

A Survey of Government Regulation and Intervention in Financial Markets

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Introduction- Link between Finance, Growth and Poverty

There has been renewed focus on financial systems, especially in the light of recent literature that documents a positive and robust relationship between development of financial systems and economic growth. Irrespective of how financial development is measured, there is a clear causal relationship with per capita income. King and Levine (1993) was the first paper that examined economic growth for a dataset that spans from 1960-1989 and found predictive power of financial systems in growth. Another richer dataset from 1960-1995 reinforces the existing relationship between finance and growth, while taking into account the issue of reverse causality (Levine, Loayza and Beck 2000). The idea of reverse causality is, that it is also possible that economic growth may encourage development of financial systems and these results may reflect reverse feedback rather than any effect of finance on growth. Finding instrumental variables to overcome endogeneity issue has been difficult but the authors use the recent discovery that systems with English common law tend to have deeper financial systems, to employ legal origins as an effective instrument. Their results rule out the thesis that relationship between finance and growth is driven by reverse causality.

The effect of finance on growth is significant enough to have policy implications. A doubling of ratio of private sector credit is associated with an increase in average long-term growth of almost 2 percent (World Bank 2001). Levine, Loayza and Beck (2000) also find a positive impact on growth over shorter periods. There is, nevertheless, a need to exercise caution in pursuing credit expansion to achieve finance driven growth. Too rapid a growth can also lead to inflation, depreciation or institutional insolvency. Financial system development is commonly associated with credit expansion. However, they must also function effectively and be large in the sense of supporting firms, services providing, amount of funds intermediated and resources employed (World Bank 2001).

Finance is stipulated to affect growth through three channels: mobilizing savings, promoting efficient allocation of capital funds and transforming risk both reducing it through accumulation and enabling it to be held by those most willing to bear it (Levine 1997, Merton and Bodie 2000). There is evidence that finance affects growth by improving total factor productivity rather than quantity of capital or through increased aggregate savings (Beck, Levine and Loayza 2000, Bandiera et. al. 2000). Nevertheless, deeper financial systems do contribute to increasing external financing opportunities for firms (Demirguc-Kunt and Maksimovic 1998).

However, it is claimed that financial systems and services it offers only benefits the rich and it may have an adverse effect on poor, in terms of worsening the income distribution. If this were to hold true, then financial development would be relegated as a policy instrument to deal

with poverty. One theoretical study conjectures that to participate and benefit from the financial sector, agents are required to pay an initial setting-up cost. As poor households will not find it in their interest to incur this cost and will prefer to use their savings for other purposes, they will fall further in the distribution of wealth (Greenwood and Jovanovic 1990). This supports the view that finance is 'regressive'.

There exists very little empirical literatures that examines the effect of financial development on absolute poverty levels. Rajan and Zingales (2003) argue that a well functioning financial system can facilitate a competitive environment and undermine power of the incumbent firms and can help poor households escape from exploitation of the middle man. Furthermore, available evidence also rejects this trade-off between growth and poverty. One cross-country examination studies inequality and shows a significantly negative relationship between financial depth and Gini index (Li, Squire and Zou 1997). The authors suggest that as the financial sector develops, credit constraints are alleviated for the poor households which enables them to make investments. For instance, if poor farmers have access to secure form of finance, it can protect them from a bad year and put them under poverty line. There also exists some indirect evidence on the link between finance and poverty. For instance Dehejia and Gatti (2002) study a panel of countries for incidence of child labor, which is correlated with poverty. They find child labor to be affected by the degree of financial depth of an economy. Furthermore, they isolate countries with well-developed and deep financial system and examine the role of national income shocks. They show that national income volatility has an insignificant effect on child labor, which suggests that financial depth can insulate poor households from shocks. In a preliminary set of regressions, Honohan (2003) shows that a 10% reduction in ratio of private credit to GDP should reduce poverty ratio by almost 3 %. Although bank finance does contribute to lower poverty, stock markets do not have the same effect (as measured by stock market capitalization and turnover). The concentration of the banking industry also appears to be insignificant. In empirical work on finance and poverty there is a lower possibility of a reverse causality. The fraction of financial assets that may be held by the poor population are so low, that poverty rates are unlikely to significantly influence the level of financial depth. Therefore, empirical studies can abstract from the issues of reverse causality which has plagued finance and growth literature.

Finance can also serve as a stabilizing force, reducing economic volatility. A study for a set of 60 countries find financial development to be significantly associated with output growth volatility (Easterly, Islam and Stiglitz 2001). There empirical results show that a doubling of private credit as a percentage of GDP can reduce volatility of growth from 4 to 3 percent annually. Although finance may protect output growth from trade shocks, it may worsen the affect

of inflationary shocks (Beck, Lundberg and Manjoni 2001). Therefore, deeper finance without the correct institutional and incentive features can magnify rather than alleviate the risk.

The policy prescription from this discussion is that developing countries should not attempt to engineer credit expansion and financial system development. Instead they should create an environment conducive for participation of individuals in the market system, for financial system to deliver services effectively and functions most required by an economy are provided by finance (World Bank 2001). Any policies where government actively seeks to influence financial market outcomes are likely to have adverse effects. The ensuing discussion highlights the pervasive negative influence of the government in finance, in most emerging economies. It underscores and points out cases of efficiently performing financial systems in countries where government has limited its involvement to developing a sound business environment.

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I Investor Protection and Legal Environment

1. Policy Points

- Strong legal environment and investor protection improves access to finance
- Countries need to improve shareholder rights (through better corporate governance) and creditor rights (by changing bankruptcy of laws and secured transaction laws)
- Introduce collateral registries (example :Romania). Secured transaction laws depend on good filing and enforcement.
- Bankruptcy laws matter by improving access to finance.
- Transplantation of laws is usually not effective, the need to develop country specific legal rules and most importantly ensure enforcement. Therefore, ex-ante need for good legal rules and ex-post, good enforcement of those rules.
- OECD rules are good benchmark standards to judge changes in corporate governance environment in a country and have frequently been used by many countries framing their code of best practices
- Self-regulation and regulation by stock exchanges can be effective (but only in case of strong shareholder rights), and there is a need for public rules established by the government. Therefore, legislative changes are very important.

2. Good Investor Protection

2. a Importance of Strong Legal Institutions

A strong legal environment and enforcement of legal rules are important to accessing external finance and for development of financial markets (Black et. al. 2000, Johnson et. al. 1997, LLSV 1997, 1998, Stiglitz 1999). When creditor rights are weak, financial institutions will be less willing to extend credit to firms which have a high risk of default. Foreign investors are also unwilling to invest in countries, where legal rules are weak, since costs of loan recovery and re-contracting are mitigating. In contrast, strong investor protection is associated with better access to information about firms and investor interests are protected in case of default or opportunistic behavior by management. In sum, a strong legal system is therefore associated with

greater use of outside financing.² Shleifer and Wolfenzohn (2002) formally show that firms are larger, more valuable and stock markets are more developed in countries with strong investor protection. Legal rules vary widely across countries, and offering varying protection to outside investors (La Port, Lopez-de-Silanes, Shleifer and Vishny 1997, 1998).³

Example: Argentina (Cristini, Moya and Powell 2001)

Enforcement of legal rules also varies widely across countries and within countries. Argentina is an interesting case in point, where banking operations of each province is under fairly uniform laws and the banks are subject to Central Bank's prudential regulations. However, despite the uniformity of the legal system in all 24 provinces, the speed and cost of judicial enforcement varies. Cristini, Moya and Powell (2001) find that improving the effectiveness of the legal system would yield significant benefits. If the enforcement reached the best level in city of Buenos Aires, credit would grow by 2% of GDP.

Recent literature also highlights the role of legal traditions and legal families in influencing access to equity and debt finance. For example, common law countries are found to have stronger shareholder and creditor rights and provide companies with better access to both equity and debt finance (LLSV 1997, 1998). The authors conclude that correct legal code is important for financial development, implying that transplanting the correct legal code can lead to economic development. Berkowitz, Pistor and Richard (2003), extending this argument suggest that legal family is only of secondary importance, relative to the transplanting process. The form in which a law is initially transplanted and received becomes a much more important determinant of the effectiveness of legal institution. For a transplanted law to be effective, the law must be meaningful and acceptable within the socio-cultural setting of the country and citizens must also have an incentive to use the law. In order to improve the legal system, authorities must choose to implement legal rules that are understood by the citizens and whose purpose is appreciated by the law makers and enforcers. Therefore, the enforcement of law is more important than the quality of law (Pistor et. al. 2000).

² Although it may also partially be a result of concurrent development of financial markets resulting in a lower return to capital and hence a smaller use of internally generated resources (Demirguc-Kunt and Maksimovic, 1998).

³ Strength of legal institutions encompasses two elements. Firstly, it requires the importance of 'laws on book' that protect investors. Secondly, and more importantly, is enforcement of these legal rules through judicial efficiency.

2. b-i Good Creditor Rights, Secured Transaction and Bankruptcy Laws

There is a wide milieu of elements that determine strength or weakness of creditor laws. LLSV (1997, 1998) report countries by strength of creditor protection accorded. These measure the strength of creditors in the case of default and/or bankruptcy, including: (1) the ability to replace managers, (2) the ability to reposes secured assets, (3) whether the timetable for rendering a judgment is less than 90 days, and (4) whether secured creditors are paid first. These rights -- such as the ability to replace management and seize collateralized assets -- become even more important in developing countries where inefficient courts and political pressures may delay judgement (and collateral "walks"). Some countries do not provide secured creditors the right to repossess collateral, who are usually much behind other creditors in priority over assets. For example, in Mexico many social constituencies must be repaid before secured creditors, often leaving them with very little assets to back their claims (see also example: Brazil). On another element, Malaysia scores highly, as the management is replaced by independent parties during the resolution process, which increases creditors' power. However, mere presence of laws is unimportant as laws depend on strong enforcement. Although, many countries, qualify in terms of the 'laws on books', they are lacking in terms of enforcement as both go hand in hand. Russia has 'imported' strong laws protecting shareholder and creditor rights, but the lack of an effective legal system to enforce these laws has been a key impediment (Pistor et al. 2000).

An important component of creditor rights is the insolvency regime and the degree to which it protects creditors and prevents imprudent behavior by managers. Bankruptcy laws are important to facilitate risk-sharing and provide incentives to avoid bankruptcies in the first place. A badly designed bankruptcy law which, for instance, does not give any protection to creditors, can also stunt capital market development and availability of finance. Brazil and Mexico are relevant cases of a country with poor creditor rights (see example: Brazil). Better bankruptcy protection is an important mechanism to alter lenders' incentives to monitor and screen borrowers ex-ante and ex-post and also reduce potentially debilitating activities such as asset stripping by lenders or management (Stiglitz 1999). Further, it can help overcome systemic and prolonged bankruptcies. Stiglitz (1999) argues for re-evaluating and developing stronger bankruptcy laws, which will vary from country to country, in the balance they strike between creditor and debtor rights, depending on institutional characteristics of countries.

<p>Example: Brazil – Weak Creditor Rights (Pinheiro and Cabral (1999) and Economist (2003)</p>

Brazil ranks low on creditor rights protection, in terms of the LLSV (1999) index. There are extremely large lending spreads (above 50 percent points) on personal loans⁴. Credit extension is stifled at only 25 % of GDP. The bankruptcy law, provides low credit protection, making lending unusually riskier for banks. Banks are also deterred from forcing debtors to file for bankruptcy, since debt owed to workers and tax authorities is given seniority, under Brazilian law⁵. The judiciary can take anywhere between 1 to 10 years to make a decision, due to numerous embargoes that can be made by appealing debtors and time taken to simply assign a case to a court. Therefore, judicial resource is generally the last resort in Brazil. A study on creditor rights protection and expansion of credit in Brazil, shows improving the average level of judicial enforcement (or in other words, reducing the very bad assessments) by a mere 17.8 % can increase volume of credit by 8.5 % of the GDP (Pinheiro and Cabral 1999). The weak creditor rights protection has largely been the primary reason for low expansion of credit in Brazil. Although private contractual arrangements substitute for weak judicial system, they are unable to completely substitute. However a new bankruptcy law has been proposed, although a vote on it has already been postponed a number of times. The new law replaces the over-riding role of the courts and enfranchises creditors. Some of the salient features include: (1) borrowers being able to renegotiate with creditors without going to court, (2) in case of restructuring creditors will have first claim on money injected in the firm for restructuring, and (3) in case of court-supervised restructuring courts will have to accept decisions of creditors, who will have a vote proportionate to size of their exposure. (This law is under consideration with the lower house at present).

Secured transaction laws are important in both common and civil law countries, as lenders prefer to receive collateral to ensure loan repayment. Collateral can ease borrowing constraints for firms, as lenders will be more willing to lend at lower interest rates when collateral is offered. However, the type of collateral required also varies across countries by level of their development. In developing countries, issues related to land titling and seizing of primary residences restricts the ability to use land as collateral. Most developing countries require immovable property to be pledged (or indirectly loans on movable property are made to real estate owners), which places a constraint on credit extension, while concept of lending secured by movable property is much more common in developed countries. The expansion in credit opportunities is tremendous. For example in the United States, lending secured by movable

⁴ Although the high spreads can also be explained by inefficiency amongst the largest Brazilian banks, which are all state-owned.

⁵ The uncapped workers claims on assets of collapsing firms have allowed management to award their relatives large amounts of salaries.

property is almost 40% of total credit (Fleisig 1998). By contrast, in Romania, lending follows a different pattern and the little lending that is secured by movable property is only for warehouse receipts (see example: Romania). Most developing countries are plagued by weak legal rules on secured loans, as a result of which lenders are cautious of lending on movable property collateral. Rights of parties (creditors, debtors and others) involved must be clearly delineated in order to clarify priorities of holders of interest. However, enforcement of these property rights is equally important. If repossession will take several years, then these legal rules are ineffective.

One of the recommendations to strengthen secured lending is for development of online collateral registries that can overcome information asymmetries lenders face. Online registries can allow lending institutions to know whether any creditors have prior claims on a collateralized item. Secured parties can therefore acquire a ranking of priority in claims on a collateral, which is public information (see example: Romania). Again it is important to reiterate the importance of enforcement and good filings. If filings are fraudulent or the supervisory body is unable to enforce filings for every secured transaction, then these registries are unlikely to have the perceived benefits.

Example: Romania (see Fleisig 1998, Stoica and Stoica 2002)

In Romania, movable property rarely serves as a collateral, due to legal impediments. The law on secured loans presents a costly, cumbersome procedure, as a result of which lenders refuse to finance activities that would traditionally be financed in developed countries with good secured transaction rules. Firstly, the system does not allow lenders to access information on whether other creditors or lenders have claims on the same goods used for collateral. Secondly, enforcement of agreements and repossession of collateralized goods is a lengthy process (which actually can exceed the economic life of the movable good). These problems in institutional and legal arrangements are the key factor limiting access to credit.

A new law, adopted in 1999, however introduces a system of registration of security interests. The registration is valid for 5 years and is mandatory if required by the principal obligation secured. Repossession of debt assets can be undertaken through the Romanian Civil Procedure Code or the procedure that is outlined in the new Law. The electronic archive is the most interesting aspect of the new law, as the rest of the provisions deal with strengthening enforcement. All registered security interests have now been transferred to the collateral registry. It is run by operators appointed by the Ministry of Justice. At present there are 10 operators and 366 agents in the Electronic Archive. The supervisory authority provides guidelines on operation and clarifies rules and regulations. To date, the archive functions efficiently, allowing access to

interest parties on information about creditors, debtors or assets securing a commercial or civil transaction that has taken place in the country. This information is accessible by people all over the world and presents huge cost and time saving opportunities. Furthermore, it provides an improved investment climate in Romania.

2. c Empirical Evidence on effect of good investor protection, creditor rights, accounting standards, and judicial efficiency on finance

The role of contract enforcement and its effect on choice between bank and equity finance is emphasized in recent literature (Modigliani and Perotti 1996, LLSV 1997, 1998). Empirical evidence on property rights and legal rules unambiguously points in one direction that stronger legal rights stimulate access to finance for borrowing firms, increase investment, lengthen maturity of their debt structure (Demirguc-Kunt and Maksimovic 1998, 1999; Gianetti 2003) and encourage greater foreign lending (Allayonais, Brown and Klapper 2003, Etsy 2003).⁶ Another study on loan pricing, finds the cost of external financing (larger loan spreads) to be lower in countries with stronger property right protection, measured as lower probability of repudiation of a contract and lower corruption (Bae and Goyal 2003). In terms of creditor rights, firms borrow less in country where bankruptcy proceedings are less likely (see example – Brazil) (Klapper 2001) .

In countries where legal system is inefficient, firms are largely be able to access short-term debt, as it gives less time for opportunistic behavior on the part of owners and managers and credit can refuse to roll-over debt. In a study carried out for a large cross-country set of listed firms, strong creditor rights allow firms to substitute short-term debt for long-term (Demirguc-Kunt and Maksimovic 1999). Similar substitution effect is also found for unlisted firms with volatile returns (Gianetti 2003). Furthermore, the author also finds stronger creditor rights protection improves access to finance for firms that are investing in intangible assets and therefore may lack collateral to put up for borrowing (see example Brazil). It therefore has important implications as financing choices for unlisted companies are definitely improved in

⁶ High legal risk also influences debt structures by affecting concentration of tranches in syndicated loans. In countries with low enforcement banks are forced to spread their risk, by have a more dispersed structure that raises re-contracting costs to avoid strategic default by firms (Etsy and Megginson 2003). Fauver et. al. (2003) find higher diversification discounts or lower benefits from diversification in countries with well developed capital markets and a civil law system. Firms' are most able to benefit from diversification and internal capital markets associated with it, when there rule of law is weak and cost of external capital is high.

case of effective legality. It also highlights the need to focus on developing the banking sector, since small firms mainly borrow from banks rather than equity markets. Governments seek to lengthen maturity structure of debt, by issuing long-term debt. It allows investors to have information on a risk-free term structure which allows comparison with other debt issues and encourages long-term debt markets. In Brazil all debt contracts are indexed to allow adjustments for inflation. However due to this regulation, firms hold little long-term debt, since most such adjustments are based on political decisions and are unrelated to economic fundamentals ((Demirguc-Kunt and Maksimovic 1999).

2. c-i Creditor Rights and Foreign Bank Lending

Legal rules and their effectiveness are increasingly important for foreign investors as enforcement of rules regarding seizure of collateral and other operating contracts depend on legal rules within host countries and are not governed by international laws. A study on 61 on factors influencing decision of foreign banks to fund long-term investment in 61 developed and developing countries, concludes that the legal system does determine availability of funds (Etsy 2003). Etsy finds that foreign banks are more likely to finance long-term projects in countries with strong legal rules, however, they also fill in a financing gap in countries with less developed financial systems. Decisions to access foreign debt markets are also governed by legal environments. Firms in weak legal environments, access foreign debt markets to complement supply of local funds or to lengthen maturity structure of debt, since lenders in poor legal environments will only offer them short-term debt (Allyanis, Brown and Klapper 2003).

2. d Empirical Evidence on Corporate Governance

The recent spate of financial scandals have also turned attention towards good governance. A number of structural changes in most developing countries such as changes in ownership structures as a result of privatization, greater equity listing of previously unlisted firms and a greater need to access the public market for funds, have underscored the importance of good governance (Claessens 2003). Better corporate governance and stronger shareholder rights are very important in developing countries, where ownership concentration allows controlling interests to expropriate private benefit. Effective legal rules can allow investors to actively monitor their investments and give them recourse to the legal system in case of any violations. Majority shareholders, who are more actively monitored, will be less able to fleece minority shareholders.

Institutional investors are also important in encouraging corporate governance convergence, as they apply the same set of standards all over the world. Institutional investors prefer to invest in countries where legal rules and enforcement are both strong, in order to protect their interests (Aggarwal and Klapper 2003). A global investor opinion survey by McKinsey, reveals good governance ranks highly and is as important as firm performance and growth prospects. Therefore, when evaluating investment prospects most international investors (such as pension funds, mutual funds and private investors) will be willing to pay a premium for shares of companies that meet high corporate governance standards.

