



World Bank Assistance to the Financial Sector

A Synthesis of IEG Evaluations



INDEPENDENT EVALUATION GROUP

ENHANCING DEVELOPMENT EFFECTIVENESS THROUGH EXCELLENCE AND INDEPENDENCE IN EVALUATION

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Preface

This report is a synthesis of three evaluations carried out by the Independent Evaluation Group and completed between July 2005 and February 2006, on different aspects of Bank assistance to financial sector development in client countries. The three evaluation reports are *World Bank Lending for Lines of Credit: An IEG Evaluation*; *IEG Review of World Bank Assistance for Financial Sector Reform*; and *Financial Sector Assessment Program: IEG Review of the Joint World Bank and IMF Initiative*.

This paper seeks to draw out common themes and issues that have arisen from the three evaluations, which reviewed major components of the Bank's assistance during more than a decade to the financial sectors of client countries.

For a detailed analysis of issues, IEG recommendations, Bank Management responses, and the Management Action Records, which summarize proposed Bank actions, the reader is referred to the individual reports.

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Executive Summary

This report is a synthesis of three evaluations by the Independent Evaluation Group to examine different aspects of World Bank support to the financial sector during the period, fiscal years (FY) 1993–2005.

Trends

Between fiscal years 1993 and 2003, Bank assistance for financial sector reforms was supported by some \$56 billion, or 24 percent of total Bank commitments. Most of this lending was embedded in multisector loans. The trend during this period, has been downward, owing mainly to the sharp drop in lines of credit (LOC); apart from LOC, support for financial sector reforms has declined only slightly. Lending for all LOC, including those outside the financial sector, accounted for another \$13.4 billion.

Nonlending analytic work in finance surged in the early 1990s, but the number of formal sector reports leveled off or began to decrease by the mid-1990s. Following the financial crises of the late 1990s, however, the Bank and the International Monetary Fund (IMF) initiated the Financial Sector Assessment Program (FSAP) to carry out in-depth diagnoses of the vulnerabilities and development challenges of financial sectors in client countries. As of late 2005, some 109 country assessments and 18 updates had been completed or were ongoing, and had involved substantial Bank resources.

Main Findings

The evaluations found that Bank assistance to the financial sector, both in lending and

nonlending, has contributed to the development of the financial sectors in client countries. The FSAP advanced dialogue with client governments and provided useful advice and recommendations. Lending has helped to bring about positive changes in governance, regulatory framework, market structure, and efficiency. Overall, and with the important exception of Bank support for LOC, the Bank's presence has helped to catalyze changes in the right direction in the depth and access to credit of financial systems. Nevertheless, financial sectors remain shallow, with narrow access to credit, in many, if not most Bank client countries, and there is room for improvement in the quality and impact of Bank assistance.

Outcomes and Impact at the Country Level

The Bank has focused its lending and diagnostic work more on banking issues than on other financial sector issues (e.g., capital markets, insurance, nonbank financial intermediaries, access to credit for nontraditional customers). Within banking, the Bank's lending assistance has generally been effective on institutional issues such as strengthening regulations, reducing government ownership of banks, and helping to

increase the efficiency of banking systems. These improvements can be associated with Bank borrowing—financial sector outcomes in countries that borrowed from the Bank for financial sector reforms are generally significantly better than in countries that did not.

Nevertheless, in most of the countries, although the trend has been in the right direction, the financial sectors remain relatively shallow, and private sector access to credit remains low. While some of the slow growth in private credit reflects positive developments such as the cleanup of bad loans and tighter credit quality standards, the ultimate objective of having well-developed financial systems that contribute to economic growth and poverty reduction remains largely unmet.

The focus on banking has generally been appropriate, as banking dominates the financial sectors in most countries. Going forward, however, while retaining its core business of institutional reforms in banking, the Bank needs to increase its expertise to *focus more on the nonbanking sector, and on identifying constraints to credit access, through a range of activities, including lending and diagnostic work such as investment climate surveys, poverty assessments, and other economic work that could include assessments of access to various types of financial services.*

Bank Support to Countries Experiencing Crisis

Bank assistance for financial sector reforms to countries experiencing crisis constitute some 50 percent of the lending reviewed here. The Bank was ill-prepared to respond quickly in the earlier crises (Mexico in 1994; and Thailand, Korea, and Indonesia in 1997), and better prepared in Argentina, Russia, and Turkey. Although the stated objectives of the loans were similar to those pursued in noncrisis situations, outcome ratings of closed operations are lower by more than 20 percentage points than for noncrisis lending. This is surprising given the high relevance of the objectives and the fact that crises often induce or strengthen the commitment of governments to address problems. The result is likely because of the need to state highly

ambitious objectives to justify the large loans that are necessary to fulfill the preannounced assistance packages.

More than 10 years ago, and after the Mexico crisis, Bank management had concluded that *internal Bank guidelines should be prepared for crisis situations, with triggers for actions and clear lines of responsibility. These conclusions remain valid and need to be implemented.*

Collaboration with the IMF in countries that experienced a crisis was not always smooth, particularly in Indonesia, Mexico, Russia, and Thailand. Following the Asian experience, the Bank and the IMF reached agreements, in principle, to improve collaboration.

The joint Bank-IMF Financial Sector Assessment Program was developed in response to the Asian crises. This analytic tool, which has covered a large percentage of (but not all) systemically important countries, increases the likelihood that the Bank (and the IMF) are aware of the vulnerabilities of client countries and should, therefore, be better prepared to deal with crises, should they occur. Because the program is a collaborative effort between the Bank and IMF, it should also help collaboration between the institutions in their responses to crises, compared with recent past experience. Nevertheless, the boundary between the two institutions is not always clear and collaboration will remain a challenge.

Improving Quality

The objectives of financial sector reforms were generally consistent with good practices. Seventy-five percent of financial sector projects and components of multisector operations reviewed (excluding LOCs, discussed below) had a satisfactory rating, slightly below the 79 percent average for all adjustment and technical assistance (TA) lending, excluding the financial sector. Outcomes of adjustment and technical assistance loans under the Financial Sector Network were significantly better than outcomes of financial sector components in multisector loans, even after controlling for country conditions. Similarly, for LOC, although overall outcomes were unacceptably low (at 52 percent satisfactory by number of

operations and 45 percent by net commitment), they were somewhat better in the financial sector. Outcomes of LOC were also better when they were consistent with the Bank's guidelines for LOC.

The findings imply that the Financial Sector Network should play a stronger role in preparing and managing financial sector assistance, and should provide more guidance to Bank staff working in the financial sector. However, experience with LOC has shown that guidance alone is not sufficient to ensure good quality products: implementation of the Bank's guidelines for LOC has been very poor, with many LOC approved under conditions and with characteristics that are contrary to the letter and spirit of the Bank's guidelines—although implementation of the guidelines was stronger for LOC under the aegis of the Financial Sector Network than for LOC under other sector networks.

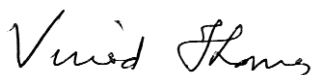
The IEG review found that the quality of the diagnostic work in the FSAP was generally high; however, it had major impact on subsequent Bank assistance in fewer than half of the countries where the FSAP was carried out. Integration of Bank analytic work into overall country strategies must be supported, not only by the Financial Sector Network, but by the country teams. As noted above, the financial sector analytical work could also be improved by better coordination with other analytic work such as investment climate surveys and poverty assessments.

One area for improvement is the need for greater consistency. Consistency of Bank support within a country has been weak at times (for example, advocating privatization of banks while simultaneously supporting expansion of government ownership of banks). This is the case as well for the coherence of the Bank's approach to financial sector reforms across countries, where the Bank has sometimes advocated rapid bank privatization in one transi-

tion country while supporting gradual privatization in another in similar circumstances. The Bank also "speaks with many voices" on important matters, such as deposit insurance and capital market development, owing to an absence of policy guidance, ongoing debates within the Bank over issues, and the decentralized nature of the institution. The differences in policy positions cannot be explained by differences in country circumstances or the willingness to reform. Therefore, more guidance on good practices is needed.

This is also the case for the Bank's FSAP work, where the Financial Sector Network has not taken advantage of the experience gained across countries and Regions in carrying out these diagnostics, to establish what constitutes good practices, develop specific examples of these from Bank experience, and to disseminate these examples proactively. The Bank should capitalize on its tremendous repository of experience in a range of topics (for example, bank restructuring, asset management companies, bank privatization, and development of capital markets) to help Bank staff to develop consistent approaches to analytic work as well as to support reforms. Best practices should also include the development of sequencing and implementation plans.

