

# Précis

## Financial Sector Reform

**A**N OED STUDY OF WORLD BANK FINANCIAL sector assistance endorses an emerging wisdom—sectoral reform is a long, complex process that requires a sustained commitment by the Bank. As the Asian crisis continues to unfold, the Bank needs to acquire a deeper understanding of the dynamics of sectoral reform.

The track record suggests, in fact, that financial reform has fallen on hard times—both across countries and at the Bank. The study found, for example, that in only 12 of 23 sample countries can the outcomes of financial sector policy and/or institutional reform be deemed satisfactory.

Current internal guidelines on financial sector operations—Operational (now Policy) Directive 8.30—are a valid framework for the Bank's financial sector operations. But the Bank should begin to solidify them operationally, in a few specific directions. First, it must recognize that successful financial reform has key ingredients. The primary ingredient is macroeconomic stability. But another is a proper sequence to reform—ensuring that certain safeguards, whether structural, regulatory, or informational, are in place before broader reform is undertaken. Second, the Bank must improve its marksmanship in targeting the factors that are key to reform—sectoral governance, the prudential framework for financial institutions, and the independence and solvency of the Central Bank. Third, the Bank must begin to invest more heavily in informa-

tion-gathering, to acquire financial and other indicators that will support monitoring efforts, if not crisis prediction. Fourth, preparatory ESW is essential for appropriate operational design. Finally, the Bank must continue its strong partnerships with the IFC and IMF, and forge even more nurturing relations with borrowers.

### Background: A New Course for Financial Sector Reform

Financial systems throughout the world have now been undergoing rapid change—technological, institutional, and competitive—for the past 15 years. The shift toward financial deregulation and liberalization across the global community has led increasingly to financial integration—which has brought crisis to some countries unprepared for it, and highlighted the fragility of the financial sectors of some others.





Until 1983, Bank instruments for financial sector reform consisted of financial intermediary loans (FILs), channeled largely through banks to provide long-term finance and foreign exchange that would attack low levels of savings and investment, the constraints to growth. Their success rate was outstanding, but essentially because they came at a time of price and interest-rate stability. As volatility in world financial markets and inflationary pressures in developing countries increased, FILs became too narrow to accommodate more sweeping needs for macroeconomic and structural reforms. Bank thinking began to shift toward linking the effectiveness and sustainability of financial sector reform with the broader structural adjustment picture, including real sector growth. Sector-specific thinking began to shift more toward structural constraints against financial reform—distortions, inefficiencies, inadequate prudential regulations, and inadequate supervisory framework—not necessarily the health of individual portfolios.

But the Bank was still slow to recognize and act on the shift. Despite the fact that the share of satisfactory financial sector outcomes in the Bank's portfolio reached a low of 40 percent in 1984 (against an overall portfolio rating of 65–70 percent), the share of FIL operations remained as high as 70 percent by 1989, as the Bank continued to channel lines of credit into distorted or fragile financial systems.

In 1989, the Bank's watershed "Levy Report" from a Task Force on Financial Sector Operations argued strongly for a more comprehensive approach to financial sector lending. Its recommendations were formalized three years later as OD 8.30, which became the framework for evalu-

ating Bank assistance to financial sector reform until the current retooling of strategy in 1997, enlightened but not predicated on the current Asian crisis. The new strategy stresses that successful financial sector reform is, foremost, a long-term, sustained endeavor, not only because it includes both macroeconomic and microeconomic aspects, but also because it touches on a country's fundamental institutions—legal, regulatory, accounting, and informational—and its incentive systems. But successful reform also requires more forceful targeting of such well-known, determinants of success—government ownership, institutional capacity, and

*"initial" enabling conditions*, including the presence of distortions, the extent of competition, the strength of the financial infrastructure, and the strength of financial institutions themselves. The third critical emphasis of the new strategy is on information—solid preparatory economic and sector work (Bank ESW) is essential for effective financial sector intervention, and quantitative and qualitative surveillance mechanisms are necessary to track the reform process and the sectoral developments.

### The Record: Country Outcomes and Bank Performance

The analytical framework for the study comes from the conceptual approach of OD 8.30. Financial sector reform and Bank lending are judged along 16 performance indicators comprising three measures: *macroeconomic indicators*, including macro-environmental and real sector incentives and distortions, the *financial structure*, including policies governing interest rates, directed credit, and subsidized credit, and the *banking system*, including the legal and regulatory framework for the sector, prudential regulation and supervision, and the portfolio and capital adequacy of financial institutions.