Good governance, influences firms at three levels: access to finance, cost of finance and operational performance. Weak corporate governance, reduces access to finance and also fewer new firms start-up (Beck, Demirguc-Kunt and Maksimovic 2002, Rajan and Zingales 1998). Therefore, better corporate governance can allow smaller firms to access greater financing. Outsiders are less willing to finance firms and charge a higher rate, if they fear a less than adequate return. There is clear evidence that cost of capital is higher and investors apply a valuation discount on firms in countries with weak shareholder protection (La Porta et. al. 2000, Mckinsey 2002). Finally corporate governance improves operational performance of firms, through better management, better allocation of resources or other efficiency improvements (for e.g. Gompers, Ishi and Metrick 2003, Joh 2003, Klapper and Love 2003, La Porta et. al. 1998). The incentives for majority shareholders to expropriate may also increase during periods of distress. A cross-country study on the 1997 East Asian crisis, finds weak legal institutions for corporate governance were an important factor in worsening the stock market decline (Johnson et. al. 2000). Increased risk of expropriation in countries with weak investor protection, made net capital inflows even more sensitive to negative shocks.

Firms can overcome weak legal protection, by establishing good governance through greater transparency, adopting international accounting standards, independent board of directors. Good governance seems to matters more in countries with weak legal rules, since minor improvements will be valued by investors (Klapper and Love 2003, Durnev and Kim 2002). However, investors and borrowers may not necessarily arrive at optimal arrangements and adapt their governance structure to overcome a weak legal environment (Bae and Goyal 2003). As good governance does not completely substitute for a weak legal environment, these findings underscore the importance of developing stronger institutional arrangements such as regulation and public enforcement of laws to protect investors. The particular nature of arrangements of enforcement i.e. whether governance should be legislated or regulated are discussed in the ensuing sections.

2. d-i Examples of Political Environments that allowed change in governance

Although changing legal rules and promoting a more effective judiciary is the best way to promote access to finance, especially since empirical evidence documents a positive relationship, it can be difficult to change legal rules, especially contract law, which may have been in operation for thousands of year (Jordan and Lubrano, 2002). Furthermore, the problem in most emerging economies is not the lack of legal rules, some of the shareholder and creditor protection standards are comparable to those in developed countries. Many of the rules are transplanted from US and UK capital market and corporate law. Countries should proceed with caution when importing governance structure or legislations. For instance in Korea, laws on cumulative voting were created, but as they were not mandatory and could be easily by-passed, their effectiveness was questionable. Soon after the enactment of these laws, Korean firms sought ways to neutralize their effect. Therefore, effectiveness of these transplanted rule, and how they are embraced needs to be examined more carefully.

Reform to corporate governance frameworks, may also not achieve their intended outcome due to importance of legal origins. Legal origins acquired centuries ago, continue to influence financial development, entry of new firms, performance of judicial systems and other characteristics (Djankov et. al. 2003). Outcome of reforms is also threatened by the need to negotiate amongst different parties. Corporate governance reforms can involve changes to ownership and power structures. Direct relationship between the government and controlling owners of private sector, for instance, in Indonesia, can impede reforms (Claessens 2003).

Example: Brazil (Aggarwal and Klapper 2003)⁷

In 2001, BOVESPA (the Sao Paulo Stock Exchange) established a new market segment Novo Mercado, which models after the Neuer Market in Germany. In order to attract smaller enterprises, new market segments in other bourses usually loosen listing requirements. Novo Mercado, however, goes against this trend. Corporate governance requirements are far stricter than those required in the old segment. At least 25% of the capital stock must be floating in the market and listed companies must adopt international accounting standards (US GAAP or IASC). In the case of merger, both controlling and minority shareholders have to be treated equally. The companies can issue only common shares. The prohibition of issuing different class of stocks is

⁷ For details see Dyer (2001a, 2001b), Ricardo (2002), BOVESPA website, Nova Mercado regulations 10.303 and Carvalho (2003).

particularly important in Latin America where the use of non-voting preferred stock is very common. The issuance of non-voting shares allows owners to obtain greater control over companies than their actual degree of ownership.

The establishment of the Novo Mercado is a part of BOVESPA'S comprehensive effort to improve corporate governance in Brazil. BOVESPA also implemented Differentiated Corporate Governance Levels in 2001. The Bourse established two new levels of listing requirements (Nivel 1 and Nivel 2), which includes the maintenance of higher flotation, adherence to the Market Arbitration Panel, and higher standards of disclosure. To show their commitment to better governance practices, listed companies can voluntarily accept stricter requirements. Carvalho (2003) finds that the migration to the Novo Mercado or to a higher corporate governance level has a positive effect on the market value of the companies around the migration date.

Example: South Korea (DO WE WANT TO KEEP THIS)

South Korea has led corporate governance reforms in East Asia. Reforms have largely focused on transparency and greater accountability, by requiring appointment of outside directors on boards of financial institutions and major conglomerates. Removing ceiling on foreign ownership has exposed the firms to greater competition (Mckinsey Quarterly, 2002). They have also reduced minimum shareholding to undertake class action, that has prompted my instances of shareholder activism (for e.g. PSPD challenged Samsung Electronics and SK Telecom). Some listing requirements are only applicable to firms with an asset size greater than 2 trillion won, or the top 30 chaebol companies (Black et. al. 2003). They must have an audit committee with least 2 /3 directors from outside the firms and an outside director as chairman. Therefore larger firms have more stringent corporate governance listing requirements. Such changes will be effective in attracting foreign capital (Black et. al. 2003).

Example: Latin America (Jordan and Lubrano 2002)

Legal reform has also taken place in Latin America and Mexico. All of these calls for changes were a result of corporate scandals. For instance, in Chile, Enersis controlling owners secured 1/3 of the price for control in return for an economic interest in the company of less than 1%. Similar instances that led to shareholder activism, have led to broad based reforms, involving mandatory tender offers, pension fund-nominated directors, accounting standards, class actions, audit committees etc (Exact changes in Jordan and Lubrano, 2002). However, most of the laws that were eventually implemented were far weaker and less stringent version of originally proposed

laws, due to resistance and opposition, especially by established firms that were unwilling to reveal more information to shareholders.

2. d- ii OECD Principles

While countries are discouraged from importing corporate governance structures, convergence is still taking place on standards of corporate governance, though not necessarily their form and structure (Sir Adrian Cadbury -). OECD defined principles on good governance, are a template of best practices and standards that firms, lenders and investors and the state which regulates businesses, can encourage. These principles define 4 rules of good governance: fairness, transparency, accountability and responsibility, which have universal applicability for state-owned, privately owned and publicly listed firms. Effective disclosure and transparency are the key elements to giving confidence to investors and stimulating flow of resources to these businesses.

Since their publication in 1999, the OECD principles have become an internationally accepted corporate governance benchmark. The OECD principles on corporate governance and accounting standards are used as a template for Reports on Observance of Standards and Codes (ROSCs) by the World Bank. These principles have encouraged improvements in corporate governance and accounting standards at a number of levels but largely they have influenced codes of best practice drafted by international organizations, exchanges, governments and companies (for example, Russia, Colombia, Poland amongst others). Codes of best practice are important tools in creating awareness on corporate governance reform and signaling direction in which ownership and corporate governance reform should take place. Frequently these codes go beyond the minimum standards laid out in OECD rules. Although they do not require compliance, many companies seek to adhere to these rules in order to signal investors. In Colombia, companies have taken the initiative to design their own corporate governance codes along the lines of OECD principles. The example of Russia and Mexico, outline the role of regulator and approach taken in affecting impact of these voluntary codes. In both Mexico and Russia, the force for change has come from within the establishment. Despite this similar, two very different approaches were undertaken. For instance, in Mexico the regulators focused on push-starting the process of drafting a code, rather than its eventual enforcement, which was a more efficient way to produce effective benchmarks. If a regulator begins to take the code as a rule of law, in a country like Russia, where there is weak judicial enforcement, it can come to be regarded as a law. Firms will then will then begin to see minimum compliance to these codes as a goal. However, this subverts

the purpose of voluntary codes, and also stunts development of voluntary initiatives and discourse on issues of corporate governance (Jordan and Lubrano 2002).

Transplantation of voluntary codes, inspired by the UK Cadbury Report or Combined Code, may be ineffective as it can conflict with the underlying legal system of a country (Jordan and Lubrano 2002). In this case, OECD principles which have been developed with a perspective of both developed and developing countries, can have wider applicability. Although similar caveats still apply, if these standards are used to develop best practice codes. For instance, in civil law families / countries, where written law and constitution are supreme, voluntary codes may be ineffective, unless they are incorporated as laws. These codes may just be ways to obtain international approval and can signal to international markets. But it can also divert attention from more effective approaches that could also negatively affect interests of those in power, so it can just be a way to promote status-quo in countries where codes are inconsistent with the legal system.

2. d-iii Role of Government vs. Exchange vs Market Enforcement of Good Governance

Although the role of the government in most economic spheres is considered counterproductive, policymakers and practitioners agree that the government has a role to play in providing adequate financial infrastructure. The government needs to work with the market to enable effective functioning of financial markets. In cases where the government has been absent from creating and supporting an effective legal system, investor rights, good accounting, effective disclosure and corporate governance standards, that are needed for effective conflict resolution of contracts, the results have been poor (World Bank 2001). Experiments with self-regulation have not worked. For example the corporate governance reform committee in Netherlands suggested self-regulation in 1997. However in 2003, a review of progress with the recommended self-enforcement was carried out, which showed the recommendations did not work. The market was also pessimistic that self-regulation would lead to changes in corporate governance and increase in firm value. Another study also concluded that self-regulation in Netherlands was not effective as the private sector recommendations did not influence firms' characteristics or improved their corporate governance structure (Jong et. al. 2000). The authors conclude that self-regulation is unlikely to be effective in countries where investor protection (in the form of shareholder rights) is not strong. For instance, the limited initiative on self-regulation by the Cadbury Committee in UK, resulted in significant changes in board structure and management characteristics, along with

firm performance, which can be attributed to the strong shareholder rights (Stiles and Taylor 1993).

Therefore, an important pre-requisite for self-regulation is strong shareholder rights, which many emerging countries lack. These instances of self-regulation and market regulation, nevertheless underscore the importance of public or government legal rules for dispute resolution and eventual enforcement through courts of law. For instance, even if the case of a self-regulatory organization, in case of violations, future compliance may have to be resolved in the courts. If such organizations are to be effective, private contracts must be augmented by the law so that recourse to courts is rendered unlikely and rules are transparent (World Bank 2001).

However, we do not advocate heavy government intervention. In order to supplement the role of the government or to fill the vacuum in cases where the government is absent, there is a practical scope for regulatory initiatives from stock markets. Most stock markets typically impose corporate governance, disclosure and accounting requirements above the minimum requirements set by company laws. An example is the Nova Mercado exchange of the Sao Paulo Exchange, that has more stringent listing requirements (see example). The Brazilian approach to corporate governance is unique because better governance practices have come from capital markets rather than legislative reform. The Brazilian authorities hope that if companies with higher quality of corporate governance obtain higher valuations then other companies will have an incentive (or face pressure from investors) to improve the treatment of minority shareholders (see example). However, despite exchange regulations and self-regulated organization, laws may still need to be augmented, especially in case of violations and to ensure compliance. To limit abuses of market power, there will still need a need for outside regulation (World Bank 2001).

In addition to exchange activism, the government can also take legislative action to improve governance. In Chile a PTO law was passed and regulatory and legislative process were undertaken by the government to improve corporate governance (see example: Chile). In Colombia, a more different form of voluntary compliance exists, where private and public initiatives complimented each other i.e. quasi-public rules (Jordan and Lubrano 2002). Many firms have created their own corporate governance codes on best practices, along lines of OECD principles. This is an example of companies taking the opportunity to design more shareholder friendly codes, since firms which want their shares to be actively traded must be transparent in their shareholder protection rules and boardroom practices. Obviously these codes can in the long-run create more competition amongst firms to create provisions as the most shareholder friendly etc.

Example: PTO law (Lye de OPAS)⁸

In an effort to improve corporate governance in Chile, the government passed the “PTO law”, which went into effect on December 20, 2000. This new law covers a wide verity of corporate governance issues, including equal shareholder rights of ADR owners, internal transactions, and public tender offers. It also raises disclosure requirements in an effort to improve transparency.

Before the enactment of the new law, ADR owners had not been granted equal shareholder rights. Under the old registration, the rights of ADR owners were vested with the President of the Board of Directors. The new law ensures proportionate voting rights in shareholder meetings and offers preemptive rights in new capital issuance and withdrawal rights to ADR owners.

In addition, shareholders have more power to veto transactions with related parties that are alleged to extract rents. Shareholders who represent at least 5 percent of the outstanding shares can call an extraordinary meeting to make a decision on all inside transactions. If the board of directors is unable to reach a decision, the board can designate two independent evaluators. The evaluators’ reports must be completed and made available to shareholders and to the board of directors within twenty working days. The new law also addresses the role of directors during a tender. Small investors were routinely subject to rent extractions because they could be excluded from tender offers. The new law requires prior notice of many director actions and requires that a public bid be offered prior to the acquisition of all stocks, with some exceptions. One important exception is the acquisition of shares that are sold by the corporation’s controlling party, provided that the shares are listed in the stock exchange and the price is paid in cash and is not substantially higher (below 10% -15%) than the market price. In addition, each director is required to submit a personal opinion on the suitability of the offer.

The above examples show varying levels of corporate governance initiatives undertaken by governments, exchanges and individual firms⁹. Countries have experimented and in most cases quite effectively, both public and private legal rules or mandatory and voluntary codes. The following forms of corporate governance rule making. Interestingly enough a third column deals with a mixture of private and public rules that have been used in recent years, which also helps to differentiate contractual arrangements between shareholders and management and voluntary rules that may have been set by the government or exchange.

	Private	Quasi Private /Public	Public
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⁸ For details see Law Number 18.045 and 18.046, Eyzaguirre and Carraha (2000)

⁹ The ensuing discussion heavily draws upon Jordan and Lubrano (2002).

Ex Ante	Contract	Sponsored Voluntary Standards	Law / Regulation
Ex Post	Arbitration	Special Arbitral Bodies	Judicial

Source: Jordan and Lubrano (2002)

The wave of corporate governance reforms in Latin America fall under the changes to public rules such as reform of company and securities laws, which are applicable to all listed companies. Many cases of expropriation of shareholder rights (Enersis in Chile and Azteca in Mexico and others in Argentina and Brazil) were significant in conception of these legal amendments. However, these changes were strongly opposed by many listed firms, that preferred to delist or not access the capital markets than comply with these legal rules as they faced having to comply to stricter standards. Nevertheless the effect of these public rules can only be determined after a sufficient period has passed, although short-term evidence does indicate that the reforms have been successful in generating awareness amongst public, stakeholders and management on corporate governance issues.

Private legal rules are important and fairly standardized private rules have developed. There is a case of successful private contracting by Ultapar (a liquefied petroleum gas distribution company) in Brazil (see example: Brazil-Ultapar). Ultapar's experience with ad-hoc contracting also influenced the content of Nova Mercado rules. Therefore, such private contracting can also shape public rules. However, the effectiveness of private rules vis a vis public rules depends on the legal traditions. For example, UK and US common law rely on courts i.e. ex-post legal rules for enforcement, although US has warmed to the use of legislation and public rules and has a formal Bankruptcy Code.

Quasi private-public rules in the form of voluntary codes of best practice have also been popular recently and can be an important tool to shape and reinforce public rules. The different approaches to adoption of these codes was discussed earlier in the case of Russia and Mexico. In Poland, two separate initiatives involving academics, institutional investors and other stakeholders were launched to develop a code of corporate governance. The code has now been implemented and requires companies to file a declaration of compliance every year. Similarly in Colombia, a combination of public policy efforts and voluntary initiatives is another example of a combination of public and private rules. These voluntary codes have also been used to develop corporate governance ratings, for example in Thailand. Once again the importance of such voluntary codes depends on legal traditions. The often cited Cadbury report of UK has had extraordinary influence, but if the same were transplanted to France, its effectiveness would be questionable due to emphasis public legal rules in civil law countries. Tunisia has also recently

introduced a new corporate law dealing with corporate governance, but it has had little interest in participating in voluntary code or a judicially oriented shareholder remedies, mostly because it is a pure French civil law country.

In most of the examples cited above, it is worthwhile to notice that the relationship between private and public rules is not static and efforts to improve corporate governance have involved reforms in both private and public contracting arrangements. For example, in Brazil there was activity in public legal rules, Nova Mercado (a quasi-public private arrangement) and private contracting (Ultapar). However, standardized private rule making like the Nova Mercado are successful only if there is agreement on the deficiencies that exist in the legal framework and a reasonably large number of issuers and investors. Similarly in Colombia, policymakers recognized the need for a set of complementary public and private legal efforts. Since there were visible collaborations between company organization, the stock exchange and pension funds association, the extent of each element may differ from Brazil.

Example: Brazil – Ultapar (Jordan and Lubrano 2002)

In 1999, Ultapar decided to offer non-voting shares to foreign investors through an ADR listing on the NYSE. However, during the road-shows, concerns were raised over the rights of non-voting shareholders, especially in the case of a takeover or merger which was not too uncommon in this industry. Under the Brazilian Company Law, there was no requirement for controlling shareholder to buy non-voting shares in the case of a takeover. In order to ease these concerns the management decided to offer tag-along rights to these foreign investors, which were convincing enough and allowed the ADR listing to go through.

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II CREDIT BUREAUS

1. Policy Points

- Encouraging lenders to obtain and provide relevant information i.e. facilitating information sharing and, legal and regulatory issues: a) liberalize privacy laws- effective dissemination broad privacy laws may unduly limit credit reporting , b) develop effective consumer protection laws. Balance privacy protection and effective information sharing, c) financial sector laws, especially laws on credit reporting, d)provisions regarding privacy and personal or corporate secret in existing laws, e) data protection laws.
- Lenders must be encouraged to provide information on borrowers to improve quality of credit reporting firm data. They must also be encouraged to use information from credit reports to review loans, through threat of sanctions.
- Consumer Protection: information should be disclosed on who accesses the credit report, provide mechanism for non-judicial dispute resolution and Consumers should be made aware of benefits of credit bureaus, so that they are not threatened by information collection.
- Secrecy laws may preclude development of a credit registry, which banks can overcome by requesting clients for written authorization to participate in credit information sharing.
- An adequate legal environment should support responsible sharing by revising bank privacy laws that may deter sharing of information and all lenders (including non-bank lenders) should be able to obtain credit reports under the same protocol.
 - review bank secrecy laws which can constrict information flows
- It should also safeguard consumer rights, by allowing them to access the data held with credit bureaus; to dispute and correct erroneous information; to know who has accessed their credit reports and should be aware that their credit history information can be collected.
- Any regulatory framework, should also have clearly defined government agencies that provide oversight for enforcement of regulations and self-regulation should also be encouraged. Regulatory framework with enforcement (deal with competition policy aspects of credit information).
 - consumers have ability to bring complaints outside judicial system
- Encourage entry of foreign / international credit reporting firms. It can accelerate the process of establishing a private credit registry. In the Czech Republic, Guatemala, India and Mexico,

private bureaus are being formed with foreign firms, which provides technical assistance and expertise.

- Discourage banker association controlled credit bureaus in top-heavy systems.
- Security aspects of dealing with sensitive information
 - Open system, not closed network
 - ownership by a limited group of lenders, bank association, can discourage a broader database
 - Collect both positive & negative information and information from wide sources
 - Maintain data for a reasonable time frame - 5 years minimum
 - do not delete data on non-payments when debt repaid
 - **But** a limit on time data is maintained should also be there, so that borrowers have an incentive to repair their credit.
 - Data-collection notification to inform borrowers
 - Integrity and transparency are paramount
 - special standing of any group, including owners or government, will discourage participation
 - Access to detailed information preferable
 - loans described individually, not aggregated
 - institutions providing credit identified
 - Restrictions to prevent “cherry-picking”
 - Distribution reflects privacy, security considerations

2. Overview

Credit bureaus are firms that hold a database of information on borrowers in the financial system. The information that they carry will vary, but typically includes data on borrower’s past payment history, either only highlighting negative aspects such as defaults or late payments or also including positive information on timely repayments. A World Bank survey on credit reporting systems, reveals almost half of private reporting firms in their sample of 76, started their operations in 1989, while 13 new registries were formed in Eastern Europe since 1992. Since 1989, a number of new public credit registries (PCR), which are government operated bureaus, have been established. In the survey 17 countries established a PCR since 1989, of which 9 were

operating in Latin America. However many other countries including Croatia, Czech Republic, Hong Kong, India, Singapore, South Africa and Tanzania have recently shown an interest in creating a PCR (Miller 2003). The Doing Business Report (2003) by the World Bank highlights that poor countries are as likely as developed countries to have public credit registries and legal rules that protect credit information. The only difference lies in the time and cost of creating and enforcing security in developing countries. However, developing countries are less likely to have private credit bureaus. Another significant difference is in extent of population who's credit histories are provided. While in New Zealand, Norway and the United States, credit histories on every adult are present, in Ghana, Montenegro, Pakistan and Serbia, there are credit histories for less than 1% of adults.