These findings suggest that there is scope to improve the overall coherence of Bank work in the financial sector within a country as well as across countries. *The Financial Sector Network has a key role to play to ensure that: (i) country strategies incorporate, where relevant, a coherent strategy for the financial sector that draws on the FSAP or other relevant diagnostic work; (ii) the sector strategy carries through to lending and nonlending; and (iii) quality control exists for lending and nonlending assistance to the financial sector, whether categorized under the financial sector or other sectors.*



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ACRONYMS AND ABBREVIATIONS

CPIA	Country Policy and Institutional Assessment
ESW	Economic and sector work
FSAP	Financial Sector Assessment Program
FY	Fiscal year
GDP	Gross domestic product
IEG	Independent Evaluation Group (formerly OED)
IMF	International Monetary Fund
LOC	Lines of credit
OECD	Organisation for Economic Co-operation and Development
OED	Operations Evaluation Department (changed to IEG)
PFI	Participating financial institution
TA	Technical assistance



Introduction

This report synthesizes three evaluations completed by the Independent Evaluation Group (IEG) between July 2005 and February 2006 which examined Bank support to the financial sector. The three evaluation reports are *World Bank Lending for Lines of Credit: An IEG Evaluation*; *IEG Review of World Bank Assistance for Financial Sector Reform*; and *Financial Sector Assessment Program: IEG Review of the Joint World Bank and IMF Initiative*.¹

Owing to its importance for the development of a country, the financial sector has been supported by the Bank for over 50 years, with assistance in a variety of forms, including both lending and nonlending. The reviews summarized here examined the assistance to the financial sector during the period, fiscal years 1993–2005, although the Financial Sector Assessment Program started only in the latter part of this period.

The *IEG Review of World Bank Assistance for Financial Sector Reform* covered lending for adjustment and technical assistance in support of structural reforms aimed at the financial sector and nonlending assistance outside of the Financial Sector Assessment Program. It examined individual operations and experiences at the country level, compared the quality of lending to “good practices” as found in the literature and in Bank guidelines, and examined outcomes and impact at the country level by measuring changes in financial sector indicators across more than 10 dimensions during a 12-

year period. Finally, because “crisis lending” was such an important part of Bank lending during this period, the evaluation examined Bank experiences and outcomes with support to countries experiencing crises, particularly when those crises involved the financial sector.

The review of *World Bank Lending for Lines of Credit* focused on a specific instrument of Bank lending—financial intermediary lending, or lines of credit (LOC). LOC involve channeling funds to investors, usually in the private sector, through financial intermediaries, often banks. Many LOC also aimed to strengthen the participating financial institutions and, thus, indirectly strengthen the financial sector, although the majority of the LOC were not categorized as “financial sector” operations, but were typically in the rural, urban, or energy sectors. The focus of the LOC evaluation was on the extent to which the LOC followed the Bank’s guidelines, and on project outcomes.

Finally, *Financial Sector Assessment Program: IEG Evaluation of the Joint World Bank and IMF*

Initiative reviewed an important aspect of Bank nonlending assistance. The FSAP assesses vulnerabilities and developmental needs of financial systems in client countries. The analysis covers the period fiscal year 1999 (when the program started) through fiscal year 2005. The report examines the relevance of the effort, the country selection, scope and coverage of the analysis, and the extent to which there has been follow up on the FSAP, either in conjunction with Bank lending or by the authorities without Bank assistance.

The importance of the financial sector for development is widely recognized. Financial sector development is essential for mobilizing resources, channeling them to productive investments, managing risks, and thereby contributing to economic growth and poverty reduction. A growing body of literature, much of it associated with or emanating from Bank research, has established links between financial development and growth (Levine 1998; Levine, Loayze, and Beck 2000),² thus also establishing a strong rationale for Bank attention to the financial sector. In addition, the past decade provides many examples of the devastating impact that financial crises can have on countries, wiping out decades of growth and poverty reduction within a very short time. A well diversified, robust, and stable financial sector can better withstand the forces that induce crises—although it may not be able to prevent them entirely. Thus, both to promote growth and reduce poverty and to help countries avoid financial crises, the Bank has a

role to play in supporting financial sector development in its client countries.

A review of the literature related to the financial sector, detailed in chapter 2 of the *World Bank Assistance for Financial Sector Reform*, showed that certain tenets, such as the appropriate role for banking supervision and minimum capital requirements for banks, have evolved over time, while others, such as the importance of macroeconomic stability for financial sector development, are widely accepted today in both the theoretical and empirical literature. By contrast, the literature is ambiguous on a number of questions, including the best mix of financial institutions (whether the market should be bank-based versus capital market dominated) and on whether market concentration or more competition in banking leads to more efficiency or greater stability. The literature is more definitive in that state control of banks is associated with poorer financial sector performance and lower access, or no better access, to credit than privately dominated systems. Finally, emerging literature on banking regulations and banking supervision point to the need to tailor these systems to the country conditions. In any case, reforms should focus as a priority on creating the incentives and tools (accounting, auditing, disclosure requirements, rating agencies) for market participants to monitor financial institutions. The literature review was used as a benchmark against which to examine Bank guidelines, strategies, and lending assistance delivered to client countries.



Trends in Lending and Nonlending Assistance to the Financial Sector

Trends in Lending

In the 1990s, the Bank shifted its focus from support of individual financial institutions to support of sectorwide improvements in the financial sectors of client countries. Between fiscal years 1993 and 2003, some \$56 billion or about 24 percent of total Bank commitments during the period, included reforms aimed at the financial sector.

Much of this lending took the form of multisector adjustment loans with conditionality aimed at the financial sector, particularly the banking sector (reducing government ownership, strengthening supervision, and upgrading regulations to align with international norms), and to a lesser extent, the nonbank financial sector, including capital markets. Most of the investment lending aimed at strengthening the financial sector was in TA loans approved in tandem with the adjustment operations. Loans with financial sector reforms accounted for some 16 percent (by number of projects) up to 1999, and about 11 percent thereafter (figure 2.1).

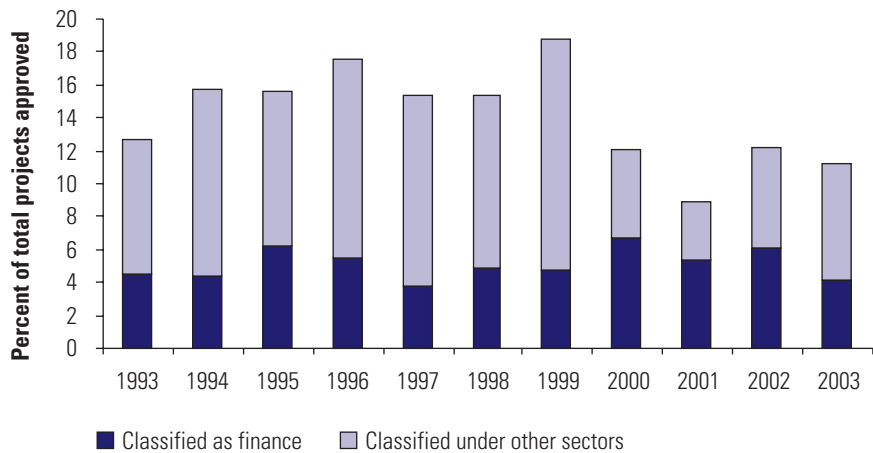
At the same time, lending continued, albeit in declining volumes, to individual financial intermediaries, for on-lending to (mostly) private sector borrowers, who are required to repay their subloans (figure 2.2). These LOC have a long and contentious history in the Bank and are the subject of ongoing debates about the extent to which they overcome market failures and promote growth and employment,

or whether they introduce distortions, are unsustainable, and crowd out private sector intermediaries. Nevertheless, some \$13.4 billion was committed in the form of LOC, representing about 8 percent of Bank commitments for investment lending during fiscal years 1993–2003.¹ LOC were identified (see box 2.1) in many sectors; the rural sector accounted for almost one-third of them, with financial and urban sectors each accounting for another 15 percent.²

Trends in Nonlending Assistance to the Financial Sector

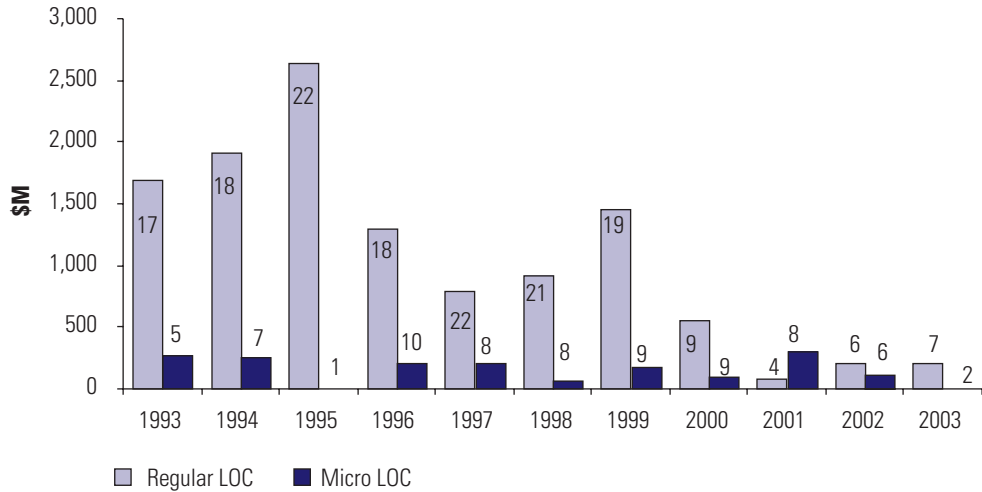
The shift in the focus of Bank assistance to the financial sector in the late 1980s and to sectorwide reforms was accompanied by the need to better understand the constraints and issues in the sector. This is reflected in the surge in formal economic and sector work (ESW) reports containing financial sector analysis, growing from single digits per year in the 1980s to double digits per year in the 1990s, with a gradual shift

Figure 2.1. Bank Loans with Financial Sector Reforms, by Number of Loans, FY93–FY03



Source: IEG data.