The sample for the study consists of 23 (of 58) countries receiving 43 (of 88) Bank financial-sector adjustment loans between FY1985 and FY1996. Countries are from all regions, represent all per capita income groupings, and exhibit an array of "initial" conditions.

The study contributes to the literature in three major respects: (i) the data provide a highly systematic way to assess reform outcomes and Bank performance, (ii) the study

**Table 1: Bank-supported policy reforms and initial conditions (percentage of reforms)**

<i>Developing</i>	<i>Overall average</i>	<i>Removing distortions</i>	<i>Promoting competition</i>	<i>financial sector infrastructure</i>	<i>Strengthening institutions</i>
Hits	64	78	48	52	78
Misses	25	17	48	22	13

highlights the range of considerations—including those unique to the client—that the Bank should consider as it designs its operations, and (iii) the study emphasized a need for more information.

#### *Country Outcome: Financial Sector Reform Must Go Deeper*

Countries have largely been unable to break the macroeconomic barrier. Although 74 percent of sample had satisfactory outcomes for macroeconomic indicators, far fewer had satisfactory outcomes for financial structure (52 percent) or the banking system (35 percent). And although countries that had satisfactory outcomes for macroeconomic indicators were more successful at strengthening their financial structure and banking system than countries that had unsatisfactory macroeconomic outcomes, the recent financial crises in Korea and Indonesia clearly indicate that strong macroeconomic health can surmount, and perhaps even mask, frailties with the financial structure and banking system.

#### *Country Outcome: The Bank Should Not Back Away from Reform*

The 12 countries that implemented satisfactory reforms received an average of about 2.3 adjustment-related operations; those with unsatisfactory outcomes had an average of about 1.5. The finding implies that the Bank's in-depth, ongoing involvement in financial sector reform enhances the sustainability of reform and institutional development.

#### *Bank Performance: Solid Relevance*

A “hit and miss” analysis—whether the Bank supported or did not support policy reforms for four *initial conditions* that were deemed unsatisfactory—suggests that the Bank's lending operations have targeted sectoral reforms, particularly policies aimed at removing distortions and strengthening financial institutions.

Almost two-thirds of Bank-supported reforms in the financial sectors of the 23 countries were “hits”; 25 percent were “misses.” (See Table 1.) Of note, the Bank had numerous “overkills”—supporting policy reforms that were already considered satisfactory.

#### *Bank Performance: Mixed Efficacy*

The Bank has been more successful at implementing reforms to develop financial “infrastructure” (stronger banking laws and stricter prudential regulations) and at removing financial distortions (eliminating controls on interest rates and reducing or eliminating subsidized credit). It has not had much success at implementing reforms to strengthen individual institutions or increase competition—42 percent and 33 percent of sample countries, respectively, carried out these two reforms satisfactorily.

#### *The Difficulty of Strengthening Institutions Constrains Institutional Development*

The Bank uses both FSLs and FILs to support institutional development. FSLs target structural mechanisms either sector-wide (the legal, regulatory, supervisory, and

**Table 2: Comparison of FSL and FIL performance on institutional development**

<i>FSLs</i>	<i>Initial Conditions</i>	<i>Implementation Record</i>	<i>Outcome</i>	<i>Sustainability</i>
Strengthening financial infrastructure	0.21	0.93	0.80	0.71
Strengthening Institutions	0.17	0.71	0.62	0.75
of which bank restructuring	0.12	0.67	0.50	0.67
<i>FSLs</i>	<i>Initial Conditions</i>	<i>Implementation Record</i>	<i>Outcome</i>	<i>Sustainability</i>
Overall rating	0.38	0.44	0.42	0.42
of which: Portfolio quality	0.52	0.42	0.40	0.30
Financial performance	0.63	0.42	0.41	0.47

accounting framework) or for individual institutions, including restructuring and privatization. FILs target the operational mechanisms of individual institutions—internal policies, structure, capabilities, and financial performance and health. FILs have had little impact on institutional development, largely because such aspects as portfolio quality, resource mobilization, and financial performance depend heavily on the macroeconomic stability and the creditworthiness of bank clientele—two factors that bank management cannot control.

The performance of FSLs themselves shows how difficult it is to strengthen specific institutions. (See Table 2.)