2. a Role of Credit Bureaus

Credit bureaus are an important element of a financial system. By providing accurate information on borrowers (both consumers and firms), credit reporting can overcome a fundamental problem of credit markets: existence of asymmetric information between borrowers and lenders. Reliable information on potential borrowers, for instance past behavior in terms of loan repayments, can allow lenders to accurately determine credit risk and thus reduce problems of adverse selection.¹⁰ Credit reporting helps lenders by reducing default rates and borrowers by allowing them to develop payment histories or “reputation collateral” that they can use in securing more competitive loan rates. Once loans have been provided, sharing data on payment information through credit bureaus, can serve as a sanction on borrowers, as credit information is circulated across financial institutions. This threat of sanctions, can encourage timely payments and limit moral hazard because the cost of paying late or defaulting on a loan of one institution is greatly increased by the effect this has on securing subsequent financing across the financial system. Credit bureaus, by ensuring better risk management, serve to increase banking sector stability and improving access to finance to borrowers that many have been previously excluded, such as small and medium sized firms.

Although asymmetric information and resultant moral hazard and adverse selection in the context of credit markets, have been deeply examined in economic literature, the role of credit reporting to overcome these problems has not been sufficiently addressed. Theoretical contributions determine structures that encourage sharing of information in credit markets. In the case of competitive credit markets, lenders will not volunteer any information that erodes their

¹⁰ Credit reports are found to be a more reliable determinants of credit risk, than financial reports (Karlberg and Udell 2003)

market power and rents. Therefore, information sharing will arise when borrowers are heterogeneous and credit markets are large (Japelli and Pagano 1993). However, complete information sharing may be a sub-optimal solution, compared to limited information, as long credit histories reduce value of each negative behavior and reduce borrowers' incentives to comply (Vercammen 1995). Effectiveness of information sharing mechanisms also depends on type of information shared. For bureaus to make an accurate assessment of risk, both negative and positive information must be shared, because if only negative information sharing takes place, borrowers with bad credit histories will drop out of the market, to avoid high interest rates or unduly high effort will be induced to avoid default (Padilla and Pagano 2000). A study on default rates, measured by credit card write-offs, shows countries where bureaus share both positive and negative data have lower write-off rates (given the level of penetration of credit cards) relative to countries where bureaus mostly share negative information (Bailey, Chun and Wong 2003). Although both Hong Kong and Taiwan have the same penetration rates of credit card, the default rate is three times as high in Hong Kong, where credit bureaus mostly share negative information. In the US, comprehensive credit reporting exists. Examination of loan applicants based on data from 3 US consumer reporting agencies, also supports benefits of positive information. It finds the gain from the inclusion of positive information (compared to only negative information) is over 90% (Barron and Staten 2003).

2. a-i Winners and Losers of Credit reporting

In order to encourage credit reporting through credit bureaus, it is also important to assess benefits or costs faced by borrowers and lenders. Well-connected and large firms will find it easier to obtain loans in countries without credit bureaus. Credit bureau information is especially useful when making decisions on lending to individuals and SMEs, for whom information is scarce. While lending to large companies involves detailed analysis of financial standing, for smaller borrowers, past payment history is typically a good predictor of credit risk¹¹. Without credit bureau information, banks rely on "application scores" that only use demographic information and have had poor success in the past in predicting default, for consumer and small business loans. Information sharing through credit bureaus allow banks to lend against "behavior scores" determined by past borrowing and repayment histories, which allows bank to lower their costs in two ways: First through a lower cost of processing loan applications and second via their

¹¹ Pinheiro and Moura (2003) find credit registries in Brazil have a limited role in loan decision-making process, in the case of large firms.

improved ability to predict defaults and successfully manage credit portfolio risk. A survey of bankers conducted in 2001-2002 in 34 countries with operating credit registries, shows that banks gain significantly from using information from credit registries. More than 50 % respondents indicated that use of credit history information decreased processing time, costs and defaults by more than 25 % (Doing Business in 2004: Understanding Regulation). However, although, information sharing benefits banks by reducing moral hazard, raising recovery rates and profits, credit reporting can also induce greater market competition, reducing profits. Bigger banks with an informational advantage are more likely to be affected by successful credit bureaus , losing their competitive advantage over other smaller lenders. Therefore, whether information sharing is beneficial for lenders, depending on the strength of the two effects (Padilla and Pagano 1997).

In India, rural borrowers need to acquire a “no dues certificate” from every other lender in the village that they do not have an outstanding loan. This is a costly and time consuming process for borrowers and consequently, if farmers require a loan quickly there only option is to go to an informal moneylender. A credit bureau would eliminate the need for these certificates and decrease time necessary for loan approval and disbursement. Therefore greater information sharing can benefit small and new borrowing firms, by increasing overall lending and alleviating credit rationing.

2. a-ii Empirical Evidence

The small amount of empirical work that has been carried out to determine these effects, supports the above claims. A study using a unique dataset on credit reporting firms in over 40 countries, shows greater information sharing to increase lending as a percent of GNP and lower default rates (Japelli and Pagano forthcoming). Similarly in Chile, Cowan and De Gregorio (2003) find credit data increases volume of lending, the greater the historical record and information in the report. Existence of credit registries is also associated with a higher private credit to GDP ratio. On average, countries without credit registries have private credit to GDP ratio of about 16 %, while those where private bureaus operate the ratio is 67% and in countries where PCR exist it is about 40% (Miller 2003).

In Argentina, Berger et. al. (2003) find small and more informationally opaque firms to deal with smaller banks. They tend to rely on relationship banking, where greater contact with banks allows information on credit history to be accumulated. Greater information sharing can benefit small and new borrowing firms, by alleviating credit rationing based on lack of credit history. Impact of information sharing on access to credit are examined by Galindo and Miller

(2001). They find firms use less internal funds and are therefore less credit constrained if credit reports are available. Another recent study based on an enterprise survey in 52 countries finds that about 50% of small firms report financing constraints in countries without a credit bureau as compared to 27 % in countries with a bureau. Furthermore, 28 % of firms are able to obtain a bank loan in countries without a bureau versus 40% of firms in countries with a bureau (Love and Mylenko 2003).

2. b Best Practice: Ownership, Regulation, Consumer Protection etc.

A credit registry may be established in the private or public sector or operate as a joint venture between the state and member banks (as in the case of Sri Lanka) or between member banks and foreign private bureaus (such as in the case of India). Many countries have both public and private registries operating, though the latter are more prevalent in the developed world. Latin America has the most widespread credit reporting system in the developing world and most countries have both public and private credit registries. However PCR's have begun to spread to other countries in Africa, Asia and Eastern Europe. Chile and Argentina also have joint public-private cooperation systems, where the public bureau outsources data collection and credit scoring to a privately operated bureau. Another form of ownership of credit registries that is also prevalent is by bankers associations. However, in top-heavy systems, it must be pointed out that banker's associations will be dominated by the largest banks that can exploit their position for possible misuse of information from competitors. For example, in Mexico, smaller banks allege that the larger controlling banks have used their information deposited in the credit bureau, unfairly. Furthermore, smaller banks are also forced to pay a disproportionately charge for credit information sharing, in a concentrated market.

Private credit registries are able to collect information from a wider set of sources including financial institutions as well as firms selling goods on credit. Since participation in private registries is voluntary, it may not include all financial institutions. For instance, in countries dominated by one or two large banks, the dominant financial institutions may choose not to share their proprietary credit information. However, the Doing Business (2003) report supports the former view. It finds on average private bureaus cover 321 borrowers per 1000 people, while the average PCR contains records on 40 borrowers per 1000 people. PCR's are usually set up by a central bank and serve a dual purpose of assisting banks in improving their risk management and strengthening bank supervision. Therefore, PCR's report information for supervised institutions while private registries have a much broader scope including leasing and finance companies and retail corporations. A study based on survey conducted by the World

Bank for more than 70 countries between 1999 and 2001, finds similar evidence. It shows PCR collected data to determine aggregate risk of lending institutions, while private registries report more detailed information on borrower history. The main finding is that public registries complement private credit reporting arrangements, due to different sources of information and services offered (Miller 2003).

Conversely another study based on a survey finds public credit registries substitute private credit bureaus in countries where the latter are unable to function due to poor legal environment or privacy laws that preclude information sharing (Japelli and Pagano forthcoming). Specifically PCRs are a response to weak creditor rights protection. In their survey, the authors report private credit registries existed in 65 percent of countries, without a public registry, further supporting the view that the two systems are substitutes. Since many developing countries are in the process of establishing some form of credit bureau, clearly more research is warranted on these issues.

A clear legal and regulatory framework is necessary for successful functioning of credit reporting. Policymakers may choose between laws regulating the industry versus a self-regulating code of conduct. When considering circulation of personal data, two concerns must be addressed: privacy of information and access to information. Every country protects an individuals right to privacy, but in order for credit registries to function, institutions and individuals must be willing to share and circulate information. Overly restricting information sharing, for example through unnecessarily severe penalties or complicated procedures can constrain access to information and discourage firms to enter the business of credit reporting. Although these concerns may move in the opposite direction, it is necessary to create a balance of privacy protection and effective information sharing. For instance, only credible lenders should be allowed to access information, and consumer concerns can be safeguarded through adequate consumer protection laws that allow consumers to challenge incorrect information.

Regulatory weakness also exist in the area of collection of data. Although Argentina, Chile and Colombia meet international minimum standards in defining information that can be collected and distributed by reporting firms, other countries in Latin America do not meet these standards. Another troubling law relates to extent of payment history that can be included in credit reports. If negative data is deleted after a specific number of years, it can help people with bad credit histories in the past at the expense of those who are honoring their debt obligations. Longer payment histories can also induce greater willingness to pay (Villar, Leon and Hubert 2003). For instance in Latin America, except for Mexico, payment histories are only maintained

for a few years, which deliberately undermines the role of credit bureaus¹². However, in South Africa, the long payment histories actually worked to the disadvantage of the black African community that was effectively deemed high credit risk. Therefore, deeper examination of these regulations needs to be done.

2. b-i Privacy Laws

Bank privacy laws or secrecy laws that preclude or place limits on positive and negative information that can be shared, can drastically limit operation of private credit registries. Importance of facilitating information sharing is also evident from the case of former Soviet Union countries. The secrecy provision in banking and data protection laws have been a major impediment to development of credit bureaus. Every countries has tried to set up a private credit bureau, but has failed (Doing Business 2004). Laws on credit reporting can help overcome lenders' unwillingness to share information due to fear of competition or unfamiliarity. Government and central bank support in this area has been effective. For example in Mexico the Central Bank imposes 100% provisioning requirements when data is not submitted to a bureau. Bureau code of conducts such as those in Singapore and being developed in Saudi Arabia are also another way to set standards (Doing business 2004).

Bank secrecy laws in many developing countries are largely a result of inheritance of legal tradition of colonial powers that seek to reassure clients that their wealth and transactions will not be revealed to the government or public. For example, France in particular places heavy emphasis on secrecy laws. Banks are also unwilling to share lending information, in order to maintain their hegemony and information rents. Although banks usually ascribe bank secrecy laws as a reason for lack of credit reporting, it is an excuse to conceal willingness, since Switzerland which is the most notable jurisdiction for bank secrecy, also has credit reporting. Therefore, the key issue is willingness on the part of banks to request clients for written authorization to participate in a registry, so that even without a legal foundation, they can develop a credit reporting environment.

Privacy laws may also limit access to data to particular sectors such as banks. Credit reports that contain only negative information have less predictive power relative to reports that contain both positive and negative information (Barron and Staten 2003, Bailey, Chun and Wong 2003, Padilla and Pagano 2000, Pinheiro and Moura 2003). Lenders who are unaware of positive

¹² For instance in Chile, it is a 7 year period, while in Brazil and Argentina, negative data can be maintained for 5 years (Villar, Leon and Hubert 2003).

aspects of a borrowers credit history, may not offer available amount as they are unable to determine credit risk accurately. As credit reports are more important for extending credit to informationally opaque borrowers, limits on data collection will disproportionately affect these borrowers (Barron and Staten 2003). Policymakers therefore encourage full data collection, and support removal of bank privacy laws.

2. b-ii Consumer Protection

Private credit bureaus must be regulated to protect rights of individuals and firms with regard to the information collected in credit bureaus. Borrowers should be able to access their own credit reports at a fair price and specific steps should be in place to challenge and correct erroneous data. International guidelines for personal data protection emphasize individuals rights to access and dispute information held with data controllers, limits on information that can be collected and the data controllers responsibility to maintain up to date information and specify the purpose for which it is collected. Access to information by consumers is important to strengthen confidence in credit registry systems, for both borrowers and users of information i.e. lending institutions. It allows consumers to dispute incorrect information and report misuse (Villar, Leon and Hubert 2003). Consumer rights concerning credit reporting have not been paid much attention in developing countries (see example South Africa). PCR in many countries have also denied access to consumers to information housed within these agencies (Miller 2003). However, the trends are changing, with almost all countries in Latin America, allowing consumers access to their credit reports. However, in Colombia, there are no rules on timeliness of delivery of reports. In the following Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico and Peru, dispute resolution mechanism exist for consumers to challenge information contained in credit reports (Villar, Leon and Hubert 2003).

Example: South Africa¹³

South Africa's credit information system has played a vital role in increasing access to financial services, particularly among low-income consumers with little or no history of banking borrowing. The country provides useful lessons for other countries in Africa and elsewhere seeking to build a credit registry industry. South Africa has a competitive credit reporting industry, with 8 all privately owned bureaus that collect information from a wide range of lenders including banks, retailers, microlenders and medical providers. However a significant shortcoming is in its consumer protection laws. The industry is self-regulated through a

¹³ This section draws upon work by Klapper and Krauss (2002).

Consumer Protection Code of Conduct developed by the Credit Bureau. This change was also a response to pressure from consumer groups. In 1994 the association – working with the Business Practices Committee of the Department of Trade and Industry – formalized the code, which applies to all credit bureaus in South Africa. On the surface it provides adequate guidelines on fairness and privacy to consumers; accuracy and transparent of information; limits types of information that can be reported; provides assistance to consumers to explain disclosed information; procedures to deal with disputed information. However it does not address how consumers who suffer harm from distribution of inaccurate or incomplete information can take action against creditors or credit bureaus. Furthermore, there is also a need to educate consumers.

In September 2001, the South African media reported complaints from consumer bodies, business groups and political parties against credit bureaus and the Credit Bureau Association in particular. This backlash against credit bureaus is partly due to lack of consumer awareness. Consumer perception in Africa of credit bureaus has been that they are simply “blacklisting agents” Most consumers know have little knowledge of the role of credit bureaus and their rights to access credit reports and dispute any incorrect information in their credit files that may cause them damage. In addition, the attacks on credit bureaus were politically motivated, which served to encourage consumer perceptions that bureaus exist only to prevent black South Africans. Consumers also accepted politically motivated comments that overstated the power and influence of credit bureaus, which further fuelled anger against credit bureaus. These incidents of misinformation created a political challenge, and therefore there is a need in South Africa to educate consumers about activities of credit information industry and for stricter enforcement of consumer protection laws.

2. c Public Bureau – Examples of outsourcing in Argentina, Chile etc.

An advantage of a public credit bureau is its rapid setup because it uses central bank regulation rather than new laws. Establishing a public credit bureau is also cheap. A public credit bureau may also complement function of private credit bureaus. For instance, it can remedy lack of private information sharing or complement private bureaus by focusing on bank supervision. Information sharing is a public good that may be in short supply if left to the markets. Financial intermediaries may also refuse to share sensitive information with third parties and can invoke privacy laws that may discourage credit registries. For instance in Brazil, banks only share negative information to enforce repayment and will avoid sharing proprietary positive information to avoid losing their “information rents” (Castelar and Moura 2003). Therefore, a public bureau can support collection of adequate information, which private credit bureaus are

free to take and transform into scores and other products. The public registry can be housed with the central bank or outsourced itself to the private sector. The important aspect is that regulated institutions are required to report and in many countries voluntary agreements have also been signed to incorporate non regulated institutions. In Latin America, both Mexico and Chile have one public registry and one outsourced, while Argentina has a public one and a private one that takes the information and enhances it (see example Chile).

Example: Chile¹⁴

In Chile, credit information is provided through a mixture of public and private firms. Most information is collected by public institutions that disseminate it to financial institutions or to wider public. Financial institutions are required to disclose all individual debt information to Superintendence of Banks and Finance Houses (SBIF), which are the bank regulators. The SBIF maintains a record of all borrowers in the financial system. It checks the disclosed information for consistency and distribute it to banks, effectively providing a credit report. Two other sources of information include Boletín de Informes Comerciales, which is a bulletin of negative information (such as bad checks and overdue bills of exchange within the financial system) published by the Chamber of Commerce and Boletín de Morosos del Comercio (SICOM), which contains information on individuals with arrears at one of the 7 largest department stores. Private companies have evolved that collect information from these sources, process it and add other privately collected information to it. Although these companies are not credit bureaus, per se, as they do not collect data directly from lenders, they have occupied an important role in credit information industry in Chile. Furthermore, as unique tax identification numbers (RUT) are assigned to all individuals in the system, it is easier to collate and merge information from different sources. DICOM is one of the largest private companies operating in Chile, since 1979. Although initially, it was providing clients with information from Boletín de Informes Comerciales, SICOM and internally generated address verification, in early 1980s it was able to provide information services to SBIF. In 1989, it began to directly process information distributed by SBIF for banks.

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¹⁴ This section draws upon work by Cowan and De Gregorio (2003).

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III Proper Regulation and Supervision of Banks and Financial Markets

III-1. Bank Regulation

1. a Policy Points

- Regulations on entry and banking activity are negatively associated with bank performance, banking crises, increase corruption and reduce access to finance. Official supervisions also suffer from similar problems. This supports the importance of market discipline on banks., which can alert regulators of risky behavior. Governments need to enforce greater private sector monitoring, through (1) High accounting standards and complete disclosure of information, (2) easing barriers to foreign entry (3) subordinated debt – which can enhance supervisions. However, when government guarantees are in place, they reduce incentive of market participants (such as debt and equity holders) to monitor and market discipline will not occur. Therefore, Credible no-bailout policies (and avoid forbearance) towards insolvent banks may be required in developing countries as a source of market discipline (Karacadag and Taylor 2000).
- Reduce policies of directed credit and portfolio composition
- Allow prudent entry of foreign banks. Although this is a tough political issue, (among other benefits) it can provide expertise to local banks and supervisors in areas of risk-management (Mishkin 2000).
- Supervisors must be independent, strong, free from political pressure. They must have substantial resources to do their job. Improve effectiveness of on-site supervisions through more forceful recommendations. Strengthen off-site supervisions through planned analysis of capital asset quality, management soundness, earnings and liquidity (CAMEL) framework.
- The research shows that the role of supervisors is not intervention in bank management, but enforcing disclosure and transparency. In middle and high income countries, good governance will lead to market discipline -- through market analysts following listed firms, large depositors and bond holders, and forced bond debenture issuances. In low-income countries, it is important for regulators to enforce good governance -- and publicize violations -- but they still should not to be given the power to intervene, because there is likelihood of greater government corruption and they are more

susceptible to misuse for political purposes. To the contrary, Mishkin (2000) supports that Central Bank should be engaged in bank supervision – since they will need to make the bailout in case of a crisis.

- Adoption of Basel standards is insufficient, especially since they fail to consider institutional weaknesses in developing countries, when they emphasize role of internal ratings and supervision. Supervisors are unlikely to be completely independent, where banking sector is highlight concentrated and owned by powerful business elements. Furthermore, capital adequacy rules may create greater pro-cyclicality – and delay recovering in developing countries which are mostly bank based. Need for something more than Basel perhaps ?