Figure 2.2. LOC Commitments and Number of Projects



Source: IEG data.

toward more informal sector reports in place of formal sector ones. During the period under review, the trend remained relatively constant in terms of the number of formal and informal ESW on the financial sector, although with the advent of the FSAP in 1999, the nature of financial ESW became more tailored.

The FSAP is a major initiative, undertaken in response to the financial crises of the late 1990s.

The program undertakes an in-depth diagnosis of the vulnerabilities and development challenges of the financial sectors of client countries, resulting in written reports for government authorities and for the Executive Boards of the Bank and the IMF. As of late 2005, 109 country assessments and 18 updates had been completed or were ongoing, and had involved substantial Bank resources.

Box 2.1. Identifying LOC

In the absence of a reliable database for all LOC, IEG examined appraisal and completion reports for more than 2,000 loans and credits (and found more than 200 LOC). Other than those projects specifically classified as financial intermediation loans, it was not always obvious whether LOC were embedded in project designs. Some appraisal reports mentioned that a component would be passed on to beneficiaries as subloans to be repaid, but with no other detail. In other cases, it was difficult to know whether the subloans were being financed by the Bank loan or credit and if so, the amount. China presented special challenges, as virtually all Bank lending is passed on to provinces, municipalities, state agencies, and other institutions in the form of subloans. IEG also compared its database to those of other databases on LOC within the Bank and International Finance Corporation to ensure completeness.



Quality of Bank Assistance to the Financial Sector

Quality of Bank Lending for Financial Sector Reforms

The review of 35 country case studies found that the objectives of financial sector reforms supported by Bank lending were generally consistent with good practices as found in the literature, particularly in areas where there is widespread agreement in the literature and within the Bank.

Those objectives have included reducing government ownership of banks and other financial intermediaries; improving prudential regulations consistent with international standards; and strengthening bank supervision to be consistent with international principles. The latter two areas were also a primary focus of the FSAP. Examples of good practices exist in every Region.

Even where the reform objective was consistent with good practices, however, specific conditionality or design of the loan was not always appropriate for achieving the objective. For example, in Algeria, Lao PDR, and Vietnam, the Bank aimed to strengthen the health of the banking sector without addressing the underlying reasons for its poor situation. There is ample evidence that new investment in banks with political mandates is not a sustainable solution to improving the health of the banking system; such an approach generally results in a reaccumulation of bad debts. Nevertheless, the Bank supported recapitalization of state banks in these countries, absent of any government

commitment to change their governance, particularly through privatization. These findings are similar to those in the review of Bank assistance to pension reform, where the Bank did not always follow good practices. For example, the Bank supported multipillar pension systems in the absence of proper initial conditions, including sound macroeconomic policies, an adequate financial sector, and good implementation capacity (in terms of strong regulations and good governance).

In pursuit of reducing the role of government as owner of banks, Bank lending was sometimes overly focused on privatization as an end in itself, and too little focused on having well-managed banks whose owners had incentives to both manage risks and realize returns. The Bank did not discourage privatization of a bank or banks to inappropriate owners, which in Mozambique led to considerable expense for the government, and in Georgia led to concern about the quality of the banking assets. In Uganda, the Bank encouraged privatization of banks to inappropriate owners, which led to a

renationalization and reprivatization, also at considerable expense to the government.

Consistency of the Bank's approach to financial sector reforms across countries needs to be improved, particularly with respect to the priority for Bank support for payments systems, deposit insurance schemes, and capital market development. The ongoing debates within the Bank (for example, whether and how to support deposit insurance schemes), an absence of "good policy" notes, and the decentralized nature of Bank operations have all contributed to a situation in which the Bank speaks with many voices on important matters of financial sector policy. This situation cannot be fully explained by differences in country circumstances or a willingness to reform. The Financial Sector Board needs to have a larger role in establishing guidelines and good practices.

Consistency within a country also needs to be improved. For example, in some countries the Bank has sent mixed signals across different but closely timed strategy and diagnostic work, between ESW and lending, or within lending. In Russia, for example, an early banking sector study focused on the need to restructure the large state banks, while the country assistance strategy that followed soon thereafter mentioned only that the government should assign high priority to privatizing state banks and consolidating private ones, while focusing Bank lending on providing LOC to private banks (and leaving the larger issues untouched). In a number of countries, the Bank advocated closing or privatizing state banks, while at the same time supporting expansion of government ownership of banks: in Albania, for example, the Bank supported, within the same credit, closure of a state-owned rural bank and establishment of a new one, which then closed down four years later after accumulating a poor portfolio of loans. In Mongolia, the Bank supported liquidation and privatization of public banks while concurrently helping the government to establish a new state-owned commercial bank and a savings bank. In both Morocco and Cameroon, the Bank supported developing the post office as a lending agency at the same time it was encouraging privatization of commercial banks.

On deposit insurance, the Bank has also sent mixed signals within a country. For example, a sector report for Ukraine in fiscal year 1995 recommended that creation of a deposit insurance scheme should be an objective only for the long term, to be established only after other reforms were in place and the banks were strong enough to give such a scheme credibility. Yet, the introduction of deposit insurance was a condition of the fiscal year 1999 Financial Sector Adjustment Loan. These inconsistencies may reflect disagreements within the Bank (which in turn reflect international disagreement) on good practices or on the appropriate approach in a given country, but they suggest the absence of a coherent approach to financial sector development in a specific country.

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

Quality of LOC throughout the Project Cycle

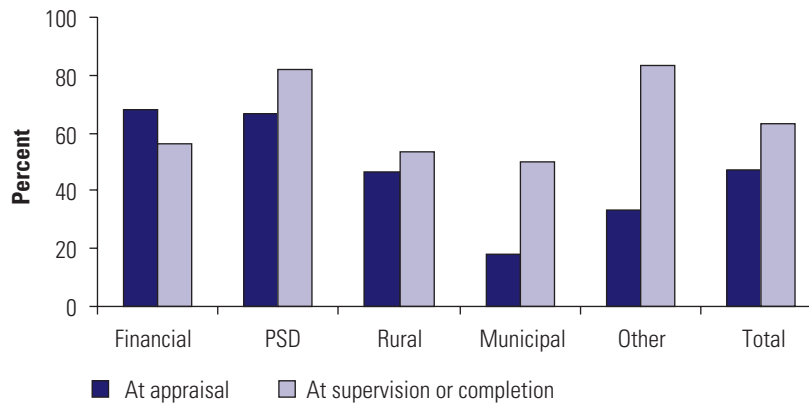
In contrast to most other Bank lending, LOC are governed by specific guidelines for the conditions under which they should be considered and basic principles that should be followed in their design. These guidelines were developed in an effort to improve the poor performance of LOC in earlier decades. A detailed review of a large sample of LOC approved in the past decade showed that implementation of the guidelines has been poor at all stages of the project cycle.

Contrary to the guidelines, one-quarter of the LOC were approved in highly unstable macroeconomic conditions, but because macroeconomic stability has improved since the late 1990s, this is now less of an issue. Moreover, contrary to the guideline that only relatively sound institutions should be used to intermediate Bank funds, fewer than half of the projects used any specific eligibility criteria to select the participating financial intermediaries (figure 3.1). In some cases that had criteria, they were unacceptably weak (75 to 85 percent loan repayment rates, for example). At appraisal,

fewer than 40 percent of the LOC reported on the quality of the loan portfolio or other salient information about the participating financial intermediaries, and the percentage drops further in supervision and completion reports (figure 3.2).

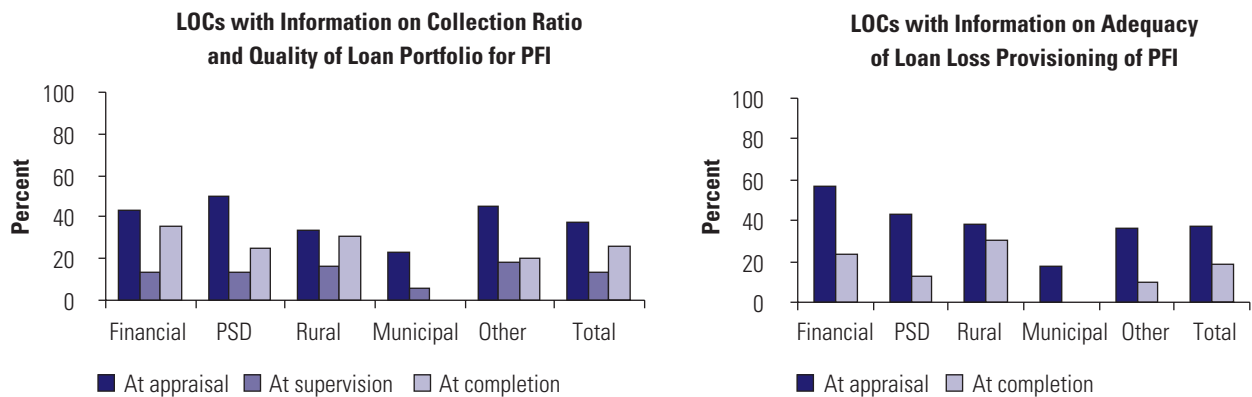
At completion, almost 40 percent of the LOC had no information on repayment rates of Bank-funded subloans. One-third of LOC with potential environmental impact had no mention at appraisal of requiring environmental assessments on subprojects; at completion, only about half mentioned environmental impact. The LOC

Figure 3.1. Eligibility Criteria at Appraisal and Monitoring during Implementation



Source: IEG data.