### The Critical Elements of an Operational Agenda

The Bank's assistance for financial sector reform has not been strong. Other analyses from the study, as well as the research underlying it, suggest that building on OD 8.30 and drawing on the current Asia crisis for additional lessons will be critical to the Bank's future sectoral success. Beyond adopting a long-term, sustained approach to financial sector reform, the Bank should use the full array of lending and nonlending instruments at its disposal—including the recent introduction of the adaptable program loan (APL), which would appear to be highly appropriate for supporting financial sector reform. In support of its lending operations, the Bank must also move ahead on five other prerequisites for reform.

#### *Prefatory ESW*

Solid diagnosis and recommendations should precede adjustment operations. The Bank had more “hits” than misses” on policy reform and initial conditions in countries supported with prefatory ESW. Two thirds of the countries with prefatory ESW also had satisfactory reform outcomes.

#### *Stronger Monitoring and Evaluation Systems*

Investing more resources on collecting detailed information on risk exposure and governance of financial sectors is critical. The OED study, for example, developed two measures of financial fragility and applied them to Mexico and Venezuela, and found that, had the indexes been available earlier, the urgency of reform in the two countries would have become clearer sooner. (See Box 1.)

#### *Rational Sequence to Reform*

Reform efforts may have perverse or unsustainable results if several conditions are not in place. One, as suggested by OD 8.30, is macrostability. But two other special sequencing cases should be noted. One, com-

plete interest rate deregulation should be pursued only when the regulatory framework is sound, bank supervision is effective, accounting and auditing systems are adequate, financial markets are competitive, and banks have positive net worth and capable management and staff.

Second, the recapitalization of banks should be preceded by a change in the incentive systems that allowed or encouraged the banks to lose their capital in the first place—lending to defaulters must be stopped, strong bank supervision and monitoring and adequate information systems should be put in place, management of insolvent banks should be changed, and, if state owned, the banks should be part of a workable privatization plan.

#### *Productive Bank Partnerships with IFC and IMF*

Complementarity with IFC and IMF is a critical component of successful financial reform efforts. The Bank's conflict with IFC over funds and its sometimes overlapping responsibilities with IMF (in banking supervision

### Box 1. Financial Fragility Indexes: Useful Indicators for Crisis?

The OED study developed a macroeconomic and a microeconomic financial fragility index (FFI) and applied both to two countries that were in the throes of financial crisis—Mexico and Venezuela. The Mexico case is illustrative

In 1989, the Bank provided a financial adjustment loan to Mexico in response to its financial crisis. Both the Bank's regional operations staff and OED rated the outcome of the Bank's loan as highly satisfactory and likely to be sustained. Within two years, however, another crisis hit Mexico, prompting the Bank to respond quickly with another adjustment loan. Yet the macroeconomic and microeconomic FFIs developed for this study showed that Mexico was experiencing increasing financial fragility during 1989–95. Had these indexes been available, analysts would have been able to see more clearly the urgency of certain reforms not targeted by the first Bank loan. In addition, it would have been clear that the impact of the first loan on financial sector reform was neither as satisfactory or sustainable as supposed at the time.

Although the study's FFIs are not meant to be predictors of crisis, they can serve as useful indicators of a system's susceptibility to crisis. And they show that other statistical exercises are both necessary and promising.

and regulation, and legislation) can be minimized. The ongoing cooperation between the Financial Sector Board of the Bank and the Monetary and Exchange Affairs Department of the IMF suggests the type of commitment that will facilitate the Bank's partnerships.

*Rich Bank Relationships with Borrowers: Institutions, Sustainability, and Ownership*

All theory is irrelevant if "borrower conditions" are taken for granted. Bank work must focus on three ingredients for a successful reform partnership with coun-

tries: (i) the pace of financial sector reform should be tailored to the pace at which institutions—legal, regulatory, supervisory, and accounting—are strengthened; (ii) financial sector reform is sustainable only if it penetrates the institutions it targets—its governance issues; and, (iii) the Bank should get beyond the tricky issue of ownership. Although financial sector reform presents an especially difficult case to secure genuine commitment, the Bank's moral imperative is to use its cross-cutting, cross-country experience to identify distortions that encourage "rent-seeking" behavior.

## Précis

\*OED Sector Report: "Financial Sector Reform: A Review of world Bank Assistance," by Nicolas Mathieu, Report No. 17454, March 1998. Available to Bank Executive Directors and staff from the Internal Documents Unit and from regional information service centers, and to the public from the World Bank InfoShop: 1-202/458-5454  
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