1. b Objectives of Sound Bank Regulation

Regulation of the financial sector is important to limit moral hazard by banks and to ensure that banks have the incentive to allocate credit and perform other functions, cautiously. Excessive risk-taking by banks can propel a banking crisis, underscoring further the need to develop a set of rules to regulate behavior of the financial sector. Banks are typically subject to tighter restrictions compared to non-banking financial institutions, as any shock to the banking system is likely to sharply affect payments and credit system. The role of the government is therefore important in monitoring the financial system. Regulations may include a wide range of rules and guidelines designed to improve information efficiency of financial markets, protect creditors against fraud and promote stability of the banking sector (World Bank 2001). Supervisors supplement regulatory restrictions, to oversee operations of the financial institutions, monitoring on behalf of depositors to assess and take necessary steps in case of any problems. However regulations and supervision may also involve costs. For instance from the perspective of bank management, excessive supervisions may increase scrutiny of use of funds and the need for internal improvements to meet minimum requirements. Regulations may lead to a decline in competition and reduction in incentive to innovate. Most importantly badly designed regulations may further distort incentives of regulated institutions.

Example: Need for Regulation of Islamic Financial Institutions ? (Hawary, Grais and Iqbal, 2003)

Islamic financial institutions (IFI) have witnessed a sharp increase in popularity. At present, there are more than 200 IFIs in the world, controlling between \$150 to \$180 billion of financial assets. Many global banks such as Citibank, Goldman Sachs, BNP- Pari-bas and UBS have established Islamic banking services in several countries (Sundarajan and Errico 2002). It is expected that these institution will attract savings from 40-50% of Muslim population. These estimates, highlight both the growth opportunities and importance of developing effective regulation.

Although theoretically Islamic finance is based on profit and loss-sharing arrangements between agents and should be risk-free, therefore precluding the need for regulation, in practice there is a divergence. In fact IFI profit and loss sharing and moral hazard associated with it, introduces additional risks to the industry: a) The heavy skewed concentration on asset-backed securities and lease-based transactions on the asset side (particularly due to their low risk), relative to profit lost sharing schemes (mudaraba and musharaka schemes, trustee-finance contract and equity partnernership, respectively). This practice though conservative in nature, has costs of exposure to credit and operational risk. b) Emphasis on trade and short-term financing c) Need for clearly delineated investment policies that is consistent in allocation of assets between those funded by demand deposits, investment accounts etc. Instead the assets are treated as a large pool combined with stakeholder funds. This is an area that critically requires regulation so that for instance investment funds are separated from funds such as those of equity holders, d) Although investment accounts are supposed to operate as profit and loss sharing in premise, they in fact do not write value of deposits which implies losses on asset side are borne by depositors or equity holders. This requires greater transparency of information, e) holders of investment accounts, that are used to finance investment of financial institutions, are not allowed to participate in governance of the project. This also calls for need to tailor regulation to ensure adequate monitoring to protect rights of investment account holders, and finally f) other risks such as displacement risks and market risk based on interest rate benchmarks that are faced by conventional banks.

These issues raise the need for regulation of the IFI industry. At present, though many countries such as Indonesian, Iran, Pakistan, Sudan and Turkey have implemented separate Islamic Banking Laws, many other countries such as Saudi Arabia and Egypt has no such laws to regulate IFI activity. Furthermore, the tailored Islamic Banking laws may not completely take into account the unique characteristics of IFIs. Most studies (for example see, Archer and Karim 1997, Archer, Karim and Al-Deehani 1998 and Errico and Farrabaksh 1998) agree for the need of a regulatory framework that encourages greater disclosure of information and strengthen

accounting standards. In November 2002, the Islamic Financial Services Board (IFSB) was created for the same purpose of establishing standards for IFIs related to transparency, corporate governance and disclosure. However, there is still a long way to go, in terms of encouraging emphasis on capital requirements, supervision and licensing and even greater emphasis on transparency and disclosure compared to conventional banks.

1. c Empirical Evidence on Effect of Bank Regulations on Financial Sector.

A wide array of rules and standards have been implemented in the banking sector. During the 1980s, regulations commonly involved policies of directed credit and other guidelines on portfolio composition. These policies were aimed at increasing access to long-term credit, for firms in developing countries where long-term credit has typically been scarce. However, these schemes rarely reached their intended recipients (Atiyas 1991, World Bank 1989). Despite their failure governments found it politically infeasible to reverse the schemes. Although government subsidies may have increased long-term debt of firms, they did not allow firms to grow faster (Caprio and Demirguc-Kunt 1998). Instead of promoting prudent credit policies, most banks under directed credit, were suffering from significant portfolio problems (non-performing loans)¹⁵. The banking sector of India is an example of problems associated with directed lending policies (see example: India – Directed Credit in section IV-1). Other regulatory restrictions on bank entry have also been abandoned due to their ineffectiveness (see example: India – Social Banking) The recent liberalization of its banking sector has led to improvements, especially since stronger regulations have been in place. However perverse incentives continue to exist, due to heavy state ownership.

Example: India – Social Banking

Due to failure of social banking policies, policymakers are now turning towards microfinance. For instance in India, an initiative of social banking was started. Regulatory restrictions were placed on commercial banks, requiring them to open a branch in at least 4 non-branch areas, before they could open a branch in an already ‘banked’ area. This approach of strict licensing was continued between 1977 and 1991. Despite improving credit opportunities and significantly affecting poverty for the targeted population, the program became undesirable due to its very high default rates (Burgess and Pande 2003).

¹⁵ Siraj 1983.

The experiments with supervisory based system and directed credit guidelines, along with ensuing banking crises have reinforced the belief that authorities need to design policies that promote market forces and market discipline. Presently the plethora of regulations typically used involve: supervisions by government officials, capital adequacy rules, deposit insurance requirements, monitoring by private agents / private sector , restrictions on foreign and domestic bank entry and restrictions on activity of banks i.e. expansion into different service lines (Barth, Caprio and Levine 2001b). Empirical studies find greater regulatory restrictions such as those identified above, to be associated with an increase in corruption, greater likelihood of a banking crisis and lower banking sector efficiency (Barth, Caprio and Levine 2001b)¹⁶. The main beneficiaries of bad regulation are the government and firms that receive credit on softer terms. Although, if there is a good regulation that is only imposed on private sector banks and not enforced on public banks, the latter can continue to benefit in a good regulatory environment.

There is further evidence that tighter entry regulations and restrictions on bank activity negatively affect banking sector development, do not reduce the likelihood of a banking crisis (Barth, Caprio and Levine 2001b) and increase interest rate margins (Demirguc-Kunt, Laeven and Levine 2003)¹⁷. Weaker banking sector development reduces pool of finance available, and high interest margins raise cost of finance for borrowing firms. Tighter regulations can also be subject to political capture, with politically connected banks and firms frequently evading specified rules. Cross-country evidence also indicates capital adequacy and generous deposit insurance mechanisms increase likelihood of a crisis and do not reduce the moral hazard associated with explicit deposit insurance (Barth, Caprio and Levine 2001b)¹⁸. This supports the argument by Allen and Gale (2002) that the market should be left to determine the socially optimal level of capital and intervention through regulation (albeit to control market failure due to deposit insurance) is not justified. Financial crises are associated with a deadweight loss, but distorting effect of regulation on economic incentives and associated administrative costs must also be considered. Regulatory restrictions that create a big role for government may not necessarily

¹⁶ Berger and Udell (1996) and DeLong (1991), also find less regulations to be associated with lower costs and improve operational efficiency of the financial system.

¹⁷ Regulatory rules that restrict entry and limit competition, allow monopoly control and enhance risk-taking activities. They are also associated with greater likelihood of a bank crisis (Keely 1990, Caprio 1996). Reducing restrictions on bank activities can allow banks to exploit economies of scale and a broader set of activities can diversify income streams (Barth, Brumbaugh and Wilcox, 2000; Claessens and Klingebiel, 2001) .

¹⁸ This contradicts the idea that capital requirements protecting against future losses (Dewatripont and Tirole, 1994) or align interests of bank owners with depositors, in the cases of deposit insurance (Stevens, 2000; Keeley and Furlong, 1990; Kaufman, 1991).

promote stability of the banking sector. Specific regulations that encourage involvement of the private sector, allow banks to engage in wide-ranging activities or supports private monitoring of banking institutions will support better banks performance and greater stability.

Example: India – Failure of Directed Credit Policies (Hanson 2003)

India began to liberalize its banking sector in early 1990s and reduce the heavy intervention that was characterized the banking system. Prior to that, the banking system was heavily dominated by state banks. The nationalization process started in 1969 when 14 largest private banks were brought under government control. Further nationalization in 1980 raised public sector banks share to 92%. Credit policies were heavily regulated, with priority sector lending requirement at 40% of net loans. The rates on priority credit and volume of each individual loan were detailed by the Reserve Bank of India (RBI). The state and the borrowers who were eligible for the statutory liquidity requirement or received subsidized credit, were the only parties that benefited from these policies. The borrowers in agriculture sector and bank employees that received low cost loans as part of their remuneration were other beneficiaries. The government financed its public debt, by raising cash requirements of banks. Therefore by absorbing government debt, these banks provided a cheap source of finance. However the return on government debt was lower than the average costs of banks.

The liberalization process of the financial sector began in 1992. The main policies included deregulation of interest rates, reduction in directed credit and increased competition. However unlike liberalizations undertaken in other countries, these were supplemented by strengthening regulation and supervision of the sector. For instance, banks were recapitalized and a minimum capital adequacy rule of 8% of risk weighted assets was imposed, first on Indian banks with foreign branches and subsequently on all Indian banks. This weight was raised to 9% in 1998 to be effective by March 2000. Non-performing loans problem was adequately addressed. Finally, on-site supervision of banks based on CAMELS (capital adequacy, asset quality, management quality, earnings, liquidity and systems evaluation) was introduced. Competition was encouraged by fostering activities of non-bank financial institutions in an environment with freer interest rate and less directed credit policies. Licensing requirements were eased, and 9 private banks were granted licenses in 1994, while 21 new foreign banks entered the market between 1994 and 1999. Requirement that the RBI needed to approve large loans were also gradually eliminated. Despite these attempts to liberalize, the major obstacle towards success has been the large role of public sector banks that continue to control 80% of commercial bank assets. Although equity of 9 banks was sold

in the capital markets, no public sector bank was completely acquired by private owners. The Bank Nationalization Act would have to be amended to support sale of public banks, which continues to be politically difficult.

The positive outcomes of this process included an increase in availability of credit for the private sector by both the banking and non-banking financial corporations¹⁹. Finance through capital markets, equity and bond also increased significantly in the 1990s (RBI 1999). The increased competition amongst banks for prime borrowers, reduced lending spreads for all banks after 1997. Another major force in reduction in interest margins was competition from capital markets, as the largest Indian borrowers have begun to turn to capital markets for their financing needs. However, these gains continue to be limited by the government debt which has crowded-out credit to private sector through market sales rather than forced investments. NPLs continue to plague state owned banks, reflecting little change in legal and institutional environment that severely limits creditor ability to recover collateral. This creates perverse incentives for borrowers to service debt. Lack of access to credit history of borrowers is also another factor for the high NPLS. Improving the performance of the financial sector will involve reforms in legal, informational and incentive frameworks . For instance better bankruptcy law and better processing by debt tribunals must be encouraged. Finally, privatization of banks would provide better incentives to reduce NPLs. Although greater role of the private sector is necessary, it should be supported by stronger regulatory and supervisory environment to limit moral hazard associated with private ownership and deposit insurance.

Example: Mexico – Regulation of Entry and Privatization (Haber and Kantor 2003)

In Mexico, the entire banking system was privatized in 1991, nine years after it had been nationalized. Banks were sold via auction and, to generate as much revenue as possible for the fiscally strapped government, bidders were given signals that they would not operate in a highly competitive environment. In particular, the sector would remain comprised of nineteen banks as entry would be tightly regulated, and the handful of large banks that dominated the system would be sold intact. There were also explicit restrictions that largely precluded foreign investors from bidding for banks. By the time of the Tequila Crisis in 1994-95, the newly privatized sector was insolvent and required a government rescue involving assumption of non-performing assets,

¹⁹ There was a decline of almost 50% in non-bank financial corporation deposits in 1997, when collapse of a major corporation led to system-wide withdrawals.

capital injections, short-term liquidity support, and the formal intervention of many banks. A second round of privatization began in 1996. In an effort to re-capitalize their insolvent banking system, the Mexican authorities removed all restrictions on foreign entry. Nineteen of the thirty-two banks in operation today in Mexico are foreign controlled, and those banks hold well over half of the sector's assets.

1. d Role of Supervisors

Good supervision clearly can identify imprudent practices by banks and allow the market to take corrective action before it results in a crisis. The role of supervisions, as also identified in the Basel framework is to introduce qualitative judgments and reduce strict adherence to quantitative rules that may at times, fail to predict bank failure or excessive risk. The most important defining characteristic of good supervision must be independence of the supervisory agency. However, the effectiveness of supervisions may vary across countries and especially in developing countries where institutions are weak. Good supervision is of relatively more importance in developing countries as it can provide a credible threat against detecting any illegal activity (Caprio 1996).

Incentive structures in most developing countries, such as low remuneration relative to private sector and possibility of legal action are some of the factors that are likely to discourage sound supervision (World Bank 2001). Incentives of supervisors will not necessarily be aligned with social welfare, as they may be more concerned about their reputation, job prospects. Banks (especially in developing countries) dominate the financial industry and have significant clout to persuade regulators to delay undertaking action against the bank (Chami, Khan and Sharma 2003). In other cases, government may force regulators to postpone resolution of a problem. The case of Banco Latino in Venezuela is relevant, where failure to resolve the problem early on, led to a collapse of banking system eventually (see example).

Empirical evidence supports these concerns. A study based on two separate surveys carried out on firm-level access to finance and bank supervisory framework, for 49 countries shows official supervisions positively associated with financing constraints and corruption (need for political connections) to access finance (Beck Demirguc-Kunt and Levine 2003)²⁰. Private agents can exert more effective control over banks as compared to official supervisors. The negative effect on access to finance declines when private agents are presents, since the need for

²⁰ Beck, Demirguc-Kunt and Levine (2003) also find regulations that require information disclosure to be associated with lower obstacles to finance.

special connections reduces. There is further evidence that official supervisory indicators such as loan classification and provisioning stringency, supervisory power or longer tenure of supervisors etc are not strongly linked to bank performance and stability (Barth, Caprio and Levine 2001b, Beck, Demirguc-Kunt and Levine 2003).

Therefore, although bank supervision matters, concentrating control in the hands of the government, may not improve social welfare (Becker and Stigler, 1974). Politicians may use official supervisors to direct bank finance to favored firms rather than to protect interests of the society (Becker and Stigler, 1974; Stigler, 1975; Rajan and Zingales, 2003). While government supervision and regulation can create further obstacles to financing, independent supervisors or empowering private sector to monitor and disseminate information can ameliorate the market failure. However, regulations that empower the private sector must be backed by central bank officials and make credible limited bailouts (Calomiris and Powell 2001, Krivoy 2000)²¹.

There is also a need to alter the approach of bank supervisions, which involve ascertaining a bank's holding of capital at a particular point in time. This approach may be faulty, since innovations in financial markets allow banks to take excessive risk which can quickly drive a healthy bank into insolvency (Mishkin 2000). For instance, Barings bank, which was well capitalized initially, went into insolvency in a matter of months as a result of dealings of a rogue trader. Examining a bank's balance sheet may indicate whether it has excessive risk in its portfolio, but will not indicate a bank's predisposition to undertake excessive risk in the future. Therefore a superior alternative is to determine best practice for risk management and compare banks on this criteria. (Mishkin 2000).

Example: Venezuela - Weak Supervisory Environment (Caprio 1996, Krivoy 2001)

In January 1994, Banco Latino, the second largest and one of the most powerful banks in Venezuela collapsed. Its collapse started a run on other banks and within three weeks a third of the banks were either shut down or operating with government financial support. Eighteen months later, the government was forced to operate 53 failed financial institutions. The Venezuelan banking crisis which cost 11% of GDP, seemed to occur suddenly, but its symptoms were showing as early as two years ago.

Banco Latino had been mismanaged for a while, enjoying benefits from its cosy relationship with the Central Bank president., Tinoco, who incidentally also had a large ownership stake in the bank. Tinoco's close relationship with the President of Venezuela, created

²¹ This is because central banks may need to duly monitor banks to which it may serve as a lender of last resort (Mishkin, 1992).

a belief that the bank would not be allowed to fail. Even after Tinoco's death, an implicit protection to the bank persisted. Banco Latino in the meantime, undertook excessive risk lending to more than 'optimistic' opportunities in hotel, tourism, real estate and luxury apartment buildings. These long-term loans were financed mainly with very short-term deposits²².

In 1992, the Central Bank recognized the impending problems and issued a medium risk rating for Banco Latino. The National Securities Commission, Fogade (deposit insurance agency) and Ministry of finance were aware of the need for recapitalization of the troubled banks. However, no heed was given to the warning, until the problems had spread to 17 other banks. Despite changes in Central Bank Laws, and wider powers given to supervisors, the supervisors were unable to undertake action without approval from other government agencies. The government continued delaying a plan for an orderly resolution, while the Central Bank propped up the bank liquidity through loans. When all rescue operation possibilities through shareholder recapitalization, loans from other banks and loans from Fogade, had dried up, the Central Bank was forced to withdraw the bank from the check clearing system. However, by then entire Venezuelan Banking system was in danger. This shows that supervisors are likely to be captured by political forces and need to be free from political pressure.

Example : Argentina (Calomiris and Powell 2001, 2003) – Good regulatory environment, but negative government influence

A case in point is Argentina that went through substantial regulatory reform in late 1990s, migrating from extensive government regulation of interest rates and credit allocation, to a system with free entry for domestic and foreign banks, limited safety net of deposit insurance and capital adequacy requirements Private sector was also empowered through dissemination of accounting information, transparency of credit risk and credit ratings through private monitoring agencies. Calomiris and Powell (2001) argue that market discipline is important in encouraging risk-management policies that minimize banking sector risk. They also point towards the fact that although effective regulatory blue-prints can be transplanted, the political will required to enforce it is also equally important.

However the recent financial crisis in Argentina suggests that even the most well-regulated banking system can be vulnerable to fiscal imbalances (Calomiris 2003). Despite competition from foreign banks and private sector discipline, the Argentine banking system

²² In a few banks some 12 –14 year projects were financed through 8 day funds (Krivoy 2001)

collapsed. However this does not point towards bad regulatory environment. Instead excessive government intervention and change in regulatory rules of Banco Central, were contributory factors. The excess liquidity and capital were considered a ‘problem’ which was fixed by government officials by changing rules in Banco Central that reduced this excess liquidity and also forced banks to become involved in government financing schemes. This supports the need for private sector supervision, since strong officials may use regulation and supervision to meet their short-term needs, without a view on their long-term implications.

1. e Basel Accord

Basel I and Basel II, are widely recognized as international benchmarks that banks in both developing and developed countries are required to comply with. Although these standards of supervised capital adequacy are easier to adopt (being simplified quantitative restrictions), the underlying procedures and the supervisory skills required are harder to acquire (World Bank 2001). Basel I (1988), though voluntary, has been accepted and implemented by more than 100 countries in some form. Countries have voluntarily complied with these international regulatory standards as they can provide legitimacy to the country’s financial market and banks.

Basel I accord prescribes an 8% rule of capital adequacy, but only focuses on credit risk and does not consider market, interest rate and operational risk²³. The new Basel seeks to overcome these deficiencies by reducing the emphasis on regulation and shifting focus to direct supervisions of banks’ risk management processes. Basel II accord hinges on three pillars: capital requirement rules, supervision and enforcement of these regulations and market discipline through enforcement by financial markets and institutions.

Although most countries agree to comply with these standards, they have important flaws when considered in the context of developing countries. Defining internal and external ratings to determine capital requirements remains the biggest obstacle. The Basel II framework offers a choice for banks to rely on either a standardized approach (external parties rating credit risk) or an internal ratings based approach²⁴. The primary method of ratings proposed by the Basel II is

²³ This failure to incorporate other types of risk has meant that banks were able to comply with the regulation and still economize on capital by securitizing loan portfolios and selling credit risk in secondary markets instead of keeping it on balance sheets (Chami, Khan and Sharma, 2003). They securitized high quality credit and kept low quality credit on their balance sheets. The development of derivatives market and business group connections with banks has highlighted the shortcoming in the 1988 accord, as strict capital guidelines can easily be subverted.