Figure 3.2. Project Cycle Information on Financial Health of Participating Financial Institutions (PFI), by Sector



Source: IEG data.

in the financial sector did somewhat better than LOC in other sectors in implementing Bank guidelines, which suggests that oversight by the Financial Sector Board in the design of LOC improves the quality-at-entry.

Quality of FSAP

The objectives of the FSAP—to identify financial sector vulnerabilities and development needs of the financial sector—are relevant to the missions of the Bank and the IMF, and the joint nature of the Bank-IMF cooperation has been a positive aspect of the program, permitting an integrated approach to financial sector vulnerabilities and development needs. The Bank, however, can do more to sharpen the program’s relevance, quality, impact, and efficiency.

The FSAP has not yet covered all “systemically important” or vulnerable countries, or selected countries where financial sector development assessments can be most effectively used. The voluntary nature of the program has the advantages of ensuring cooperation of the authorities and access to detailed information and key staff, but it also limits the program’s overall effectiveness in identifying systemic risks. Nevertheless, the authorities and staff surveyed for the FSAP review concurred that the

voluntary nature of the program should be maintained because of the importance of having the authorities’ cooperation.

Given the resources available, FSAP assessments and updates have been limited to 17 to 19 per year. At this rate, coverage of the full Bank/IMF membership would take approximately 10 years, which does not support either a surveillance or development objective; a two-to-three-year cycle would be more appropriate for updates.

Survey and interview respondents were satisfied with the quality of FSAPs, with 70 to 90 percent of country authorities expressing satisfaction with coverage and depth of the analysis. However, a detailed review of the FSAPs found uneven coverage and quality of analysis in specific sectors (table 3.1). While banking sector coverage was satisfactory, the coverage in the nonbank financial sectors was not as strong. In addition, the Bank needs to develop better approaches to analyzing missing markets and access issues, and devise creative solutions to improve those areas. Finally, prioritization of recommendations is weak: either too many recommendations, or sequencing and implementation capacity were not well addressed (table 3.1).

Current analytical tools, such as stress tests and the reports on standards and codes

Table 3.1. Summary of Results of Detailed Reviews

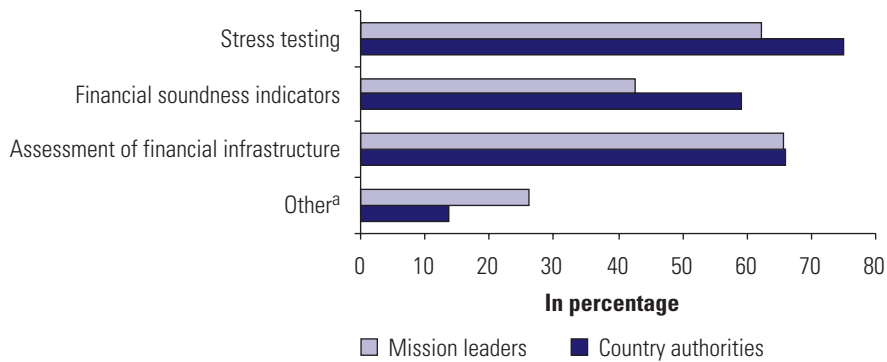
Criteria	Mean score (on scale of 1–4)	Percentage of ratings indicating some problems (ratings of 3 or 4)
Coverage of overall financial sector	2.38	26
Balance of development and stability issues	2.02	16
Banking	1.76	7
Insurance	1.73	29
Capital markets	1.78	19
Asset management / pensions	2.29	58
Market infrastructure	1.98	31
Clarity and candor of findings	2.16	16
Importance and consequence well explained	2.25	26
Clarity of recommendations	1.93	11
Usability of recommendations	2.08	21
Prioritization of recommendations	2.62	53

Source: IEG evaluations. “1” is the highest rating, “4” is the lowest rating.

(ROSCs), are highly valued by country authorities and other constituencies (figure 3.3), and can be useful for vulnerability assessments and development priorities. Nevertheless, the tools can be improved by strengthening the methodology of stress tests and deemphasizing ratings when reporting ROSCs.

The candor of the reports is generally satisfactory, although staff sometimes have (under pressure) softened the written reports. In addition, because there is a long lag between the assessment and the resulting Bank document, the FSA (see table 3.2), the Bank's Board is not informed on a timely basis.

Figure 3.3. Most Useful Analytical Components



Source: IEG/IEO Survey, multiple responses allowed.

a. Includes analysis of vulnerabilities and development needs.

Table 3.2. Time for Completion of FSAP Documents

	Number of days since start of first mission	
	Joint Bank/IMF FSAP	IMF-only FSAP
Draft aide-mémoire left in field	68	75
Delivery of final FSAP report to authorities	297	289
Completion of FSSA	311	293
Completion of FSA	394	N.A.

Source: Financial Sector Liaison Committee data, as of February 14, 2006.



Outcome Ratings of Bank Lending in Finance

Although outcome ratings of individual operations do not capture whether the financial sectors themselves have developed, it is useful to examine the ratings for insights on patterns, relationships, and trends that could provide recommendations for improving quality.

Outcome Adjustment and TA Loans Aimed at Financial Sector Reforms

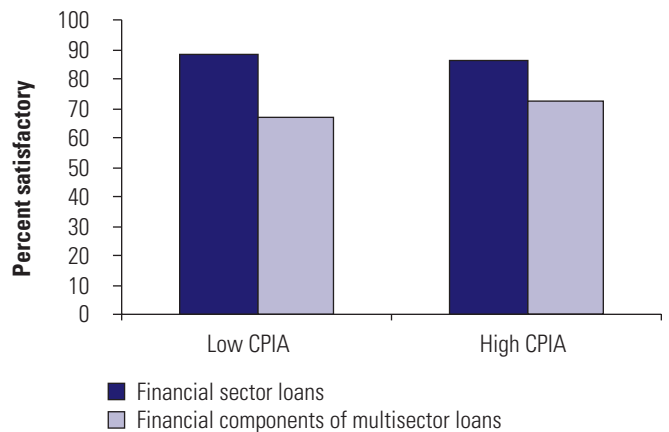
At the time of the analysis for the Financial Sector Review (March 2004), 159 operations had closed and been rated, or some 60 percent by number and 63 percent by value of approved loans/credits during the period. Outcomes, including financial sector and components of multisector operations (excluding LOC) average 75 percent satisfactory, slightly below the 79 percent average for all adjustment and TA lending (excluding the financial sector).

Outcomes of loans under the financial sector board were significantly better than outcomes of financial sector components of multisector loans (figure 4.1). The results cannot be explained by differences in reforms or conditionality, as they were similar in financial sector and multisector loans; neither was there any preference for use of financial sector versus multisector loans in crisis versus noncrisis situations. Nevertheless, it is possible that the results might be driven by differences in country characteristics; this was tested by examining outcomes, controlling for Country Policy and Institutional Assessment (CPIA) rating and per capita income level.

The results (figure 4.2) show that even controlling for these characteristics, outcomes of financial sector loans do better than financial sector components of multisector loans. Most of the results are statistically significant. These findings suggest that financial sector reforms under the control of the Financial Sector Board have better outcomes than similar reforms under other Networks, suggesting that Financial Sector Network staff should be closely involved in quality control at the preparation stage. In addition, counterparts from finance (ministry or central supervisory authority) in the client country should also be closely involved in the design and implementation of the financial sector reforms (which may be less often the case in multisector loans). These results are similar to those in the pension review, which found that outcomes of pension components in operations that were under the Financial Sector Network had better outcomes than operations in most other sectors (except the Social Protection Network).

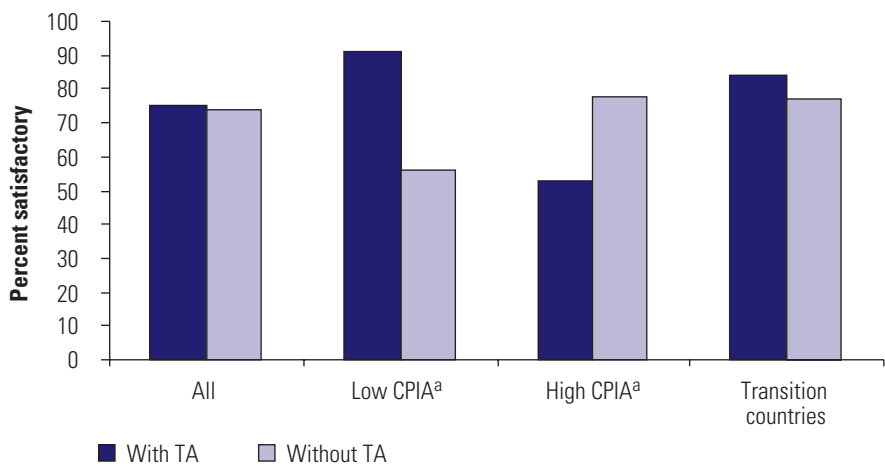
Outcomes of Bank loans accompanied by Bank-financed TA loans were compared with outcomes where no Bank funding for TA was

Figure 4.1. Outcomes by Sector and CPIA Ratings, by Number of Loans, FY93–FY03



Source: IEG data and analysis.

