactively assess and address the creditworthiness of these clients. Several reports were developed to continuously assess and evaluate banks' performance based on both quantitative and qualitative aspects to facilitate in-depth financial analysis, performance tracking, and assessment including risk management, internal control aspects and development of early-warning indicators. **It is worth noting that without the commendable progress achieved during phase I of reform program in coordination with ECB and solid testimony of their experts,**

Annex F

the ECB would not have provided further support to the second phase of Egyptian Banking Sector reform program through the implementation of Basel II standards that will come into effect in FYE 2012/2013.

14-The Assessment Report judged the performance of the operation and the reform on the basis of several actions, triggers and policies that were not part of the reform program as set by the authorities:

a. The first phase of the banking sector reform program (2004 – 2008) has explicitly and publicly announced that one state owned bank namely Bank of Alexandria will be privatized; and the transaction was successfully completed in October 2006. The plan to privatize Banque de Caire (BdC) came at the suggestion of the Government in 2007 after the transfer of ownership from the Ministry of Finance to Banque Misr (BM). The transaction to divest 67% of the ownership of BM in BdC to a strategic investor did not materialize in June 2008 as the price offered by the highest bidder was below the minimum price set by the official valuation committee. Accordingly, it was decided that BdC will remain as a subsidiary of BM managed separately by an independent executive management and Board of Directors.
As for National Bank of Egypt (NBE) and Banque Misr (BM) it was clearly stated by the CBE that they will not be privatized and will remain as "National Champions" capable of competing in the local and regional markets after conducting a full fledged operational and financial restructuring of both banks as outlined earlier.

b. Enacting a new solvency and bankruptcy law as well creating a registry for collateral security on movable assets was never part of the first phase of the reform program as the focus of the program at this stage was on creating a viable banking sector through operational and financial restructuring, consolidation, weeding out of weak banks and resolution of NPL's. Moreover the enactment of laws is beyond the authority and domain of the CBE and falls with the Ministry of Justice.

Finally, the CBE disagrees and refuses the conclusion of the assessment report which was expressed in the following two statements:

p. 29

" Thus, despite the impressive scope of the reform program, the creation of a truly resilient and competitive financial sector still remains questionable compared to other reforming countries and would have benefited from stronger safeguards."

p. 59

"Thus, despite the impressive scope of the reform program, the commitment of the authorities to the creation of a truly resilient and competitive financial sector does not appear to be as strong as in other reforming countries around the world."

Not only does this statement ignore the factual reform results outlined above which proofs the resilience of the banking sector that was tested in several real time crises, but it also belittles the efforts and dedication of the officials involved in the design and implementation of the reform program and finally contradicts with previous independent World Bank and IMF assessment reports as well as other international renowned research and financial institutions that work directly with the CBE and the banking sector.

Annex G. Borrower Comments: Pakistan

From: Mahtab Haider - BSD
Sent: Wednesday, June 20, 2012 10:06 AM
To: 'avaroudakis@worldbank.org'
Cc: 'akhadr@worldbank.org'; Inayat Hussain - ED (BP &RG); Lubna Farooq - Director BSD
Subject: INTERIM Response to Independent Evaluation Group's Draft on Project Performance Assessment Report of Financial Sector Lending Operations
Importance: High

Dear Mr. Aristomene Varoudakis,

Kindly refer to the World Bank's letter dated June 07, 2012 pertaining to Independent Evaluation Group's *Draft report on Project Performance Assessment Report of Financial Sector Lending Operations* (Loan No. IDA-35710 and Loan No. IDA-40310 FSLT-72700).

In this regard we have to point out that certain discrepancies exist in the data presented at page 56 and 57 of the draft document. Our observations are as under:

Table 1 (page 56): Cost to Income Ratio (*selected banks*) are in conformity with BSD's data.

Table 2 (page 56): Financial Soundness Indicators (**FSIs**) for the Banking Sector, 1999-2003 covers only the performance of Commercial Banks i.e. excluding Specialized banks. Therefore, appropriate disclosures regarding source of data and coverage should be included in the table. Moreover, BSD *quarterly data set* begins from Dec-04 onwards hence, we cannot verify ratios for Sep-03.

Table 3 (page 57): Pakistan Financial Soundness Indicators (FSIs), 2005-Sept 2010, covering commercial and specialized banks, includes array of key performance indicators. Except for last two data points i.e. 2009 and Sep-10, most of these ratios do not conform to BSD's data set. Therefore, we may suggest IEG to use BSD's FSIs from table 1.4 of Quarterly Compendium: Statistics of the banking system. BSD compiles FSIs of the banking system on quarterly basis and places the same on its website. Quarterly Compendium: Statistics of the banking system for Mar-12 (archive) can be accessed from SBP's website http://www.sbp.org.pk/ecodata/fsi.asp

We will revert back to you for our feedback on the draft document.

Regards

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Date: 06/26/2012 03:32 AM
Subject: FW: INTERIM Response to Independent Evaluation Group's Draft on Project Performance Assessment Report of Financial Sector Lending Operations

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Dear Mr. Aristomene Varoudakis,

In continuation to our following email, we have to state that The Draft Project Performance Assessment Report of Financial Sector Lending Operations) on two projects i.e. **a)** Pakistan Banking Sector Restructuring and Privatization-USD 300 million, became effective in December 2001 (Loan No. IDA-35710); and **b)** Pakistan Banking Sector Development Policy Program – USD 300 million including USD 100 million from IDA and USD 200 million from IBRD (Loan No. IDA-40310 FSLT-72700) contains the factual position. We, therefore, agree to the findings of the report in general with the exception of a few data discrepancies in tables given at page 56 and 57 of the draft document. The data errors are already communicated to IEG through our email (*underneath*) dated June 20, 2012.

Regards

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