²⁴ Under the new framework the size of capital requirements will be significantly changed, with poor credit risk banks having as high as 12 % and banks exposed to high quality credit may see their credit requirements drop to 1.6 % (Vosen, 2003).

ratings by external credit agencies²⁵. Developing countries question this approach as it places excessive power in the hands of rating agencies. Credit ratings for corporate borrowers are hard to find in emerging economies, partly due to the high number of small and medium enterprises and partly due to low level of development of capital markets (Powell 2002). Although credit bureaus can fill this gap determining ratings based on local portfolio risk, however, they are also underdeveloped in developing countries. In Argentina, where although 80,000 corporate borrowers are listed with the credit bureau, there only exist ratings for 150 of them (Powell 2002). Therefore, in developing countries, the value and quality of ratings would be suspect. Developing internal ratings based on the Basel proposals require sophisticated modeling of risk, that banks in developing countries may lack the expertise for (Chami, Khan, Sharma 2003)²⁶.

It is questionable whether banks in developing countries can achieve economies of scale required for investment in risk-management systems, especially since these resources may be better diverted towards more fundamental shortcomings (Vosen 2003). Internal risk based ratings may place smaller banks (lacking necessary technical expertise) at a disadvantage relative to larger banks with greater resources at hand, which this could drive out smaller banks and lead to a consolidation in the industry (Chami, Khan and Sharma 2003).

As banks are the most important source of finance in developing countries, correct rules on capital requirements and supervision can have large macro-economic effects. For instance, an effect of Basel 1 was pro-cyclicality of bank capital, with bank capital reacting to business cycles. Therefore, they would be a credit crunch during periods of recession and increased lending during booms. For instance, banks may be unable to extend loans, if they cannot maintain the minimum percent of risk-based capital²⁷. Concerns have been expressed that this effect will be even more pronounced for emerging countries (Ferri and Kang, 1999; Chiuri, Ferri and Majnoni, 2002)²⁸. The Basel II framework, further reinforces the relationship between bank lending and capital and can deepen effect of a balance sheet shock. A study finds procyclicality to increase only if banks using internal based ratings which are affected by the point of business cycle, as opposed to external ratings which are relatively stable (Catarineu-Rabell, Jackson and Tsomocos 2003). Furthermore, they find banks will not select the stable ratings mechanism. Since most developing

²⁵ The biggest argument against this is the poor predictive value of such ratings, which also could not foresee the Asian currency crises before they occurred (Karacadag and Taylor 2000).

²⁶ Due to this shortcoming it is claimed that developing countries will continue to use standardized approach relying on external ratings (Karacadag and Taylor 2000).

²⁷ Although they may be less capital constrained if they hold more capital, Greenbaum and Thakor (1995) and Chami and Cosimano (2002) point out that capital is costly and banks will be unwilling to hold more capital than is necessary.

²⁸ Chiuri, Ferri and Majnoni (2002) show that new capital adequacy ratios have contributed to reduction in credit extension by banks in developing countries.

countries are bank-based, recovery from a downturn will take much longer. This result has strong policy implications and has been factored in the Basel committees proposals in October 2002.

The new Basel recommendations largely depend on strong supervision. It will require developing countries to significantly improve regulatory skills and quality of supervisory staff (Karacadag and Taylor 2000). Developing countries do not have sufficient experts and certified regulators to examine banks' risk management. Hence any role of Basel framework depends on political will and incentives of the supervisors.

However in developing countries, which are fraught with cases of corruption and fraud, placing excessive reliance on supervisors may not be the most effective approach. The Basel standards attempt to force a convergence to developed countries norms. Developing countries many need to develop an approach based on features of their institutional environment and financial markets. Supervisors may not be independent and complexities in finance make it difficult to them to examine capital adequacy at banks. A solution to the limited time available with supervisors to devote to monitoring institutions, is ceding greater control to markets, which the Basel framework also recommends (Chami, Khan and Sharma 2003). Complete transparency and disclosure of information by financial intermediaries that overcomes information asymmetries is essential and can reduce social cost of supervising banks (Martinez Peria and Schmukler, 2001). Possible monitors in the private sector include owners, board of director, rating agencies and the market. The banking industry in emerging economies is highly concentrated and there is a lack of credit rating agencies, which limits the role of the above two players. Credit rating agencies have already been proposed under the Basel Framework. They may not release enough information on borrowers for fear of losing future business. Market-based ratings may not accurately predict emerging market risk. This is evident from weak performance of rating agencies in the United States on emerging economies (World Bank 2001). Therefore, market disciplining becomes essential.

A proposal to instill market disciplining involves the use of subordinated debt i.e. to create a class of investors whose incentives to monitor will be aligned with regulators and deposit protection firms (see Calomiris 1999, Evanoff and Wall 2001 for details). It also aims to increase transparency of bank operations, as banks are forced to issue debt in the market which reveals information about them to the market and supervisors. If debt is traded in a public market, secondary market prices reveal further information on risk of banks. Use of subordinated debt is surprisingly common, with 92 of 106 countries in a World Bank survey, used it to meet some of their capital requirements (World Bank 2001). However, it is difficult to ensure that the debt issuers have an arm-length relationship with the debt holders. It is also argued that in developing

countries where both equity and bond markets are narrow and with low turnover, any disciplining through the market is unlikely to be effective.

Example: Argentina – Subordinated Debt (Calomiris and Powell 2001, World Bank 2001)

In Argentina banks are required to issue subordinated debt for 2% of their deposits every year. There are several ways to comply with these requirements, including issuing a bond or receiving a loan from either foreign or local investors that satisfy specific requirements on credit rating. Initial experiments in Argentina have been successful, where after introduction of subordinated debt in 1998, complying banks paid lower deposit rates, had faster growth in deposits, lower capital ratio and lower non-performing loans. Study by Calomiris and Powell (2001) find that banks which achieved highest degree of compliance were relatively strong in terms of deposit growth. Banks that failed to comply were penalized by being forced to increase capital and liquidity. These penalties were so high that they reduced the gains from non-compliance. The authors conclude that subordinated debt led to better monitoring and risk management in Argentina.

Developing countries lack the strength of political will which is necessary in order to confront banking problems and deal with any negative effects that regulation and adoption of Basel II may bring. However, adoption of Basel standards is insufficient, especially since they fail to consider institutional weaknesses in developing countries, when they emphasize role of internal ratings and supervision. Supervisors are unlikely to be completely independent, where banking sector is highlight concentrated and owned by powerful business elements. Furthermore, capital adequacy rules may create greater pro-cyclicality – and delay recovering in developing countries which are mostly bank based.

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III-2. Regulation of NBFIs

2. a Policy Points

- Allow NBFIs to take deposits so they are not constrained by internal funds.
- However deposit taking NBFIs should then be regulated like banks.
- Non-deposit taking institutions
 - Entry requirements and licensing rules
 - Disclosure requirements
 - Official Supervision
 - Deposit taking institutions (must be regulated to the point where their likelihood of failing is very small).
 - Licensing requirements
 - Capital adequacy for credit risk and market risk
 - Loan provisioning guidelines
 - Operation risk guidelines
 - There is still a need to regulate for systemic risks, that can be done by having a surveillance or supervision of the whole industry. Similar to the banking industry, this can then serve as an early warning system of abuse of incentives and the need to take remedial action.
- Reforming Taxation of NBFIs: Reviewing complicated tax structures and removing unfair tax schemes which do not impose similar taxes on banks and other financial intermediaries. Harmonization of taxation.

2. b Role of Factoring and Leasing in Access to Finance

This section reviews non-deposit taking NBFIs such as leasing companies or factoring companies. The importance of financial institutions other than banks is generally blurred, especially due to highly skewed proportion of bank assets in financial sector of most countries. The costs of entry for NBFIs such as factoring and finance companies are typically lower (as they are better equipped to deal with high operating costs of small customers) than the banking sector. Their activities are especially significant in improving access to finance for smaller borrowers,

especially in countries where presence of weak bankruptcy and collateral laws reduces incentives to engage in straightforward credit that may have higher associated risk. For instance, factoring is particularly appealing in middle-income countries, where it is more difficult for firms to raise working capital. In middle-income countries, large information asymmetries between borrowers and lenders make it difficult and costly for firms to receive financing. In addition, many developing countries have weak bankruptcy and secured transaction laws which prohibits the use of collateral. Consequently, in general, firms receive financing contingent on their future expected cash flows. However, account receivables (AR) can be defined as expected cash flows to the firms independent of the firms' business risks. This suggests that an additional incentive exists for firms in high-risk countries to sell their AR from high-quality customers, both domestically and internationally, as a source of short-term financing. by securing repayments against accounts receivables or using self-executable legal instruments.

Similarly, the primary role of a strong leasing market is also in financing capital investment for small and medium enterprises and can be important in countries where collateral laws are weak. Leasing companies also contribute in financing start-up firms that would find it difficult to raise funds from banks. In many cases, tax-benefits from leasing, for start-up firms also exist. Strong lease markets also help broaden financial markets. In early stages, they generally raise finances from wholesale markets such as banks, insurance companies and pension funds. However, as they develop, they expand to issuing commercial paper and to securitizing lease receivables which also assists in deepening the securities market (Carmichael and Pomerleano 2002).

Factoring differs from bank credit operations, as purchase of receivables is on a non-recourse basis and does not involve pledging of collateral. Thus, factoring operations require a more detailed credit evaluation and acquaintance with the clients businesses. Factoring companies are generally non-deposit taking institutions and cannot take deposits or issue bills of exchange. These differences with financial intermediaries means there are several benefits of borrowing from factoring companies. Funding does not depend on the sellers creditworthiness, so exposure of credit provider is limited. Consequently, companies in legal difficulties can borrow from factors because factoring depends on creditworthiness of their customers. Although factoring has higher implied interest rates, they can be explained by the nature of service provided which requires greater scrutiny and the limited sources of finance available. A survey based empirical study finds factoring levels are significantly higher in countries with greater total bank credit (as a percentage of GDP), even though real interest rates are insignificant (Klapper 2000). This suggests that factoring is not a substitute for bank lending but is determined instead by the

demands of businesses for a service that banks cannot provide. In addition, factoring levels are significantly higher in countries with higher country sovereign debt ratings, a large manufacturing sector and high percentage of exports. Another obstacle to development of factoring industry is that factoring companies are not allowed to hold reserves in foreign currency accounts, for example in Brazil (see example). This subjects them to exchange rate risk, making it difficult to serve exporting firms without introducing commercial banks. Italy and United Kingdom have used factoring to finance SMEs involved in exporting. Amongst Latin American countries, Mexico has also begun to engage in international factoring (Kumar 2003).

Ultimately, however, the presence of an efficient legal system may prove to be the single most important factor fostering the growth of factoring. Factoring, as it is becoming clear, can only thrive in conjunction with a conducive legal framework and judicial support (Klapper 2000).

2-c Regulation of NBFIs²⁹ -

When considering regulation of specialized non-banking financial institutions which undertake leasing and factoring, we need to determine the extent to which these institutions involve market failure associated with asymmetric information. There does not seem to exist a potential for market failure of this type, unless these institutions take deposits. Therefore, the important distinction is whether it is a deposit-taking institution or not. When institutions take deposits from the public, chances of asymmetric market failure are greatly increased. If these deposits are either explicitly or implicitly guaranteed the risks become higher, necessitating the need for prudential regulation similar to standards imposed on banks.

In the case of non-deposit taking factors or leasing companies, regulations can be lax. These institutions typically raise funds from wholesale rather than retail markets. As a result, their corporate structures are less complicated than that of banks and insurance companies. Furthermore, the social costs of their failure are low, as the cost is localized to immediate debt and equity holders. However minimizing prudential regulation for non-deposit taking NBFIs does not imply that they should not be regulated at all. There is a need for strong competition regulation to ensure cost efficiencies are passed on to customers. Furthermore, oversight may be necessary in countries with weak legal enforcement and prevalence of illicit activities (see example on factoring in Brazil). Thus there is a strong need for effective disclosure requirements to meet concerns of market participants. This will include reporting requirements, inspection or audits to ensure that incentives are not abused. Given good competition and disclosure rules, the

²⁹ This closely follows Carmichael and Pomerleano (2002).

likelihood of systemic threat is low. However, this does not imply that these institutions are low risk. For instance, leasing companies can have exposure to a small number of industries, which can expose them to swings in performance of these industries (Charmichael and Pomerleano 2002).

Example: Brazil – Factoring (Kumar 2003)

The factoring industry in Brazil is relatively large and is an important source of finance for firms. In 2001, there were an estimated 720 factoring companies, providing services to more than 65,000 small and medium enterprises. These enterprises received 6% of their financing (US \$ 10 billion) from factoring companies, an increase of 50% since 1998. However, compared to other countries, the size of factoring firms is small. For example, the United States has less than 300 entities, but a portfolio that is 10 times as large as in Brazil. One of the factors explaining the small size of the firms is the prevailing Usury law in Brazil, which caps interest rates at 12%. The high implicit interest rate charged by factoring firms has meant that the industry has suffered from disputes on charging of usurious interest rates. The spread between the purchase factor, which is the price paid for sale of credit right, and bank discount rate has declined over the years, however its level is still high by most standards. In February 2003, it was almost twice the inter-bank lending rate. Most financial intermediaries have been able to receive exemption from the Usury law, but since factoring is considered a commercial activity it is not considered as part of other providers of finance. Another obstacle to the factoring industry is the prohibition on holding foreign currency accounts. This isolates the exporting firms, which must deal with commercial banks to reduce their risks.

Most financing takes place on a non-recourse basis, which places all the risk with the factoring company. In order to alleviate exposure of factoring companies, there is a need for recourse financing, the latter has not been recognized in the jurisprudence. The legal framework does not clearly separate recourse and non-recourse activities. Also in general the legal framework is fragmented. A draft law has been approved by a commission of the Senate in 2002, but amendments are still under discussion. Most importantly, there is not supervisory structure that provides oversight. The only self-regulatory framework is that Code of Ethics of ANFAC (Brazilian Factoring Organization). The negative public image of factoring due to claims of usury and illegal activity also suggests the need for closer scrutiny of these entities. Although supervision undertaken by the Central Bank may not be the most appropriate solution. Many

factoring companies have sought to overcome the low public image by transforming into microfinance institutions, signaling their regulated nature.

Example: Turkey – Factoring (Ekmekcioglu 2003)

The first factoring operation within a bank in Turkey was launched in 1988, when the FCI also initiated factoring. 2 years later the first factoring company was established (1990). However the first form of regulation of factor industry came about in 1994, when rules on establishment and operation of factoring companies were legislated. Since then, there has been tremendous growth in the market, about 27% in 2002. Export factoring has also witnessed considerable growth in volumes and in 2002, Turkey was the 2nd largest export factor amongst FCI countries. International factoring is also 27% of total factoring volume. Despite these achievements there is a need for a new law on factoring. A number of legislative problems pose a hurdle for factoring companies and create unfair competition for them from the banking sector Firstly, the existing operations are carried out under decree 545, related to borrowing money transactions. Since it also concerns money lenders, factoring arrangements for accounts receivables that are sourced from invoiced sales are misrepresented as borrowing transactions, which creates a negative image of factoring. The improper definition of factoring precludes other functions that it performs, for example: receivables management, protection against credit risk and debt collection.. Secondly, there does not exist any legislation that protects factors against delayed payment or default, which raises the risks faced by the sector. Conversely, banks offering factoring under the banking law can make provisions and deduct them from taxable income. Thirdly, another problem involves unfair taxation of factors that depend on external sources of funds. In Turkey factoring firms can either depend on internal funds or use loans obtained from domestic and foreign banks. These loans are subject to a 5% banking and insurance transaction tax (BITT) and 5% BITT applies when these sourced funds are used by the clients. However, only a 1% tax is imposed on banks undertaking factoring transactions. This creates unfair competition and also raises cost of financing for factoring companies. The higher financing costs for factors ultimately translates into a higher cost for SMEs. The firms are also unable to tap into interbank funding systems within the existing legal framework. Fourthly, although credit insurance has been introduced, it does not cover factoring companies. This prevents them from carrying out guaranteed domestic factoring transactions. Finally, only banks are able to benefit from credit risk evaluation and credit information services as the law is only applicable to banks.

Example: Brazil – Leasing (Kumar 2003)

There are 65 leasing companies in Brazil, extending nearly US\$ 5 billion of funds in 2000. This represents 3% of domestic enterprise financing. The leasing industry is sizeable compared to other countries. In terms of assets, vehicle leasing is 57.5% of total leasing, although its use has been declining in the last decade. By February 2003, machines represent 25.5%, technology and equipment 12.3% and other assets 4.7%. The growth of the leasing industry has been volatile. Regulatory arbitrage in the tax system has played an important role in spurring development of the industry, especially in consumer vehicle leasing in the late 1990s. However, further changes in the tax regime, along with the effect of devaluation on dollar indexed loans has lead to a contraction in leasing activity.

Leasing operation provides a tax shield for enterprises because payments are treated as expenses and may be deducted from taxable income. Individuals cannot deduct lease payments as operational expenses. In Brazil, leasing activity is subject to numerous taxes including service tax (ISS). ISS is collected in the location where the service is provided. This poses difficulties of collection due to variation in ISS rates in different locations and for different economic activities. They range for 0.25 to 5 %. Other taxes include federal profit and contribution tax (CSSL), social security tax (COFINS) and the PIS. The tax regime for leasing is complicated due to treatment of residual value. If residual value is low, leases are sometimes treated as loans. The industry is seeking to clarify this distinction. Leasing also has an accounting advantage in Brazil as it does not increase a firm's indebtedness ratio. Most operational leases are recorded as capital leases, which allows capital acquisition without increasing indebtedness ratio.

The Conselho Monetario Nacional is empowered to regulate and supervise commercial leasing activity. Nevertheless leasing regulation is scattered and a new dedicated leasing law is under preparation. Presently the leasing industry is subject to supervision from the Central Bank. Lessors must be leasing companies organized as corporations or banks authorized to operate a leasing portfolio. Prudential regulations limited exposure to a specific client to 25% were in place until recently. These significantly impeded the commercial flexibility of the industry, especially if the client was the government. However recent modifications to this rule have eased these concerns.

Taxation of NBFIs differs from framework of banks in some respects. In some countries (for instance **Brazil**) factors do not pay interest as there are restrictions on access to funds from outside sources. Therefore, interest expense cannot be deducted from income, resulting in a higher tax burden. In countries where factoring firms can employ external finance, inconsistent taxation schemes across banks and factors has stunted growth of factoring companies (see **example Turkey**). In the case of leasing industry, leasing firms have had to pay value-added tax, although banks and other financial institutions are exempt from these taxes (see **example Mauritius**). Due to these tax distortions many leasing companies are forced to take on deposits instead of turning towards the debt market. In Brazil, a complicated structure of taxation on factoring companies exists, wherein nearly 25% of the purchase factor is due to taxes (Kumar 2003). A simplification of tax treatment is important to reduce factoring costs. These challenges highlight the need to review tax structures for both leasing and factoring companies.

Example: Mauritius (FSAP 2002)

Distortionary tax policies in Mauritius have contributed to diminished growth in commercial leasing industry. Low rates of income tax, along with generous tax incentive schemes have resulted in heavy government reliance on other revenue schemes such as transfer taxes. Transfer taxes of about 20% on sale of unlisted shares and property and value-added taxation scheme has precluded development of leasing. A preferential rate of corporate income tax is also given to deposit-taking leasing companies, which creates an inequality of treatment among deposit taking institutions.

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III-3 Well Regulated Capital Markets

3-a Equity Markets

3. a-i Policy Points:

- **Effective disclosure** comes first: other rules on listing requirements and insider trading become unimportant if effective disclosure is enforced.
- A strong regulatory framework must be supported by **well-resourced regulators** who are independent and have strong incentives to check violations (see example of Poland).
- **Enforcement and prosecution**
- **Educate market participants:** in cases where there is not strong enforcement, market players can play an important role in disciplining.