Figure 4.2. Outcomes of Adjustment Loans, with and without Technical Assistance



Source: IEG data and analysis.
 a. Excluding transition countries.

provided, controlling for a country’s institutional capacity. An important caveat is that TA may have been provided by other donors. Nevertheless, in low-capacity countries, as reflected by their CPIA, adjustment loans had significantly better outcomes when a TA operation was associated with it than when there was no TA (figure 4.2). In high-capacity countries, the opposite was the case: outcomes

were better when there was no TA operation. One explanation could be that in higher-capacity countries, the existence of a TA loan may signal that the government is not fully committed to carrying out the reforms. The conclusion from this analysis is that accompanying TA lending can help in low-capacity countries but does little to foster ownership or commitment to reforms in higher-capacity countries.

Outcome Ratings of Lines of Credit

In sharp contrast with adjustment and TA operations, outcomes of LOC have been much less positive. At the time of the review, about half of the LOC, by number and commitment amounts approved during the relevant period, had been closed and rated.

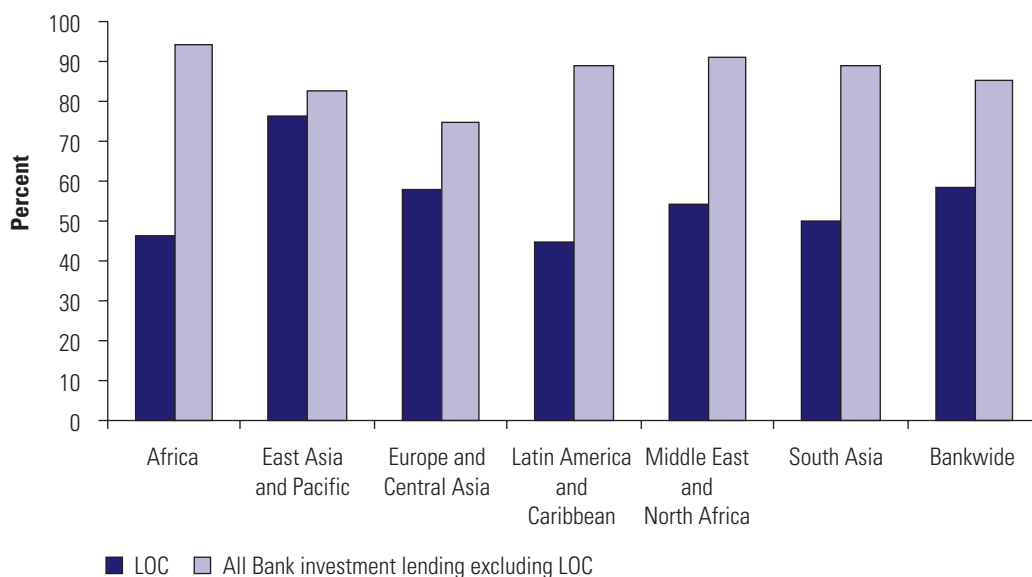
A salient feature of these closed LOCs was the high cancellation rate of the originally committed amount (see figure 4.3). At 40 percent, it was twice that of Bank average for other investment lending; in about a fifth of the LOCs, at least 90 percent of the original LOC amount was canceled. These cancellations occurred despite efforts to spur lagging disbursements. About 40 percent of these LOC had revisions in project design, mostly aimed at easing disbursements. The most frequent design changes were in eligibility criteria for ultimate borrowers and in interest rates.

According to implementation completion reports, external conditions caused cancellations in some countries: large macroeconomic shocks, government delay, and subsequent change of conditions. But in many cases, design weaknesses surfaced during implementation, including overestimation of demand, weak

participating financial intermediaries, and lending terms and conditions that proved too difficult to meet. Other possible factors include lending by other multilateral or bilateral development institutions, and the size of the LOC relative to the size of the financial sector: the smaller the LOC, relative to the financial system, the better it disbursed. Finally, there has been little growth in credit to the private sector (as a proportion of GDP, see next chapter), which suggests that the Bank may have been too optimistic in its underlying assumptions about the expansion of the financial sector in the borrowing country. These findings underscore the importance of using conservative estimates of demand for subloans and ensuring that the LOC is a modest fraction of total estimated demand for credit in the system.

Outcomes of LOC were poor and even these ratings may be overstated. The availability of supporting evidence for outcome ratings varies widely. In the best of cases the rating is based on a beneficiary assessment, financial information on repayment rates of subloans, and/or financial information on the quality of the participating financial institutions portfolio. In the worst of cases, the rating is based mostly on the fact that

Figure 4.3. Disbursements as a Percentage of Commitments, by Region



Source: IEG database and analysis.

the LOC were disbursed without supporting evidence on end-use or repayment.

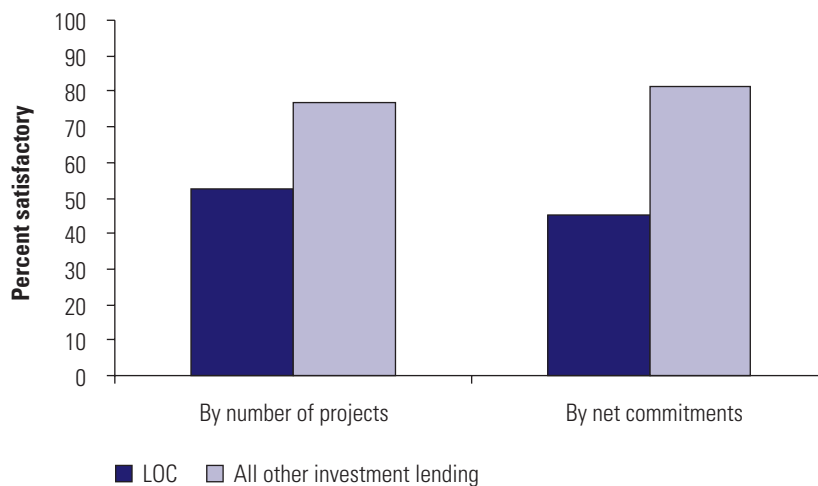
At 52 percent satisfactory by number of projects and 45 percent by net commitment amounts, outcome ratings for LOC have been unacceptably low (figure 4.4). Outcomes were somewhat better in the Rural Sector (67 percent by number), while the worst were in Private Sector Development (10 percent by number).

The extent to which satisfactory outcomes could be associated with the conditions and minimum requirements stipulated in the Bank’s guidelines for LOC are shown in figure 4.5. The outcome of an LOC was more likely to be satisfactory if it was implemented in the following manner:

- under stable macroeconomic conditions (low inflation);
- in stronger financial sectors as reflected in the CPIA ratings for the sector (which reflect financial sector stability and financial sector depth, efficiency, and resource mobilization);
- by privately owned financial institutions (rather than state-owned financial institutions); and
- using clear eligibility criteria in the selection of the participating financial institutions.

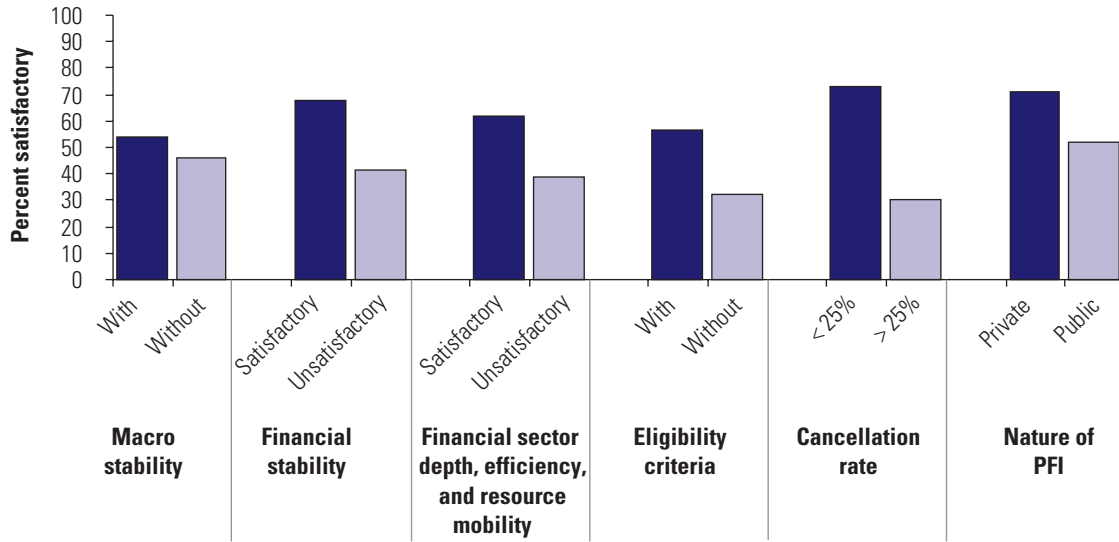
These findings indicate, in sum, that following the Bank’s guidelines for LOC resulted in more satisfactory outcomes.

Figure 4.4. Satisfactory Ratings by Number of Projects and Net Commitments



Source: IEG database and analysis.

Figure 4.5. Factors Associated with Differences in LOC Outcomes



Source: IEG data and analysis.



Outcomes and Impact at the Country Level

Impact of the FSAP

Of the 34 cases where a country assistance strategy has been written after an FSAP, about two-thirds had a discussion of the FSAP and its primary findings and recommendations. The remaining third had only a brief mention of the FSAP or its findings, ignored the FSAP, or inaccurately presented findings.

A review of the Bank's lending and nonlending programs following an FSAP showed that only 42 percent of the FSAPs have had an impact on the Bank's assistance program. This is consistent with findings from the review's survey, which show that only 34 percent of country authorities recall follow-up on the FSAP from the Bank (as opposed to 80 percent recalling follow-up from the IMF). Factors that could affect the degree of impact include: country selection (some countries do not need Bank assistance; some lack the preconditions for a strong financial sector, or have no commitment to reform, or cannot use a development assessment effectively); absence of a clear mechanism for Bank follow-up (in contrast to the IMF's Article IV discussions); country units are not always fully involved in the planning and implementation of FSAP activities.

In the client countries, authorities praised the FSAPs for expanding their knowledge of financial sector vulnerabilities and improving technical abilities. The authorities also found the assessments useful for providing an "independ-

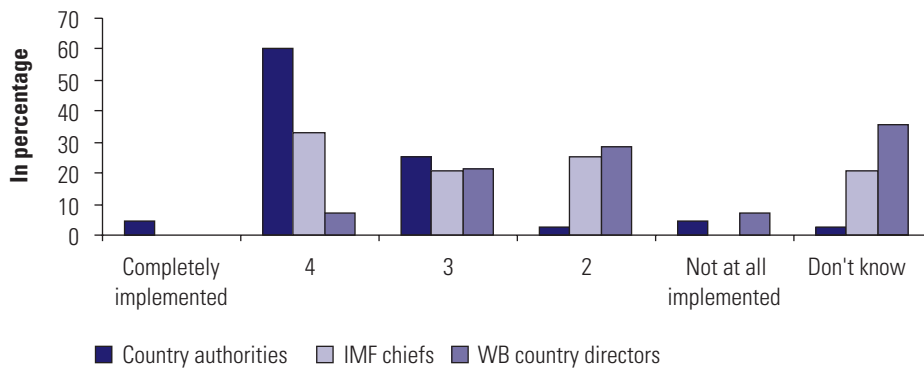
ent evaluation" of the system, and for contributing to the policy dialogue within the country. While country authorities responding to surveys generally stated that most recommendations had been implemented, Bank and IMF staff, as well as reviews of the country programs, did not see as much evidence of implementation of reforms (figure 5.1). However, the more difficult reforms will take more time, and greater impact may be seen in the future.

Outcome and Impact at the Country Level of Bank Lending

The shift to private ownership of banks between 1991 and 2003 has been dramatic. This shift has occurred in countries that have borrowed from the Bank for financial sector reforms as well as in countries that have not, but the shift has been greater in the borrowing countries (figure 5.2).¹

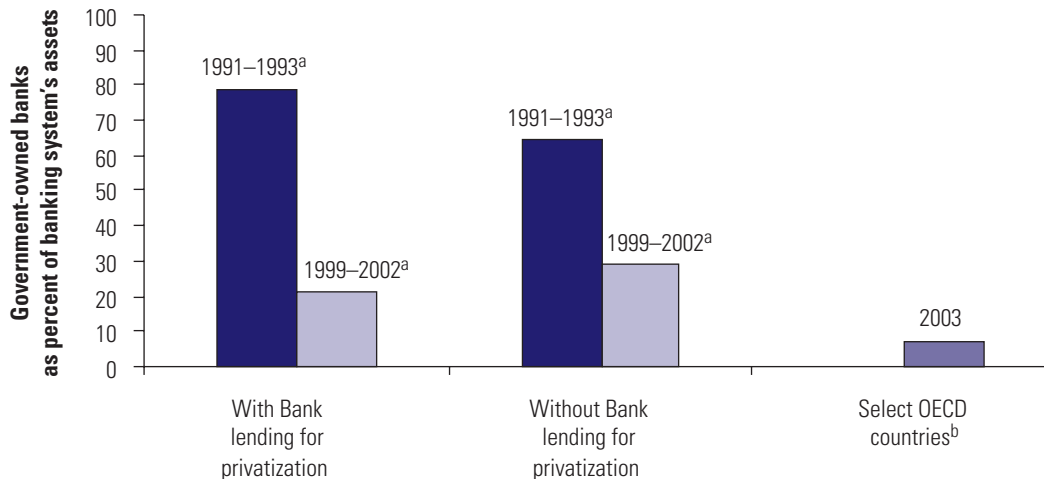
These data mask the full picture of government control of financial intermediaries. Governments often retain significant minority ownership in banks that are considered private

Figure 5.1. Degree of Implementation of FSAP Recommendations



Source: IEG/IEO Survey. Article IV mission chiefs; World Bank country directors; country authorities.

Figure 5.2. Changes in Government Ownership of Banks



Source: IEG data and analysis.

a. Latest year available.

b. Includes OECD members as of 1993 and excludes Bank borrowers.

and many countries have state-owned nonbank financial intermediaries that do substantial lending. Thus, reducing the role of governments in financial intermediation remains a challenge.

Laws and regulations governing the financial sector grew somewhat closer to international standards in borrowing countries, although there was no clear improvement relative to nonborrowing countries. But on the critical aspect of implementation of the laws and regula-

tions, there was little information, and thus it was not possible to assess the extent to which laws and regulations were observed. There is considerable anecdotal evidence that a number of countries that borrowed from the Bank to strengthen banking supervision are still far from complying with Basel core principles. Better indicators are needed to measure progress in reforms in the legal and regulatory environment and in financial supervision. In particular, indica-

tors are needed to measure compliance with laws and regulations and the degree to which banking supervision adheres to Basel principles for good supervision.

Outcome: Market Structure, Contestability, Efficiency, and Health

Changes in financial market structure are mixed. Concentration levels (the share of total banking assets held by the three largest banks in a country) have decreased significantly since the early 1990s for all countries, although more so in nonborrowers than in the 54 countries that borrowed from the Bank for financial reforms (and where information is available). The results were statistically significant.

By contrast, since 1998 (the earliest year for which data are available) contestability, measured by the ease of entry and restrictions on banking activities, increased in borrowing countries and decreased in nonborrowing countries. Finally, the change in foreign ownership (another measure of ease of entry) doubled in the borrowing countries and increased by somewhat less in the nonborrowing countries. On balance, the countries borrowing for financial sector reforms seem to have slightly increased competition levels in banking, as compared with nonborrowing countries.

Interest rate margins (as a measure of efficiency) narrowed significantly in borrowing countries and did not change in nonborrowing countries, suggesting that Bank borrowing for financial sector reforms can be positively associated with improvement in the efficiency of the banking system.

The health of the banking sector, as measured by nonperforming loans and capital adequacy, seems to have improved in borrowing countries (data were insufficient to compare with nonborrowers), although the data should be interpreted with care. Many Bank loans supported restructuring and recapitalizing banks, which included removing problem loans from bank portfolios. Such measures obviously result in an immediate drop in nonperforming loans and an increase in capital adequacy, without any change to the underlying dynamics that led to the nonperforming loans in the first

place. The real test of banking health will be what happens to these ratios over time.

On balance, Bank borrowing for financial sector reforms is associated with good outcomes in the measures of financial sector incentives, market structure, efficiency, and health, and, where information permits comparisons, to mostly better outcomes than in nonborrowing countries.

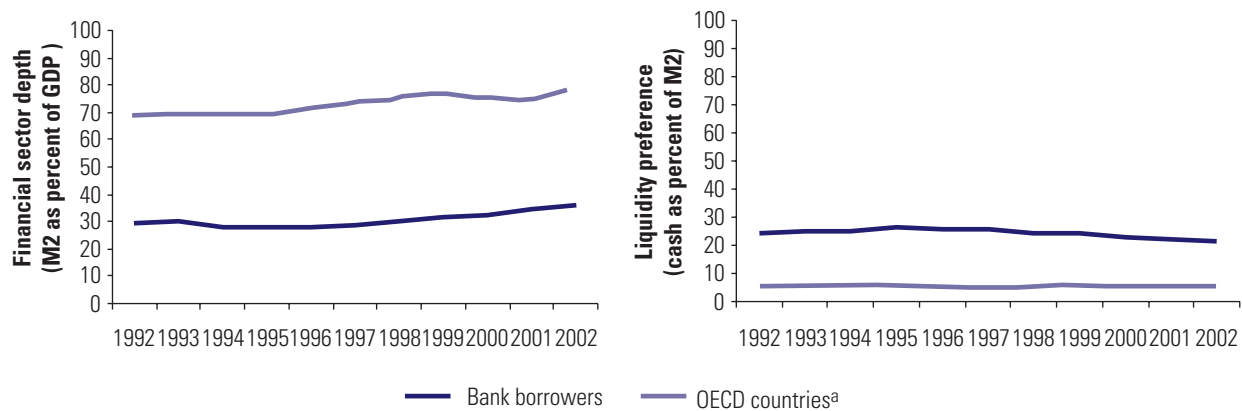
Impact: Financial Sector Depth and Stability

The ultimate objectives of most Bank lending in the financial sector, as expressed in Bank documents, are (i) to achieve a deeper financial sector that mobilizes resources and lends them out to the private sector, and for those countries borrowing for capital market development, a deeper capital market; and (ii) to improve the stability of the financial system, or reduce vulnerability to systemic insolvency and shocks.