3. a-ii Overview

Well-functioning equity markets can reduce the costs of capital by providing a competitive environment for banks and increasing the number of market participants to include retail, institutional, and foreign investors. Policymakers have recognized that simply establishing an organization that allows formal trading of shares is not enough. In order for a market to function efficiently and attract investor interest, there needs to be effective enforcement of rules that regulate transparency and disclosure. Equity market regulation is justified as a tool to guarantee investors a level-playing field (Levitt 1998). A cross-sectional study on effect of securities market regulation and cost of capital, finds stricter regulation (in the form of high disclosure requirements set by the exchange or government) and strong enforcement is associated with lower cost of capital (Hail and Luez 2003).³⁰ Firms in corrupt countries are also found to trade at lower multiples (Lee and Ng 2002.) and disclosure requirements by stock exchanges increase liquidity (Frost et. al. 2001). Similarly, another study shows that different regulatory approaches taken by Poland and Czech Republic, strongly affected development of the local stock market (Glaesser, Johnson and Shleifer 2001). The Czech Republic which had a more hands-off approach to regulation of the capital markets, was associated with an inactive equity market, while Poland which had more strict enforcement of regulation and disclosure, witnessed strong growth in its capital market (see example). The Polish example is a case of beneficial regulation, where regulators enforced credible and effective disclosure. Another difference between these two countries exists in regulation of intermediaries, an idea credited to Landis (1938). The idea is

³⁰ The authors also find, that as capital markets become more integrated, these effects become smaller.

that instead of regulating individual market participants and ensuring compliance with rules for listed firms, intermediaries such as brokers, accounting firms, investment advisors should be regulated. The regulatory body can then monitor activities of these intermediaries and by having power to issue and revoke their licenses can monitor market participants. By delegating responsibility of enforcement of disclosure to these intermediaries, regulators can also reduce their cost of enforcement (Glaesser, Johnson and Shleifer 2001).

3. a-iii Rules and Institutions that Support Strong Equity Markets

In order to ensure fairness in the market, regulators must enforce the responsibilities of issuers to provide timely and accurate information on the company or shareholders that can impact investor decisions. Although it is not possible to provide perfect information to investors, the objective of securities regulation is to provide enough information for buyers and sellers to make an informed trading decision. Other regulatory rules, such as on listing requirements, insider trading and, more recently, mandatory corporate governance ratings, assume only a secondary importance to effective disclosure. For example, mandatory disclosure of board voting records, insider transactions, etc. can support fair trading. In the pursuit of fully informed market participants, Australia has pioneered the concept of continuous disclosure (see example: Australia). Other smaller countries such as Bangladesh, Jordan and Kenya have also followed suit, although enforcement of continuous disclosure rules in these countries is suspect.

An issue related to security regulation is the division of responsibility across exchange and government authorities. No uniform practices emerge across countries, in this regard. For example, the Financial Services Authority (FSA) deals with listing requirements to ensure consistency across the exchanges in London. However, in Australia and Toronto, each exchange has its own listing rules. These along with numerous other gaps and differences in regulation across countries have been a stumbling block for proposals on cross-border trading. The merger of Australian and New Zealand Stock Exchange and the proposals for a global equity market with 24 hour trading amongst 10 participating exchanges also collapsed due to non-uniform laws across countries (see example: Cross-border Trading and Regulation)

Example: Australia (ASX 2002)

The continuous disclosure regime, introduced in 1994, requires all companies to report any price sensitive information immediately to the Australian Stock Exchange Limited (ASX). This policy means that the market is informed at all times and investors are not disadvantaged by lack of

access to important information. The parties subject to the disclosure requirements are listed entities, if it has raised funds pursuant to a prospectus, if it has offered securities as consideration for shares in a company that is a takeover target or if the securities are issued under a compromise arrangement. Extensive monitoring of the market through a Companies Division and Surveillance Division in the ASX is carried out to ensure that entities are complying with the regulation. The ASX Companies Division, reviews all major national and regional newspapers before open of trading everyday to identify any items that may not have been reported but fall under the ASX listing rule. Over the period of July and December 2001, these bodies identified 220 such reporting failures and raised queries. As a result 101 companies made announcements following the query, while 10 companies which were not in a position to make an announcement immediately were forced to halt trading. Similarly, the divisions also review financial announcements to determine if they are consistent with the company's own forecasts and also raise queries on unexplained price or volume movements. In 2001, 269 such unexplained cases were referred to a Companies Advisor, which resulted in 191 announcements made to the market. The actions by the ASX have served to strengthen the credibility of oversight performed by it.

As a market operator the ASX has limited powers of sanction, therefore deterrence becomes important. If there is a breach of the listing rules and the market is trading on an uninformed basis, then ASX will suspend the particular securities from trading, until corrective action is taken and disclosure is made. In cases where there is a serious breach, the ASX can refer the matter to Australian Securities and Investment Commission (ASIC) that can also take up legal action. ASX made 14 referrals in the quarter ended September 2003 and 58 in the year ended June 2003.

Example: Czech Republic and Poland (Glaesser, Johnson and Shleifer 2001)

There existed significant differences in strength and independence of regulatory institutions and disclosure requirements, between Czech Republic and Poland, which effectively translated into a fast growing and liquid Polish equity market, as compared to the defunct Czech market, during the 1990s. The Polish supervisory authority was placed under aegis of the independent Securities Commission, while in Czech Republic it was under the Capital Markets Supervisors Office of the Ministry of Finance. The independence of the Polish Securities Commission created stronger incentives for it to detect violations compared to the Ministry of Finance, which had a more broader agenda. Poland also imposed stronger regulations on intermediaries. For example brokers in were required to engage in honest trading, while there

were not such strict licensing for brokers in Czech Republic. The Polish law also regulated trading on exchanges to ensure transparency. In area of disclosure, Polish law also required a prospectus and permission of regulator, to issue securities, while there is no such rule in the Czech law. In addition, periodic reporting is on a monthly, quarterly, semiannual and annual basis in Poland, while under Czech law only annual results are required. Apart from disclosure of financial results, disclosure of ownership information was also more stringent in Polish law. In addition, there were also strict regulations on custodian banks in Polish Law, which can be important to check tunneling. Finally, the Polish law gave greater power to securities market regulator to discipline intermediaries without recourse to the judicial system.

The weak securities law in Czech republic assisted tunneling and widespread financial scandals. In Poland, the financial scandals were more muted and in many cases were referred to the appropriate disciplining body. The regulatory authorities also had the power and resources to punish violations. For example there was evidence that the sale of Bank Slaski in 1994, was manipulated by its brokerage arm, and insiders were allocated shares in the privatization. The regulators quickly responded to this by revoking the license of the brokerage. A comparison of the stock markets of these two countries also supports the above claims. In 1998, the valuation of the Warsaw Stock Exchange was seven times that of the Czech market. By 1998, the market capitalization of the Polish market rose to 14.1 % of GDP, although the Czech market's capitalization remained higher at 24.2%. However, by 1998, more of the listed Czech firms had either delisted or transferred to another exchange. The number of listed Polish firms however, increased rapidly in this period. Furthermore, the IFC Investible Index, also included 34 Polish stocks in 1998 as 'investible', while only 13 Czech stocks were included. Another more significant measure of the Polish market is the ability of firms to raise finance. Although no new or existing Czech companies raised equity finance on the exchange, over \$1 billion was raised in the Warsaw exchange (1998).

3. b Bond Markets

3. b-i Importance of Well-Functioning Bond Markets

Most emerging countries have underdeveloped bond markets, compared to banks and equity markets. However, debt market development has become an important policy agenda for many countries, especially after the East Asian Financial crisis. Bond markets can be an alternative source of finance to supplement other forms of debt finance and can also provide a clear measure of opportunity cost of funds. They may also eliminate negative effects of a bank-

credit crunch. If firms are over-reliant on bank lending, they can be greatly constrained in case of a bank failure (Herring and Chaturispitak 2001). It is also argued that debt market development can hasten resolution of a banking crisis, by allowing banks to recapitalize balance sheet through loan securitization i.e. issuing bonds backed by non-performing loans.³¹ Well-functioning bond markets can influence investment decisions of firms, which in the absence of long-term debt, will prefer to invest in short-term assets.³²

From the perspective of savers, the lack of a bond market can reduce the possible array of saving opportunities. For instance, contractual savings institutions, will be unable to match maturity of their liabilities with long-term assets, in the absence of the bond market. This will also raise cost of insurance provided (Herring and Chaturispitak 2001). Bond markets can also influence functioning of banks. Lack of competition for the banking sector (in the absence of bond markets) will result in a higher cost of capital and larger interest spreads. Presence of a well-functioning debt market will allow banks to issue bonds which will reduce its market and liquidity risk. Also, in the case of concentration of credit risk, banks will be unable to securitize loans and if there is a liquidity shock, they will have to accept losses on sales (Herring and Chaturispitak 2001). Lastly, bond markets can serve as active monitors of banks and perform a market discipline. This may reduce the pressure for active supervision to assess risk-taking.

The development of an efficient bond market depends on several macroeconomic factors such as stable and low interest rates that would encourage investment in fixed income securities and rising economic activity that ensures an adequate amount of funds in the economy. In addition, microstructure issues can compound problems. For example in South Asia, the common constraints include high issuance costs, cumbersome approval processes and requirements of stamp duties (Harwood 2001). There is also a need for government commitment to build the market, by coordinating efforts between other major market players and outside regulators. For instance, the government in Korea and Malaysia, made development of the bond market a priority and undertook appropriate steps (Harwood 2001). This includes developing regulation and implementing supervision of the market infrastructure and market participants; for instance, enforcing mandatory disclosure requirements.

The government can also support bond market development through improvements in the “enabling environment”. An enabling environment consists in part of macroeconomic factors, tax policies that do not hurt bond market and legal framework such as bankruptcy codes. An

³¹ Emerging Markets Committee, IOSCO (2002).

³² This is based on the argument by Hart and Moore (1995) and Caprio and Demirguc-Kunt (1997) that firms tend to match their assets and liabilities.

important factor that influences investment by foreign investors is the security and availability of invested assets. Recognition of sub-custodians so they can represent the interest of final owners is a key factor. Uncertainty over registration of ownership or lack of a process for control of assets can effectively bar a country from investor interest. Authorities must also avoid erratic rule changes that can significantly deter market participants (Ladekarl and Zervos 2003). Similarly, a study on investment allocations of U.S. mutual funds in emerging market equities also supports the need for strong institutional and legal environment (Agarwal, Klapper and Wysocki 2003). The authors finds countries with good investor protection and strong legal rules (along with other macroeconomic and firm-level factors) significantly influence investments of mutual funds.

3. b-ii Private Placements

Many countries have underdeveloped corporate debt markets because few firms are sufficiently large and creditworthy to issue traded securities. In addition, some countries that are in early stages of developing their bond markets suffer from regulatory burdens. For example, India and SriLanka, which have both made significant efforts to build its debt market but high issuance costs, long approval processes and presence of stamp duties continue to constrain the issuers. However, private placements should require a less difficult disclosure process³³. Rather than regulate the private placement market, many countries limit market participation to Qualified Institutional Buyers (QIBs), which are considered “savvy” investors able to self-monitor the market. The lower issuances cost can attract more participants who can issue privately placements as an intermediate step in countries where bond markets are not well developed.

3. c Role of IOSCO

Enforced market regulations are intended to bring confidence to the market, and is important for growth and development of securities markets. IOSCO’s principles on security regulation serve to set an international benchmark to measure a country’s practices in regulation and supervision of securities market. The IOSCO principles are widely used by the IMF, World Bank and other international agencies to assess status of a country’s securities market. The IOSCO principles on security regulation are based on three objectives: to enforce investor protection, ensure market efficiency and transparency and reduce systemic risk.³⁴

In addition to developing high standards for regulation, IOSCO also serves to provide an exchange of experiences to promote development of domestic markets. In addition, these

³³ *Whole-sale investors in India has expressed the need for limited regulation of private placements market.*

³⁴ IOSCO Objectives and Principles of Securities Regulation (2002).

internationally recognized principles are a step towards convergence of regulations across countries, as emerging markets have also indicated the desire to be measured by the same standards as developed countries. The convergence in security regulation is clearly towards stricter rules and harmonization, although there continues to exist differences across countries (see example Czech Republic and Poland). For example, in the case of insider dealing, most countries mandate an explicit rule that curbs insider trading activity. However, the convergence and standardization of regulations across countries may lead to greater cooperation and mergers among regional and international exchanges (see example: Cross-Border Trading and Regulation).

Example: Cross-Border Trading and Regulation

The merger of New Zealand Stock Exchange and Australian Stock Exchange (ASX) was announced in October 2000 with ASX rules to prevail. However, negotiations collapsed fairly quickly in February 2001. The stumbling block was differences in regulation between the two countries, with much stricter regulations in Australia. New Zealand has fairly weak securities market regulation, particularly areas of insider trading and disclosure, while in Australia insider trading is considered a criminal offence and continuous disclosure requirements are enforcements. The ASX authorities were unwilling to relax their strict requirements, laying the entire onus on New Zealand to raise the bar higher. These regulatory gaps eventually led to collapse of the proposal. However, presently discussions are continuing on an informal basis, and New Zealand seems to be moving towards the Australian business law in areas related to electronic transactions and competition law. It also introduced a new takeover code in July 2001 (New Zealand Ministry of Foreign Affairs and Trade 2003). This year it also announced changes to its insider trading regime. The government has also agreed to institute a continuous disclosure system, bringing it closer to Australian laws on insider trading. Therefore, the trend is again towards greater regulation.

Another similar collapse of a scheme was the New York Stock Exchange (NYSE) proposal to creating a 24 hour trading global equity zone with the participating exchanges in each of the three main time zones: Australia, Hong Kong and Tokyo in Asia- Pacific; Sao Paulo, Mexico and Toronto in the Americas and Euronext the combined Amsterdam, Brussels and Paris exchanges. The proposed global equity market would link the exchanges and provide a global market structure based on transparency, disclosure, self-regulation and agency auction price discovery. Cost-effective post trading processing would be achieved through alliances with

clearing and settlement agencies of exchange in each of the countries (NYSE 2000). These proposals also fell because of regulatory gaps across countries and no country was prepared to lower regulation to allow cross-border trading. Questions related to exchange governance, listing rules and regulations and other uncharted territory must be adequately addressed if the global equity market is to become a reality.

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III-4 Regulation of Insurance and Pension Companies

4. a Policy Points

Pension Funds

- Regulations will mirror banking sector regulations, involve supervision, development of early warning systems, actuaries reports on exposure of funds, licensing requirements, capital requirements etc.
- Draconian rules i.e. quantitative rules in countries with an embryonic industry, low transparency of corporate information and low investor protection. For instance, portfolio restrictions, including exemptions of some high-risk assets classes.
- Eventual phasing and relaxation of rules / liberalization as capital markets mature and regulatory system develops– as was carried out in Chile. For instance, in terms of allowing investment in equities – as investment restrictions are relaxed, they will stimulate growth of affected asset classes
- Careful management of liquidity – pensions funds that trade heavily are likely to have high administrative costs, while funds that have a “buy and hold” strategy are likely to reduce liquidity in the market.
- Foreign investment should be introduced progressively and accompanied by reforms to strengthen the economy

Insurance Industry (based on IAIS guidelines)

- Although IAIS guidance on solvency is vague, there is a need to have well defined capital requirements based on riskiness of the company. Attempt has been made in developed countries like U.S., Canada and Norway to develop capital requirements based on a more comprehensive risk assessment.
- As there are limited investment opportunities in developing countries and inadequate disclosure, special focus must be given to assessment and management of risk. Asset valuation matching and diversification rules must be in place.
- Reinsurance has been used by emerging countries as a way to transfer cash abroad. Nevertheless domestic access to reinsurance should not be inhibited, but closely monitored.
- In early stages regulators should set premium rates and approve the type of insurance products that will be offered. These can later be relaxed.

- Need to separate insurance companies from other commercial and financial activities, life-insurance companies from non-life insurance companies etc. – stricter rule as compared to developed countries
- Need to control licensing and have strict capital requirements for licensing and operation.
- Supervisors should ensure transparency and disclosure of information – since there is widespread distrust between insurance companies and consumers. (Impavido 2001).

4. b Empirical Evidence on Pension Reform

Contractual savings represent a large share of financial assets in many countries. In 1996, many countries, which also included developing countries such as Chile and South Africa, held with more than 50% of the financial assets in form of contractual savings. They are also becoming important in Argentina and Mexico. Costs of public pension schemes have been rising in the face of population ageing. In countries like Poland and Italy, where fully funded public pension schemes exist, pension expenditures can reach 15 % and gross implicit pension debt can be almost 400 % of GDP (Impavido, Musalem and Vittas 2002). Since most alternatives such as encouraging labor migration or delaying retirement age, to avoid pressures of pension cost, are likely to be politically infeasible, there have been efforts to reform pension systems. Emerging trends in pension reform include, funding of current liabilities; private management of assets; defined contribution schemes and individual responsibility and choice (Impavido and Musalem 2000). However, any pension reform plan should be preconditioned by development of a sound regulatory and supervisory environment that ensures effective licensing requirements; investment of funds, timely payment of contributions and enforcement of contractual terms (Impavido, Musalem and Vittas 2002).

Pension reform and its effect on bank lending and other economy wide effects have been the subject of numerous debates (e.g. Holzmann 1997, Arrau and Schmidt-Hebbel 1993, Feldstein 1996, Mackenzie, Gerson and Cuevas 1997, Schmidt-Hebbel 1998). Pension reform is stipulated to have welfare effects by developing a channel for saving and increasing economic growth and productivity. It also creates macroeconomic stability by reducing political pressure that can threaten financial stability of pension funds. However, empirical evidence presents ambiguous and economically insignificant effect of pension reform on savings and economic growth (Coronado 1998; Morandé 1998; Hachette 1998). Consequently, the indirect impact on savings through capital market development becomes more important.

Contractual savings can be powerful instruments to increase supply of funds. Private pension funds or other contractual savings funds, which invest in long-term securities, including equities and bonds, can drive development of stock markets and bonds. They may have a positive impact on growth and welfare through an efficient allocation of funds. Development of pension funds can lead to a lower cost of capital because of pooling of financial savings (Iglesias 1998), and hence capital market development. For instance, pension funds may become large relative to domestic capital markets and may seek to invest abroad. Accumulation of funds may also spur development of new, particularly long-term financial instruments.³⁵ Such developments can lead capital market towards greater integration.³⁶

An empirical study for a set of 32 OECD and emerging economies, finds an increase in assets of contractual saving institutions increases depth of both stock and bond markets (Impavido, Musalem and Tressel 2002b). This effect is strongest when there is greater transparency of corporate information and the impact on equity markets is greatest when pension contributions are mandatory and international transactions in securities are lower. Another study by the same authors finds in bank-based systems, an increase in contractual savings is associated with higher leverage and longer maturity in corporate sector (Impavido, Musalem, Tressel 2001). The banking sector also becomes more resilient to credit and liquidity risk, in the face of contractual savings, supporting banking sector stability (Impavido, Musalem, Tressel 2002a). Contractual savings can act as a competitor of supplier of funds, increase efficiency of banking sector and lower cost of capital (Impavido, Musalem, Tressel 2002b). Closed-ended pension and life insurance, have long-term strategies, which banks can fund by placing long-term liabilities with these institutions, stimulating expansion of long-term lending (Impavido and Musalem 2000). Finally these funds have also been important in development of financial innovations such as asset-backed securities, and use of structured finance and derivative products (World Bank 2001).

The above empirical evidence points towards the necessity of good regulation of insurance and pension funds. Effective government intervention in this sphere may be more important than others, where it has usually be shunned. This is because private pension funds are largely dependent on government mandates of forced savings or tax advantages given by the government to encourage savings. If pension savings is made mandatory, government needs to

³⁵ Pension funds can also lead to development of other industries. For instance Bloomestein (1998) finds pension fund growth was associated with development of life and disability insurance industry in OECD.

³⁶ These impacts of pension reform on savings, capital markets and economic growth, however depend on a stable macroeconomic environment, adequate tax regimes, regulation of the banking sector and clear well defined property rights and bankruptcy laws.

define institutions that can qualify as pension funds and deal with licensing requirements and prudential regulation to ensure that it does not distort market incentives (World Bank 2001). Furthermore, the nature of regulations affect the success of contractual savings in promoting investment and development of equity markets. For instance pension reform that allows for investment in shares is likely to have a greater impact on stock market development while pension schemes where funds are restricted to holding only government bonds will be relatively benign.