Financial sectors became deeper in countries that borrowed for financial sector reforms during the period, although not significantly more than in nonborrowing countries. In any case, they remain, on average, relatively shallow—M2/GDP, for example, was below 40 percent in the Bank borrowers in 2002 (it is about 80 percent in the OECD countries, see figure 5.3 and table 5.1). Liquidity preference (cash as a proportion of the money supply—considered the inverse of public confidence in the banking system) decreased significantly (at roughly the same rate as in nonborrowing countries), which suggests an increase in public confidence in banks. This could be the result of the reforms aimed at downsizing, restructuring, and privatizing banks and proactive efforts by governments to regulate and supervise them.

Credit to the private sector (as a percentage of GDP) grew at an annual rate of 0.4 percent in the borrowing countries (table 5.2), less than it did in the nonborrowing countries (where it grew by about 1.7 percent per year). While the basic analysis included adjustment and TA operations, LOC were also included as a variant, given that objectives of LOC frequently included enhanced lending to the private sector. However, the inclusion of LOC in the model had

Figure 5.3. Financial Sector Depth and Liquidity Preference in Countries That Borrowed for Financial Reforms, 1992–2002



Source: World Development Indicators 2004.

a. Excludes countries in the Euro zone.

Table 5.1. Annual Growth Rates in Financial Sector Depth and Confidence in the Banking System: With and without Bank Lending for Financial Sector Reforms

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

Source: IEG analysis.

a. Significantly different from zero at the 1 percent confidence level.

Table 5.2. Distribution of Changes in Access to Credit for Borrowing Countries

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

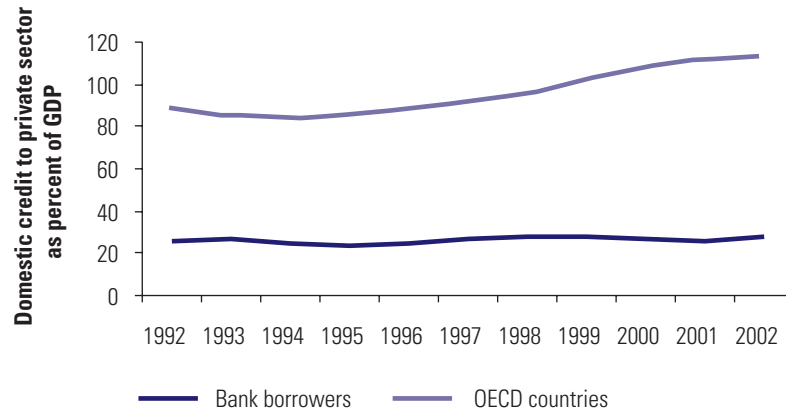
Source: IEG analysis.

no clear impact on these results. This is consistent with the high level of unsatisfactory LOC outcomes, and is inconsistent with the view that LOCs strengthen financial systems.

One explanation of the modest growth in credit is that the process of strengthening both governance and prudential regulations might have led to greater prudence in lending. Thus, although the growth in lending is slower than in nonborrowing countries, it may be more prudent lending. But on average, credit to the private sector remains very low, below 30 percent of GDP in the 62 borrowing countries for which information was available (in 17 countries, it was below 10 percent; in OECD countries, it was over 110 percent; see figure 5.4).

For capital markets, information was available for only 15 of the 30 countries that borrowed from the Bank for capital market reforms, dominated by countries in Latin America. Average market capitalization in the 15 countries increased somewhat during the period, but six out of the 15 countries experienced a decrease in market capitalization, and average market turnover decreased. There is little difference between borrowing and nonborrowing countries. The finding on capital market development is consistent with the recently completed review of pensions reform activities. A secondary objective of many pension reforms was capital market development, but most capital markets in

Figure 5.4. Credit to the Private Sector in Countries That Borrowed for Financial Reforms, 1992–2002



Source: International Finance Corporation; World Development Indicators 2004.

countries that undertook multipillar pension reform have not developed significantly. This was due, at least in part, to the fact that significant shares of pension portfolios remain in government bonds, for a variety of reasons, and thus were unlikely to influence equity markets.

In terms of stability of the financial sectors, there is no discernable pattern for borrowers versus nonborrowers; it was therefore not

possible to conclude whether borrowing from the Bank is associated with greater stability or whether borrowing during systemic bank insolvency helped the client pull out of the insolvency in the years immediately following the loan(s). While a major objective of the FSAP is to reduce vulnerability to crisis and, therefore, to increase stability, it is also too soon after its inception to see any pattern.



Bank Assistance to Countries Experiencing Crisis

There is no agreed definition of what constitutes a country in crisis. The one used by the *IEG Review of World Bank Assistance for Financial Sector Reform* is a country that experienced both a banking crisis and a macroeconomic crisis, either simultaneously or in quick succession, causing growth to drop and poverty to increase.

Using this definition, 15 countries in three Regions experienced crises during fiscal years 1993–2003. The 1994 Tequila crisis in Mexico spread to Argentina; the 1997 crisis started in Thailand and quickly spread to Korea and Indonesia, and then to Russia and Bulgaria; Bolivia and Ecuador had crises in 1998 and 1999; and in 2000–02, Argentina, Colombia, Guatemala, Jamaica, Turkey, and Uruguay all had crises.

The Bank made postcrisis loans to all but two of the 15 crisis countries (in Venezuela, the Bank made no loans, and in Russia, lending was precrisis). There are two reasons for assessing Bank lending to these countries separately from other financial sector support. One is that financial sector loans to countries experiencing or following a crisis represents over 50 percent of total financial sector lending during the period (\$12 billion out of \$21 billion). The second reason is that such lending was typically prepared and approved under emergency situations, in the context of large financial aid packages put together in collaboration with international financial institutions. It did not

always benefit from prior diagnostic work or close dialogue with government on reforms. On the other hand, governments that were reluctant reformers before crisis often became more willing adherents. These factors may have affected, in different ways, the quality of reforms and the outcomes in ways that do not apply, or apply to a much lower degree, under less urgent conditions.

In most of the countries experiencing crises, the amounts pledged and lent by the Bank were relatively small compared with the IMF. In Mexico, for example, following the 1994 Tequila crisis, the Bank committed roughly 4 percent of the \$49 billion pledged by the international community; the IMF committed 35 percent. In Thailand, the Bank lent a total of \$2.1 billion out of a total package of \$17 billion; the IMF pledged about twice that amount (table 6.1). The reforms supported in the Bank loans were similar in nature and scope to the financial sector reforms in noncrisis situations.

The Bank was ill-prepared to respond quickly in the earlier crises in Mexico (1994), and in Thailand, Korea, and Indonesia (1997), and

Table 6.1. International Rescue Efforts and Bank Response to Crisis

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

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

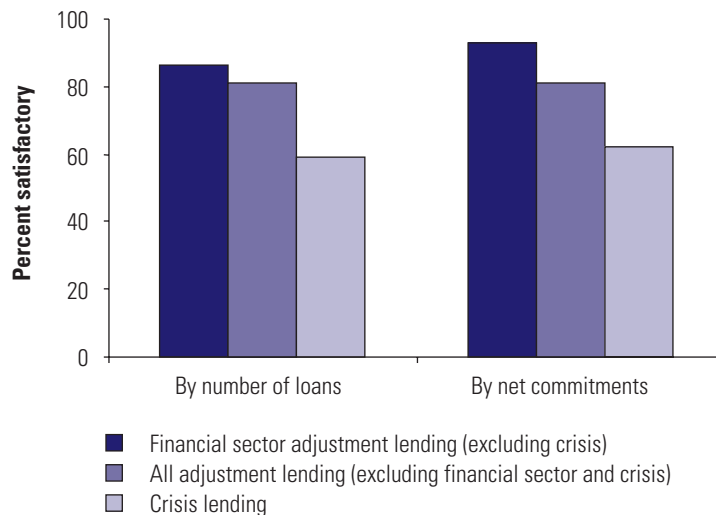
b. GDP in the first year of crisis; a more appropriate measure might be rescue package as percent of capital outflow, but this information was not readily available for most countries.

better prepared in Argentina, Russia, and Turkey. Even in countries where it recognized signs of vulnerability (Indonesia, Turkey), many official Bank documents were sanguine regarding risks.

The stated objectives¹ of the loans were similar in scope and nature to financial sector reforms

pursued in noncrisis situations. Nevertheless, outcome ratings of these closed crisis loans (32 loans/credits for \$18 billion in commitments) are lower by some 20 percentage points than outcomes of noncrisis loans (figure 6.1), despite the high relevance of the objectives and commit-

Figure 6.1. Outcomes of Adjustment Loans, Crisis versus Noncrisis



Source: IEG data, updated as of February 24, 2006.

ment of governments to reform which crises often induce. These outcome ratings suggest that the ambitious objectives in Bank documents were unlikely to be achievable in the short period covered by a single adjustment loan. The Bank needs to be more realistic and more candid about risks. The timing and size of subsequent adjustment loans, after the initial emergency phase, should be based on progress to date on reforms and the likelihood of continued progress.