4. c Regulation of Pension and Mutual Funds

When considering regulation of pension funds, necessary rules to be considered include authorization criteria, capital adequacy, asset segregation, use of custodial services actuarial reviews, information disclosure and external audits (Vittas 1998)³⁷. Essentially regulations will mirror regulations required for banking sector that ensure the industry is monitored by adequate auditing to protect it from looters. The need for experienced professionals to manage the pension funds and to maintain solvency reserve are important (Rocha, Hinz and Gutierrez 1999). Although there is a dispersion of practices of pension schemes, the main message for regulatory policies is the need to maintain quantitative rules in countries where the industry is developing, access to information is limited and regulatory capacity is weak. However, eventually restrictions on investment would need to be eliminated, as firms should be allowed to invest in securities other than government assets (World Bank 2001). Regulations can be distinguished on basis of extent of restrictions and quantitative rules – ‘relaxed’ or ‘draconian’³⁸. While countries with well-developed financial markets, investor protection and a tradition of pension funds should apply a more relaxed set of regulatory rules, developing countries with pension funds in their embryonic stage and nontransparent financial systems would perform well if they followed ‘draconian’ rules like Chile (see example)³⁹. Governments that have a compulsory pension fund scheme have a responsibility which justifies draconian rules on pension fund structure, performance and investment allocation (Srinivas et. al. 2000). However a phasing of these

³⁷ For example, external custody reduces the risk of asset managers absconding with pension fund assets and provides a safeguard (Vittas 1998).

³⁸ A relaxed regime would involve : voluntary participation; no special authorizations for participation institutions; ability to hold multiple accounts and operate multiple funds; apply prudent person rules without any investment limits, no restrictions on investment in foreign securities and no state guarantee against fraud or minimum profitability. A draconian regulatory approach would include: worker mandate; special authorizations; one account per worker; one fund per company; detailed rules on investments with maximum limits to prevent too much concentration of risk; restrictions on investment in overseas assets and state guarantees (Vittas 1998).

³⁹ Vittas (1998)

regulations is required, as they eventually result in too much caution and uniformity of asset allocation, do not offer workers a significant portfolio choice and do not provide an incentive to improve investment efficiency (e.g. Shah 1997, Srinivas et al. 2000). Liberalization of these systems is therefore the key consideration.

Mutual Funds: For their successful operation and development, mutual funds require a robust and effective regulatory framework. Beneficial regulation has been attributed as a key factor behind the strong growth of the US mutual fund industry (Reid 2000). As in all cases of agency contracts, investors need to be protected from fraudulent behavior on the part of mutual fund managers and the diversion of funds into projects or assets that benefit fund managers (agents) at the expense of fund investors (principals). Fund investors bear the investment risk, but they rely on the advertised investment strategies of mutual fund managers for making their selections. It is therefore essential that fund managers should abide by their advertised strategies and should not deviate from their declared objectives without proper prior authorization. Accounting and auditing rules as well as information disclosure and transparency requirements are of paramount importance (Klapper, Sulla and Vittas, forthcoming).

Example: Pension Funds in Mauritius – Weak Regulations (Vittas 2003)

Contractual savings account for 40 % of financial system assets in Mauritius. Pension funds are 75 % of all contractual savings and are an important player in the financial system. The pension funds invest in instruments such as government securities, corporate securities, bank deposits, housing loans and real-estate. Given their strong demand, it is expected that they will stimulate issue of long-term government securities and development of corporate debt and mortgage bond markets. The pension funding system comprises of unfounded civil service schemes, along with over a 1000 funded schemes that are administered by insurance companies or self-administered firms that are registered with Registrar of Associations. Asset allocation differs across contractual savings institutions, with public schemes investing in government securities and self-administered pension funds investing in corporate shares and foreign assets. The performance of occupational funds has been weak. Between 1997 and 2001, their costs rose from 3.8% to 5.86 % (operating expenses relative to contributions) compared to the NPF which had lower operating expenses. The investment performance of private pension funds was also weak. The stronger investment performance of NPF can be attributed to investment in government securities, while its operating performance is due to presence of economies of scale.

The weak regulatory and supervisory environment for private pension funds is also a likely factor.

The regulatory environment suffers from being fragmented amongst various laws. Although at present the performance of pension funds in Mauritius is fairly promising, they face serious challenges. A robust regulatory and supervisory environment can expand their functions to positively influence development of the financial sector. It does include positive elements such as minimum vesting and portability rules, it does not impose any limits on investment by pension funds. However, certain elements are missing from the regulatory rules. There are no limits to investment, which may be a positive departure from prevailing practices in the developing world. However, there are also no limits on investing in sponsoring employers, which can potentially place pension funds at a risk. Low limits on investment in sponsoring employers must be imposed. Regulations to ensure adequate asset diversification are also required to prevent concentration of risk. The biggest shortcoming is the lack of effective supervision. Proactive supervision also is needed, using off-site surveillance of quarterly financial statements to develop an early warning system. On-site surveillance of adequacy of internal control mechanism and risk management systems may also be necessary.

The pension funds and insurance companies have a huge demand for long-term assets. However, they are forced to engage in reverse maturity transformation, investing mostly in short-term and medium term assets. Their options in long-term securities include corporate equities, which are illiquid and volatile, real estate which performs well in long-term but is illiquid and produces low yields and housing loans, which generally perform well. However, other potentially more productive investments could include mortgage-backed securities and mortgage bonds, rather than engaging in loan origination of housing loans. Better regulation on investment behavior of pension funds, as well as creating greater awareness of these potentials to stimulate financial development and innovation of new services, can help create a liquid and efficient market for long-term securities.

Example: Pension Fund Reform in Chile (see for example Cefuentes et. al. (2002), Diamond (1994), Vittas and Iglesias (1992), Shah (1997), Srinivas et. al. (2000), Vittas (1998), Vittas (2003c),)

Chile remains the most successful example of a privatized pension system in developing countries. In 1980 a decree was passed to transfer from a state-sponsored pay-as-you-go, to an individually funded and privately managed system. These Chilean reforms and the success

associated with them, have become a blue-print for countries (in both Latin America and Eastern Europe) reforming their pension systems. The pension funds (Administradores de Pensiones – AFP) have grown steadily from 40% in 1985 to presently accounting for 55% of financial system assets (Cifuentes et. al. 2002, Vittas 2003c)

The pension regulations require an AFP to maintain one account and for workers to have only one account with an AFP. simplify the system and enforce greater transparency across funds.

⁴⁰ Account switching was highly prevalent in Chile (one in every two accounts) and grew faster when the process became less complicated after 1988. To contain this account switching across AFPs, authorities limited transfers to 3 per year. In 1997 a minimum stay requirement of 6 months was imposed.⁴¹

As part of regulation, no minimum requirements on investment limits are defined. This is a radical departure from directed credit schemes in the 1960s and 1970s. However, investments are nevertheless tightly controlled through maximum limits on different classes of instruments. However many of these rules have been relaxed as the industry has developed. Equity investments were initially not permitted, then a maximum limit of 30% of assets was operational between 1985-95 and after that the limit was relaxed to 37% in 1995 (**check what current limit is**).

These ‘draconian’ regulations have been severely criticized, with critics pointing out the high administrative costs, lack of portfolio choice and high number of switchers. However, these draconian measures have been justifiable in Chile, because of the compulsory nature of pension scheme; lack of transparency in financial markets; no history of pension funds; the need to safeguard covered workers and state guarantees to control moral hazard to protect against cases of asset managers absconding with workers saving. Over time as reform took root, the need for these regulations weakened and a more lax approach was adopted as is also evident from discussion on easing of investment controls. Addressing the criticisms cited above on the uniformity in investment and high administrative costs. The former was a result of minimum return requirements for AFPs which meant that AFPs chose very similar investments to avoid volatility of returns. This regulation when instituted was meant to prevent wide disparities in performance of pension funds that could have negative political implications. Although a sunset clause on its removal should have been included, due to its success policymakers have been afraid to remove it. The high administrative costs that were frequently cited as a failure of Chilean

⁴⁰ Although the one account per worker concentrate risk with a single pension fund company, it also reduces costs of verification of compliance, which are necessary in a worker mandate system.

⁴¹ Other administrative regulations included disclosure of accounting statements every 4 months, for workers to track their investments.

pension reform, have substantially declined in recent times. Shah (1997) argues that such regulations restrict competition amongst AFP's by encouraging investment in similar assets and raise marketing costs without raising quality of the product. However recent evidence suggests to the contrary. Vittas (2003c) finds AFP fees have reduced and marketing costs have fallen even further, resulting in significant profitability of the 7 AFPs that operate in the market. Account switching that was another problem in earlier periods has also declined from 1.5 million to 0.2 million a year.

The pension reforms have also significantly contributed to fiscal discipline, growth of equity and bond markets and creating equity in social security. The pension reforms greatly contributed development of bond markets, both by directly investing in bonds and through development of annuities that insurance companies sell. The size of traded volumes in 1990 were 10 times the amount of 1985 volumes. Insurance companies to comply with requirements on matching assets and liabilities have been a major source of demand for bonds. In an econometric study, pension fund reform was associated with reduced volatility in security prices, increased liquidity, lower transaction costs and integration of capital markets (Walker and Lefort 1999). In terms of effects on creation of new financial instruments, corporate bonds became relatively important in portfolios of pension funds during the early 1990s. Other new financial instruments whose natural client were pension funds included closed-ended mutual funds, zero-coupon bonds (Bonos de Reconocimiento), mortgage bonds for life insurance companies (Mutuous Hipotecarios).⁴² It has also propelled development of an insurance industry, which managed more than 10 billion dollars in 1998. Bank disintermediation has also occurred to some extent after pension reforms. Short-term bank financing remains important, and pension funds contributed 15.9% of total bank funding (Walker and Lefort 1999). Some of the negative developments recently have been, the decline in stock market transactions since 1996. Among other reasons, it is argued that concentration and over-regulation of pension funds may have slowed down innovation and resulted in rent-seeking behavior (Cifuentes et. al. 2002). However the removal of capital controls in 2001 and issuance of legislation on reform of capital markets, is expected to improve stock market liquidity. Fixed income transactions have begun to decline since 2000, although the corporate bond sector has seen a dramatic rise between 1999 and 2001. The decline in liquidity in public sector bonds, is also explained by concentration of pension funds industry.⁴³

⁴² These are only the instruments that have been successful. Real-estate corporations were created but they ended in 1995. Similarly commercial paper risk-rating procedures were developed in 1991, but they did not get any pension funds (Walker and Lefort 1999).

⁴³ The herfindahl index which measures concentration in market for pension funds shows a steady rise since 1995, tapering off by 1999 (Cifuentes et. al. 2002).

Since pension funds hold 70-75% of all long-term bonds, their concentration reduces transactions in the market.

These changing market conditions have induced changes in several areas. For instance, private issuers have shortened maturity length from 10 to 5 years, as a response to concentration in pension fund industry. The demand for these securities by banks, mutual funds and other retail investors has in turn increased. Despite some of these above mentioned slowdowns in the market, another important outcome of pension funds has been the increase in experience of dealer community. This has been significant for development of the corporate debt market. Regulations on investment risk has precluded investment by pension funds in risky bonds. Companies with high-risk profiles therefore, have been unable to benefit. As investment regulations favor public bonds.

4. d Insurance Companies

Insurance promotes financial stability amongst households and firms. It also supports economic growth through its capacity to mobilize savings from households and channel them to the corporate sector. Similar to pension funds a successful insurance industry hinges on strong legal rights, low inflation and presence of liquid investment markets. Insurance regulators rely on entry requirements; solvency rules, balance sheet restrictions; restrictions on associations with other financial institutions; accountability requirements and governance requirements (Charmichael and Pomerleano 2002). Development of insurance industry in many developing countries has been hindered due to excessive government regulations. Some of these repressive regulations have included state-owned firms that have monopoly power over the market and measures aimed at discouraging foreign entry (see example Mauritius and Africa). In other cases, governments have set premiums and controlled terms of insurance policies. Investments have also been highly regulated, usually requiring insurance companies to invest in low-yielding assets or in social projects. Macroeconomic instability and high inflation have also been limiting factors, specifically for long-term life insurance which depends on ability to increase real value of accumulated reserves. There is also a prevalence of widespread mistrust between insurance companies and customers. Insurance companies protect themselves from cases of fraud by limiting their liability in cases where material information is not provided at the time of purchase of a policy (Impavido 2001b).

International Association of Insurance Supervisors (IAIS) sets rules on good insurance regulation and encourages international cooperation amongst insurance regulators. Specific guidelines for emerging countries are also given: which include the need to essential legal infrastructure and strengthen underlying codes and corporate laws, create an insurance

supervisory authority, encourage self-regulation through industry codes, separate insurance companies from other financial activities and controlling licensing of insurance companies (Charmichael and Pomerleano 2002). More specifically, guidelines given by policymakers include that supervisory authorities like in the banking sector are required to ensure solvency of the companies in the industry and to ensure that insurers full their role of spreading risk. Supervisors should ensure greater exchange of information between consumers of insurance and insurance industry. In most countries, while insurance companies request considerable amount of information from the applicants, the consumers have very little information on practices of the companies. For effective supervision, liberal regulations must be in place that provide incentives for companies to innovate and operate efficiently. Insurance regulation should aim to create a competitive market that is open to entry of new firms and allows exit of insolvent firms (Impavido 2001).

Example: Mauritius Insurance Industry (Vittas 2003b)

The insurance industry in Mauritius is fairly well developed, well capitalized and with adequate reserves. It is highly concentrated, with the largest three groups controlling 76 % of total assets. Despite this high concentration, the industry is competitive and efficient. Medium sized firms are reasonably profitable, having large reserves and effective reinsurance arrangements. The regulation of the industry is undertaken by the Financial Services Commission (FSC). The prevalent regulatory framework comprises many positive features on solvency monitoring, asset diversification, international accounting standards and actuarial methods. However, there are important gaps in the legislated framework relating to solvency and risk management, which remains the main challenge for the industry. For example, solvency margins based on net premiums deviate from international standards. A solvency margin based on claims can help prevent companies which charge low premiums to operate with very low levels of capital. There are no solvency margins based on average claims, although it has been adopted all over the world.

Two proposals that seeks to address these gaps in supervision and regulation are currently under consideration. Detailed standards are developed in these frameworks dealing with capital adequacy and application of EU standards of solvency margins and introduction of risk-based capital requirements. By raising the minimum capital requirements and introducing risk-based capital requirements, consolidation and greater competition in the industry can be achieved. Regular actuaries reporting and early warning system can foster greater stability.

Furthermore, the supervisory environment is also weak. Before early 2001, no on-site supervisions had been carried out for a decade. For instance firms were operating with negative equity i.e. with large accumulated losses exceeding paid up capital, but no action was undertaken despite an auditors report. In another case, companies had extended large loans to directors exceeding the net worth. However, after the creation of the FSC, an efficient supervisory environment is being created. This is evident from the fact that companies in the examples cited above were forced to undertake action. Weaker companies have also been placed on watch lists, restructured by injection of capital, merged or liquidated. These are all positive signals of regulatory reform in Mauritius.

Example: Insurance Industry in Conférence Interafricaine des Marches d'Assurances” (CIMA) (Impavido 2001)

The CIMA region comprises of 14 countries, but since Republic of Comores has not ratified the treaty as yet, it is excluded from this discussion.⁴⁴ 98 companies are operating in this region and all are currently active. Licenses are withdrawn if a company is not active for a year. Life insurance companies represent 23% of total gross premium income, while non-life insurance the other 77%. The distribution of gross premium across countries is uneven, with only 4 countries having a share of gross premium income larger than 10% (Cote d'Ivoire 40%, Cameroon 16%, Gabon 13% and Senegal 12%). Most of these companies are financially weak, due to problems of inadequate coverage on liabilities and insolvency. Nevertheless, adequate reserve provisions have improved, as the coverage deficit declined to 0.2% in 1999 from much higher levels of 8% in 1998 and 14% in 1997. The capital based used in solvency margin was 270% of the minimum solvency margin. The number of firms that have either solvency problems or have a deficit in coverage of liabilities is very high, and 80% of all companies are under a 'plan de redressement'.

The preconditions defined earlier for effective supervision and growth of the private sector are not met in the CIMA region. The authorities work is undermined due to a heavy shortage of financial and human capital. The supervisors have only a handful of inspectors and 14 countries with almost 100 companies to monitor. There also exists a potential conflict of interest as CICA-Re is a member of the main supervisory body CRCA and also holds shares in many insurance companies. Financial reporting from companies to supervisory body is on an annual basis, which constraints carrying out effective off-site supervision. There is also

⁴⁴ These are: République de la Guinée Equatoriale, République du Bénin, République du Burkina Faso, République du Cameroun, République Centrafricaine, République Fédérale Islamique des Comores, République du Congo, République du Côte d'Ivoire, République du Gabon, République du Mali, République du Niger, République du Sénégal, République du Tchad, and République du Togo.

inadequate disclosure of information to consumer. There is no specific office dedicated to dealing with consumer complains, and as the insurance culture is not well developed in CIMA, this is a major obstacle to development of insurance industry. Investment diversification is not achieved due to lack of investment opportunities in the region. Foreign assets are not included to cover liabilities. There is no maturity-matching clause in the law, although on-site supervisions do give it important. Maturity-matching clause can be important in developing long-term financial instruments.

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III-5 Appropriate Regulation of Electronic Transactions

5. a Policy Points

5. b Overview

Electronic Finance (e-finance) refers to financial transactions that are undertaken over computer networks (i.e. virtually)⁴⁵. Recent years have witnessed a rapid growth in the use of e-finance all over the world, which is now changing the structure of financial services industry. E-finance highlights the need for government to reduce its intervention in the financial sector, because the private sector can provide services even when the financial sector is weak. The reasoning is as follows: there is a lower likelihood of market failure as information because newer technology will make information more easily available. More information will improve availability of financial services and make markets to trade risks and assets more complete, which would reduce need for government involvement. However, this does not imply the absence of regulations, for instance licensing rules will still be important in maintaining public confidence in the financial system. There is scope for the government to provide an enabling environment, in terms of improving privacy statutes or using existing post office networks for example, to provide access to e-finance services. Therefore, the role of government will change, as the need for direct provision in banking, non-banking financial services, trade finance, insurance and others will be reduced (Claessens, Glaessner and Klingebiel 2001).

5. c Regulation of E-Finance

Although there is little evidence that e-finance poses new risks, it may expand or modify existing risks associated with finance. The potential to increase risks comes from a number of elements that distinguish e-finance from conventional banking. The speed of transactions, reduce the time in which potential problems can develop and hence would require even greater monitoring. The virtual nature of transactions also complicates the traditional supervision and regulatory roles. The cross-border and industry transforming nature also raise further concerns (Sato 2001).

The four areas that are likely to be affected and require regulation are: a) prudential oversight by supervisors, b) risk management by e-finance service providers, c) market dynamics and, d) consumer protection. The virtual nature raises challenges for on-going supervision and makes a difference in ability to monitor activities. Institutions can also offer consumer products

⁴⁵ The following discussion draws upon Financial Stability Forum (2000)

over the internet without obtain requisite licensing. This also raises concerns of regulatory arbitrage and are addressed in the ISOCO and IAIS guidelines. Supervision is further complicated due to the question of whether it should be organized product-wise or institution-wise. Due to the cross-border nature of transactions it is also recommended that definition of home and host supervisors is clarified. Common standards must be developed and enforced across countries to prevent risks of regulatory arbitrage (Sato 2001).

The two key risks that may be accentuated are: operational and liquidity. Liquidity risk can be raised as consumers can quickly withdraw funds at the click of a button. A mass withdrawal, could trigger a virtual bank run in a short span of time. Therefore, enhanced monitoring of liquidity and changes in deposits and loans may be required. Online trading may also exacerbate market volatility, fragmentation and facilitate regulatory rule breaches. Finally, it raises a host of consumer protection issues, as security of data and potential of fraud are high in e-finance. In order to address these concerns, existing privacy laws must be modified. As sharing of information has eased due to technological improvements, but there is also a need to protect access to this information and prevent unfair advantage from sharing information. Internet-based transactions are vulnerable to fraud, and very few countries have legal rules specifically dealing with internet-based financial transactions (see example). Some countries have a technology-neutral approach. Most European countries favor limiting e-finance to regulated institutions, while in the United States there is a more hand-off approach to dealing with institutions that deliver financial products. However United States also favors on-site inspections, which creates a contradiction in the context of e-finance. Therefore, the old regulatory frameworks are no suitable.

Example: India (ICICI 2001)

India is one exception, where an Information Technology (IT) Act was had drawn in 2000 based on the UN Model Law for IT. India is the second country in Asia to have initiated a technology related act. The IT ACT provides legal recognition to electronic records, electronic contracts and digital signatures, through Consumer Protection Act and Negotiable Instrument Act. It also appoints certifying authority that can issue public and private key and a controller that can serve as a repository of all signatures.