Collaboration with the IMF in countries that experienced a crisis was not always smooth, particularly in Indonesia, Mexico, Russia, and Thailand. Following the Asian experience, the Bank and the IMF reached agreements, in principle, to improve collaboration, although the boundary between the two institutions is not always clear. Regional development banks also often play a role that needs to be coordinated as well. Collaboration among the international financial institutions in countries experiencing a crisis remains a challenge. Finally, after an

internal review of the Bank's response to the 1994 Mexico crisis, Bank management had concluded that guidelines should be prepared for crisis situations with triggers for actions and clear lines of responsibility. These conclusions remain valid and need to be implemented.

One positive outgrowth of the Asian crisis was the development of the joint Bank-IMF Financial Sector Assessment Program, whose review is summarized here. This analytic tool, which has covered a large percentage (although not all) of systemically important countries, increases the likelihood that the Bank (and the IMF) will appreciate the vulnerabilities of client countries and should, therefore, be better prepared to deal with crises. Because the program is a collaborative effort between the Bank and IMF, it should also increase the extent of collaboration between the institutions in their response to crises, as compared with recent past experience. This program, however, can be further improved, as detailed in the FSAP review.



Findings and Lessons

Main Findings

The evaluations found that Bank assistance to the financial sector, both in its lending and nonlending, has contributed to the development of the financial sectors in client countries. The FSAP advanced dialogue with client governments and provided useful advice and recommendations.

Lending has helped to bring about positive changes in governance, regulatory framework, market structure, and efficiency. Overall, and with the important exception of Bank support for LOC, the Bank's presence has helped to catalyze changes in the right direction in the depth and access to credit of financial systems. Nevertheless, financial sectors remain shallow, with narrow access to credit in many, if not most, Bank client countries, and there is room for improvement in the quality and impact of Bank assistance.

Outcomes and Impact at the Country Level

The Bank has focused its lending and diagnostic work more on banking issues than on other financial sector issues (capital markets, insurance, nonbank financial intermediaries, access to credit of nontraditional customers). Within banking, the Bank's lending assistance has generally been effective on institutional issues such as strengthening regulations, reducing government ownership of banks, and helping to increase the efficiency of banking systems. These improvements can be associated

with Bank borrowing: financial sector outcomes in countries that borrowed from the Bank for financial sector reforms are generally significantly better than in countries that did not.

Nevertheless, in most of the countries, although the trend has been in the right direction, the financial sectors remain relatively shallow, and private sector access to credit remains low. Thus the ultimate objective of having well-developed financial systems that contribute to economic growth and poverty reduction remains largely unmet.

The focus on banking has generally been appropriate, as banking dominates the financial sectors in most countries. Going forward, however, while retaining its core business of institutional reforms in banking, the Bank needs to increase its expertise to focus more on the nonbanking sector, and on identifying constraints to credit access through a range of activities, including lending and diagnostic work such as investment climate surveys, poverty assessments, and other economic work, which could include assessments of access to various types of financial services.

Bank Support to Countries Experiencing Crisis

Bank assistance for financial sector reforms to countries experiencing crisis constitute some 50 percent of the lending reviewed here. The Bank was ill-prepared to respond quickly in the earlier crises (Mexico in 1994; Thailand, Korea, and Indonesia in 1997); and better prepared in Argentina, Russia, and Turkey. Although the stated objectives of the loans were similar to those pursued in noncrisis situations, outcome ratings of closed operations are lower by more than 20 percentage points than for noncrisis lending. This is surprising given the high relevance of the objectives and the fact that crises often induce or strengthen the commitment of governments to address problems. It is likely the result of the need to state highly ambitious objectives in order to justify the large loans that are necessary to fulfill the preannounced assistance package.

More than 10 years ago, and after the Mexico crisis, Bank management had concluded that internal Bank guidelines should be prepared for crisis situations with triggers for actions and clear lines of responsibility. These conclusions remain valid and need to be implemented.

Collaboration with the IMF in countries that experienced a crisis was not always smooth, particularly in Indonesia, Mexico, Russia, and Thailand. Following the Asian experience, the Bank and the IMF reached agreements, in principle, to improve collaboration.

The joint Bank-IMF Financial Sector Assessment Program was developed in response to the Asian crises. This analytic tool, which has covered a large percentage of (although not all) systemically important countries, increases the likelihood that the Bank (and the IMF) are aware of the vulnerabilities of client countries and should, therefore, be better prepared to deal with crises. Because the program is a collaborative effort between the Bank and IMF, it should also help collaboration between the institutions in their response to crises, compared with recent past experience. Nevertheless, the boundary between the two institutions is not always clear and collaboration will remain a challenge.

Improving Quality

The objectives of financial sector reforms were generally consistent with good practices. Seventy-five percent of financial sector projects and components of multisector operations reviewed (excluding LOCs, discussed below) had a satisfactory rating, slightly below the 79 percent average for all adjustment and TA lending, excluding the financial sector. Outcomes of adjustment and technical assistance loans under the Financial Sector Network were significantly better than outcomes of financial sector components in multisector loans, even after controlling for country conditions. Similarly, for LOC, although overall outcomes were unacceptably low (at 52 percent satisfactory by number and 45 percent by net commitment), they were somewhat better in the financial sector. Outcomes of LOC were also better when they were consistent with the Bank's guidelines for LOC.

The findings imply that the Financial Sector Network should play a stronger role in preparing and managing financial sector assistance, and should provide more guidance to Bank staff working in the financial sector. However, experience with LOC has shown that guidance alone is not sufficient to ensure good-quality products: implementation of the Bank's guidelines for LOC has been very poor, with many LOC approved under conditions and with characteristics that are contrary to the letter and spirit of the Bank's guidelines—although implementation of the guidelines was stronger for LOC under the aegis of the Financial Sector Network than for LOC under other sector networks.

The IEG review found that the quality of the diagnostic work in the FSAP was generally high; however, it had major impact on subsequent Bank assistance in fewer than half of the countries where the FSAP was carried out. Integration of Bank analytic work into overall country strategies must be supported not only by the Financial Sector Network, but by the country teams. As noted above, the financial sector analytical work could also be improved by better coordination with other analytic work, such as investment climate surveys and poverty assessments.

One area for improvement is the need for greater consistency. Consistency of Bank support

within a country has been weak at times (for example, advocating privatization of banks while simultaneously supporting expansion of government ownership of banks). This is the case as well for the coherence of the Bank's approach to financial sector reforms across countries, where the Bank has sometimes advocated rapid bank privatization in one transition country while supporting gradual privatization in another in similar circumstances. The Bank also speaks with many voices on important matters (such as deposit insurance and capital market development) as a result of the absence of policy guidance, ongoing debates within the Bank over these issues, and the decentralized nature of the institution. The differences in policy stance cannot be explained by differences in country circumstances or willingness to reform. Therefore, more guidance on good practices is needed.

This is also the case for the Bank's FSAP work, where the Financial Sector Network has not taken advantage of the experience gained across countries and Regions to carry out these diagnostics, to establish what constitutes good

practices, to develop specific examples of these from Bank experience, and to disseminate these examples proactively. The Bank should capitalize on its tremendous repository of experience in a range of topics (for example, bank restructuring, asset management companies, bank privatization, development of capital markets) to help Bank staff to develop consistent approaches to analytic work as well as to supporting reforms. Best practices should also include development of sequencing and implementation plans.

These findings suggest that there is scope to improve the overall coherence of Bank work in the financial sector within a country as well as across countries. The Financial Sector Network has a key role to play to ensure (i) that country strategies incorporate, where relevant, a coherent strategy for the financial sector, which draws on the FSAP or other relevant diagnostic work; (ii) that the sector strategy carries through to lending and nonlending; and (iii) that quality control exists for lending and nonlending assistance to the financial sector, whether categorized under the financial sector or other sectors.

ENDNOTES

Chapter 1

1. In addition, findings from the 2006 IEG report, *Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance*, are included where relevant.

2. Levine, Ross, 1998. "The Legal Environment, Banks, and Long-Run Economic Growth." *Journal of Money, Credit, and Banking* 30 (August): 596–620. Levine, Ross, Norman Loayze, and Thorsten Beck. 2000. "Financial Intermediation and Growth: Causality and Causes." *Journal of Monetary Economics* 46 (1): 31–77.

Chapter 2

1. There is evidence that the amount of lending for LOC has increased again, in fiscal years 2004 and 2005, to about \$500 million to \$1 billion per year. It is too soon to tell whether this is an upward trend or an anomaly owing to a few very large LOC operations.

2. See chapter 3 of *World Bank Review of Lines of Credit* for a detailed discussion of trends and patterns of LOC lending.

Chapter 5

1. Countries were included only if they had an ac-

tive bank privatization program. Thus, countries were excluded if they had banking sectors already substantially privatized, such as Botswana, Lebanon, Senegal, and Swaziland, or if they had no active privatization program, such as Algeria, China, Iran, Syria, and Vietnam.

Chapter 6

1. Many countries had one sort of crisis but not the other. Brazil, for example, had a macroeconomic crisis that did not result in a banking crisis. Caprio and Klingebiel, in their paper on "Episodes of Systemic and Borderline Financial Crises (World Bank 2003, Financial Sector Network) list 83 countries that had technically insolvent financial systems between 1990 and 2002, and thus were labeled as a systemic or borderline banking-crisis country. Unless these countries also experienced a macroeconomic crisis, they are not discussed in this chapter.

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

3. IEG assessments of these loans did not question their relevance or design, but many critics have questioned whether the Bank and other international financial institutions should be providing large rescue packages and liquidity during crises.

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