There are also consumer and investor protection issues of allowing individuals to have access to financial transaction which were only dealt by market professionals previously. In this regard, both the EU and OECD have developed guidelines for consumer protection; the IOSCO has also issued recommendations which emphasize the integrity of computer networks and IAIS

recommends need for consistent rules on transparency and disclosure across all media (including the internet). The internet is also providing solutions with firms acting as certification agents, and vendors of security and privacy hardware and software on behalf of consumers and investors (Claessens, Glaessner and Klingebiel 2001)

5. d References

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IV A Competitive Market Structure

IV-1 Fiscal Transparency

1. a Taxation

1.a-i Policy Points

- Harmonization of tax treatment of financial instruments – distortionary policies can impede development of markets.
- Tax concessions may not necessarily achieve their objectives and can create perverse incentives

1. a ii Distortionary Tax Policies

Government influence on financial sector sometimes extends beyond the financial sector. Firstly, the shape of macroeconomic policy, for example, in case of high borrowing requirements financed through domestic debt, can crowd out lending to private sector. Secondly a high taxation of the domestic environment, both explicit and implicit, is also a disincentive towards financial transactions. Governments have generally used taxation of financial intermediaries as a way to relieve their budgetary pressures through a variety of explicit taxes, reserve requirements and implicit subsidies. Explicit taxation has traditionally involved taxation of elements such as corporate income, revenue and interest payments. The policy prescription from empirical and theoretical expositions is not to completely eliminate financial sector taxation, but its design should protect against sensitivity to arbitrage and inflation. There is a need to exercise caution against high capital income tax as it implies a double taxation on income. Furthermore, a thorough review of tax schemes is necessary as distortionary taxation strongly impedes development of financial markets (see example Mauritius). Globalization and increased elasticity of supply of capital income also increases difficulties of taxing capital income. But countries continue to impose them due to political considerations (Levin and Ritter, 2003). Therefore, moderation is the preferred approach.

Example: Mauritius (Aide-Memoire 2002)

Distortionary tax policies can influence development of financial markets. For example in Mauritius the value-added and transfer taxes on property sale have precluded development of

commercial leasing (see example in NBFBI section). Furthermore the transfer tax has created perverse incentives for shareholders to provide shareholder loans in place of equity and to list shares on the over-the-counter market to avoid taxes(Aide-Memoire 2002). A tax regime that treats financial instruments equally is also required as is evident from case of Mauritius where differential taxation has impeded debt market development. The corporate debentures that are listed on Stock Exchange of Mauritius, are mainly a result of the tax benefit given to debt (for new investment) of specific industries. The original incentives provided a favorable corporate tax treatment on interest income relative to that on other instruments. Consequently, there was a heavy concentration of ownership by banks, either through a displacement of bank lending or concentration of risk. After these incentives were lifted, they effectively placed debentures at a disadvantage relative to all other investments for individual investors, which effectively halted issuance on corporate bond market.

Requirements for banks to hold a certain amount of reserves with the central bank also serve as an implicit taxation. Banks may be required to deposit a certain amount of reserves with the central bank which is usually passed on to fiscal authorities as a dividend payments. Liquidity reserve requirements are also in operation in many countries which force banks to hold reserves in designated government securities. Finally requirements for banks to lend a certain fraction of resources to specific sectors or to deposit a specified amount with a specialized financial institution that can undertake the lending also constitute a form of implicit taxation on financial sector. Even if there is no explicit interest rate ceiling, such policies of diversion of funds implicitly serve to lower the market clearing interest rate for particular sectors. This will act as a tax on interest income from lending to favored sectors, which is partially compensated by higher interest rate on non-favored sectors.

Example: Brazil (Kumar 2003)

In Brazil, government borrowing and policies of reserve requirements have served to increase interest rates and spreads as confirmed by numerous studies (see *Taxas de Juros y Spreads Banacaria* 2001) Expansion of government borrowing between 1995 and 2003 has been associated with a slowdown in expansion of private sector credit. Despite controls on fiscal expansion, public borrowing, the domestically financed component of government borrowing has continued to rise. This has meant an increase in holdings of government paper by domestic agents, especially by banks, mutual and investment funds. This rise in share of securities in bank

assets (which stand at over 26% in December 2002), has resulted in a crowding out of credit to private sector, as banks find it more profitable to hold government securities.

Although reserve requirements on demand deposits have been lowered from 75 % to 45% between 1999 and 2001, requirements on savings deposits have been introduced and marginal requirements in times of macroeconomic instability have also been increased. In February 2003, requirements on demand deposits were again raised to 60%. These levels are much higher compared to other emerging countries, such as Chile (14%) and developed countries such as US and in Europe where levels ratio hovers around the 10% mark.

Poorly constructed tax systems, irrespective of whether they are a result of misdirected sophistication or a drive to earn revenues, can have considerable negative impact especially in environments with high inflation.⁴⁶ Another problem with tax systems in the case of implicit taxation is that very high effective tax rates have emerged in cases where countries would have been unwilling to impose comparable levels of nominal taxes explicitly. Practitioners have advocated corrective taxation of financial systems which have largely been successful. However, in some cases, such policy initiatives may despite achieving stated goals may indirectly contribute to stifling the financial environment. For example, there is advocacy of tax concessions for companies listing on the stock exchange, in order to motivate a shift from a heavily bank-based financial system. In Egypt tax concessions for listed firms were introduced in the 1980s and resulted in a deluge of listing. In 1990, 500 companies were listed and by 2000 more than 1000 companies were on the stock exchange. However, most of these firms had concentrated ownership structure and there was little active trading. The market capitalization of the actively traded float was only 1 percent of GDP(Honohan 2003).

1. b Subsidized Credit

1. b-i Policy Points

Government intervention is only justified if it overcomes a market failure and costs of intervention are lower than the benefits. Although DFIs and other schemes can serve to mitigate market failure, in practice the policies have failed to target the poor and also created in

⁴⁶ Although inflation has a pervasive influence through the economy, its affect on financial sector is usually deeper. For instance, high and variable inflation can result in a substitution away from non-interest bearing assets to assets with offer higher real returns.

efficiencies in the financial sector. Donor agencies can also impose greater lending costs on intermediaries channeling funds, than they realize. In addition, financial institutions are vulnerable if supplied subsidized finance from government or international financial institutions, as they lose incentive to monitor borrowers and ensure repayment. The lessons from these government are:

- Costs of public banks can be high – In Argentina, for a public bank with 25,000,000 pesos of net worth (level of median Argentine banks between 1994-1996), the nominal recapitalization payments would stand at 205.0 billion pesos if it remained in public hands. The discounted **cost of recapitalizing state-owned banks is estimated to be 383 million pesos.** (Clarke and Cull 1999b).
- Recently, there has been a decline in international and domestic supply of agricultural credit due to reduction in proportion of agricultural credit directed by multilateral banks and reduction in fiscal transfers (Rice 1993). The losses and decapitalization of state-owned development banks, and failure of directed credit policies has shifted focus on need for an alternative approach towards rural finance (Gonzalez-Vega and Graham 1995). Furthermore, commercial banks have been slow to respond towards expanding operations to rural areas (Baydas, Graham and Valenzuela 1997)
- The earlier paradigm of financial market interventions has been more of a response o specific political demands and has resulted in distorting the effect of other measures taken to promote rural financial deepening (Gonzalez-Vega 2003).
- State-owned development banks in most countries have declined partly as a result of interest rate controls that prevented them from charging interest rates that would cover operating costs and losses from default. Furthermore too much political interest, also hurt the organizations.
- Need to use finance as an intermediary tool for market enlargement and integration rather than as a policy tool for pursuit of non-financial objectives, as was being done before. For example to increase agricultural output (Gonzalez-Vega 2003). The effect of poor macroeconomic policies such as inflation tax and overvaluation of domestic currencies have also resulted in financial repression.
- the need to enforce hard budget constraints – therefore subsidies need to be explicitly budgeted.
- Many countries have suffered to excessively low loan interest rates, there needs to be a gradual but determined shift towards market determination of interest rates on all rural

- credit. Conditions under which subsidies and directed credit may be acceptable is only if they are part of operations to encourage a market oriented environment that seeks to enhance access to credit to rural poor.
- Role of the state may be more in development of physical and institutional infrastructure for rural finance markets, otherwise rural finance markets will remained fragmented and inefficient (Stiglitz 1993). Also needs to develop a framework for pledging of collateral (Fleisig and de la Pena 2003) and to reduce costs of enforcing a contract through protecting property rights and developing an efficiency judicial system.
 - Subsidies may be justified in the short term as an investment in improving services to undeserved groups. However, even temporary subsidies can create market distortions, so great care need to be exercised in their implementation. Therefore, targeted subsidies must be
 - transparent and monitored
 - capped
 - sustainable, and
 - explicitly budgeted.
 - Regulatory framework must be as follows: a) reduce barriers to entry and competition; b) eliminate fragmentation of rural financial markets, which have been as a result of regulations of restrictions on competition c) finish credit programs in non-financial institutions for example those houses in ministry of agriculture d) sales of development banks (Gonzalez-Vega 2003).
 - Credit guarantee programs are also not useful, they will worsen incentive problems.
 - Government and donors need to create financial products to reduce risk and institutional infrastructure to support adoption and implementation of these financial products. In order to reduce information and insurance risks, there is a need to introduce innovative instruments such as commodity derivatives, warehouse receipts and area based risk insurance which reduces risk associated with rural lending and encourages farmers to undertake higher risk and higher productivity activities. Government must also improve availability of information through credit bureaus and establishing uniform accounting standards.

1. b-ii Overview

Subsidized credit programs as a tool to allocate credit to preferred sectors was heavily employed by developing and developed countries during 1960s and 1970s, through market incentives such as discount facilities for selected loans, moral suasion and legal requirements.⁴⁷ Specifically they have involved preferential discount terms, restrictions on portfolios of commercial banks, guaranteed credit for public enterprises and credit lines through development (i.e. state-owned) banks. The sectors that have traditionally been most favored are small scale industrial, agriculture and real estate sectors. Governments have used a number of ways to provide credit, either through state-owned banks (or development finance institutions), priority lending or directed lending schemes, credit guarantees or explicit auctioning of subsidized credit through private banks, with state-owned banks being the most harmful in the identified spectrum. Reforms to rural credit markets have involved descaling and reducing subsidies through privatization of public development banks that were the main channel of these costly subsidies. Controls on private sector credit and forced allocations have also been reduced or eliminated. For instance, Haiti closed its national bank for agricultural and industrial development, BNDAI in 1989. Similarly Mexico is another country which has dismantled controls and closed its development bank : Banrural (see example: Mexico). While several countries are employing all tools of subsidized credit, others focus on one element. Brazil is a prime example of a country that continues to employ state-owned banks to direct credit. Banco do Brasil, the largest bank in Latin America, provides nearly 60% of all loans granted (see example: Brazil – DFIs and Directed Lending). However, it also has a private mandated program of directed lending, which has been reduced in recent years, but is high relative to neighboring countries. A credit guarantee program also operates in conjunction with DFI and directed lending schemes (see example: Brazil – Government Credit Guarantees). India fits lower down in the spectrum as a country, where strict priority rules (i.e. directed lending) continues to exist (see example: India). Mexico however, has made the transition from DFI lending to directed lending and finally to a weaker version of subsidized credit: explicit auctioning of credit to private banks for rural finance purposes. Russia reverted back to priority lending after the financial crisis in 1998 (see example: Russia).

Subsidized credit programs are usually justified as a solution to information asymmetry problems in the financial system, particularly when it comes to rural finance. Rural areas are characterized by poverty, low population densities, seasonal variations in income and lack of traditional collateral, which poses high transaction costs and risk for financial intermediaries. Furthermore, imperfect and costly information, prevents efficient allocation of credit to projects

⁴⁷ In cases where interest rates are also reduced on loans, which creates a sharp disincentive effect.

which yield highest returns. Therefore, banks may allocate credit to firms based on whether firms have sufficient internal funds or if they have a reliable credit history, rather than to firms with the best investment opportunities. These arguments are generally used to provide support for greater involvement of the government in allocation of credit as the government may also have a comparative advantage in credit supply through superior information on sectoral prospects. Therefore governments adopt directed credit policies in an effort to increase availability of long-term finance. It is questionable, though, if a directed industrial policy can reap positive externalities. In practice, cheap finance has led to diversion of credit (concentration of income away from poor), low-lender revenues and political intrusions into credit allocation (Calomiris et. al. 1992, Calomiris and Himmelberg 1994a, 1994b, Ladman 1984, Vittas and Cho 1995). Another study finds that although government subsidies may have increased long-term debt of firms, they did not allow firms to grow faster (Caprio and Demirguc-Kunt 1998). In cases, where authorities have been successful in increasing long-term finance, there has been less emphasis on institutional sustainability, loan recovery and strengthening intermediation by mobilizing rural savings.⁴⁸

1. b-iii Development Finance Institutions

Development finance institutions (DFI) essentially subsidize credit to preferred customers or sectors and provides a source of finance to those borrowers who would be unable to obtain finance from the traditional banking sector. DFIs receive cheap finance from the government, which is then lent for non-commercial purposes. They have also been vehicles for donor funds, that may not be available to private sector businesses directly. Experience with DFIs reflect irresponsible lending that reduced capacity of these institutions to provide further finance, especially as government and donor funds also began to dry up (Harvey 1991). In a sample of 18 industrial DFIs, a World Bank study found almost 50% of loans were in arrears.

In theory, the direct beneficiaries of development bank finance are the clients who may be unable to access credit through private financial institutions. However, in practice, the credit has not reached the intended recipient. The large subsidies linked with DFI lending attracts borrowers who are not credit constrained. The gains associated with these loans are large enough for them to press for more public funds from DFIs (Schreiner and Yaron 2001). The politically connected are the first to apply and finance usually goes to the more well-off. For instance, rich

⁴⁸ An extreme view is also that subsidized credit programs have basically succeeded in keeping governments in power by enhancing the position of rural elite (Ray 1984, Blair 1984).

farmers and lobbyists obtained large subsidies from agricultural DFI, in many countries (Adams, Graham and Von Pischke 1984). Perverse incentives also exist with employees at DFIs who choose to subsidize lending. These employees stand to gain from subsidies because greater funding will secure their jobs and expand their influence. The groups that bear the cost are the taxpayers, international financial organizations (IFI) if they have provided funding and borrowers who fail to receive financing for their projects.

DFIs can only be justified if they overcome a market failure such that the benefits overcome the costs of intervention (Schreiner and Yaron 2001). It is difficult to find any substantial evidence of DFIs that have alleviated the market failure and assisted high quality borrowers who were unable to receive credit from private lenders.⁴⁹ Most evidence points towards failures of DFIs to achieve their intended objectives. In some cases they have also imposed costs on the intended recipients of benefit (Yaron, Benjamin and Piprek 1997, Hulme and Mosley 1996, Krahn and Schmidt 1994, Adams, Graham and Von Pischke 1984). DFIs were unable to finance projects that had high economic and low financial rates of return and remain viable at the same time (World Bank 1989). Subsidies continued to increase, but the low repayment rates strained the budget and weakened DFIs. In Mexico the government injected almost 23 billion dollars in agricultural DFIs between 1983 and 1992, until budget cut forced a reduction in spending (World Bank 1994).

Example: Mexico

In Mexico the government, heavily subsidized rural credit through public development banks, principally Banrural (along with ANAGSA and FIRA) between 1983 and 1992, when budget cuts forced a reduction in spending. The cost of this government intervention has been estimated at nearly US\$28.5 billion, of which 80% is attributed to subsidized interest rates. In the early 1990s, it was realised that there was widespread default due to poor loan portfolio of these development banks, deteriorating income distribution due to interest-rate subsidies and regulatory and sustainability problems with credit institutions at the field level (Brizzi 2001). The government therefore started to introduce measures to reduce exposure by liberalization interest rates. The operations of Banrural were also streamlined and ANAGSA (the agriculture insurance agency) was closed in 1990. Banrural was significantly downsized between 1989 and 1992 and almost 300 branches were closed and staff was reduced to 10,000 from 22,000 in 1988. Interest rate subsidies were also reduced and real interest rates rose to market level. In 1992, government

⁴⁹ Some DFIs were able to lend profitably and maintain high repayment rates without the use of traditional collateral (Schreiner and Yaron 2001).

transfers to development banks were decreased and agriculture credit was only 8% of total credit in 1992 (Janvrey, Key and Sadoulet 1997). Controls were lifted on lending by Banrural which was allowed to diversify its portfolio to non-agricultural sectors. However, the government needed to intervene again in 1999 to recapitalize Banrural of about \$ 1.1 billion expenditure (Brizzi 2001).

Although during the 1980s the lending to agriculture sector was predominantly carried out by Banrural, during the 1990s commercial banks began to play a greater role in credit extension. The commercial loans were supported by FIRA after 1988. The role of Banrural was significantly cut in 1990s and large-scale farmers have turned to commercial banks for credit purposes and small farmers now access public welfare program, Pronasal. This dismantling process has culminated in the closure of Banrural, which is being currently being liquidated. The World Bank has provided support of \$505 million to the Mexican government to replace Banrural with a completely decentralised non-banking financial institution, Financiera Rural. This will serve to promote rural banking sector and provide credit in an efficient and transparent manner.

The increasing role of FIRA in providing wholesale credit along with technical assistance to farmers has been a positive development. FIRA is an excellent example of development bank providing partial guarantees and well-designed subsidy program. It works along the principle of lender transaction costs which banks try to minimize by reduce the number of loans they make, creating a disincentive to make small loans. In order to encourage lending to small holders the FIRA provides fixed transaction cost subsidies to small rural loans. This is preferable to interest rate subsidy as it does not distort the capital intensity of the project and also allows banks to sell to small holders (Janvrey, Key and Sadoulet 1997).

Example: Brazil – DFIs and Directed Lending (Kumar 2003)

The Brazilian rural finance credit program, is a prime example of problems inherent with directed credit. Two principal banks: Banco do Brasil and the Caixa Economica Fédéral, have been employed to channel credit to rural and housing sectors, respectively. Banco do Brasil, Banco do Noreste and Banco da Amazonia, are the three federal banks involved in rural agriculture. The system is ridden with administrative rules on allocation of credit and interest rate ceilings. Therefore the private sector tends to limit its role to provision of financial services to larger clients. It has limited outreach at high costs, instead of mass outreach at low costs. Only a third of farming households have access to formal credit. Public sector programs dominate the rural credit system, having crowded out private intermediaries whose share in rural credit has declined to 5%.

However there do exist private sector programs mandating 25% of unremunerated demand deposits to be allocated to rural finance and 65% of passbook savings deposits are directed towards housing loans. Out of the 65%, 80% is allocated to loans under government mandated Housing Financial System SFH (Sistema Financeiro de Habitacao). Directed credit fell after mid 2000, but only as a result of public sector banks exchanging directed credit for government debt, on their books. Although many of these directed lending rules have been relaxed over the years, directed lending remains high (at about 38% in March 2002), especially when compared to other countries in the region. For instance, Mexico, where most obligations have been progressively dismantled. These programs along with below market interest rates have resulted in market segmentation and price distortions that have worked towards raising overall cost of capital. Loan recovery also remains low, with the public sector banks suffering from loan portfolio problems and operational inefficiency which required recapitalization in June 2001.

The programs have rarely reached their targeted recipients, with largest 2% of borrowers receiving more than 57% of the loans, while the smallest 75% borrowers receive merely 6%. The subsidies seem to have been captured by wealthy farmers, with a resulting impact on inflating rural land prices. Land prices are inflated as subsidies are capitalized into value of land. The cost of funding of these subsidies has been borne by mandated lending rather than National Treasury, which has widened interest rate spreads and increased cost of finance for non-priority sectors.⁵⁰

Example : Small Business Administration (Bandow 2000, SBA 2003, Stansel and Moore 1997)

The Small Business Administration (SBA), is a vehicle for federal aid to small businesses. It was established in 1953, for the explicit purpose of improving credit availability for small businesses. Since 1954, SBA has been extending business loans and loan guarantees for small businesses and also providing technical assistance. The Small Business Investment Company (SBIC) was also established, under which SBA can license, regulate and make long term debt and equity investments in high risk small businesses, such as private venture capital investment companies. In 1964, it also developed an Equal Opportunity Loan (EOL) program, which eases collateral and credit requirements for low income applicants. The programs offer a wide spectrum of loans ranging from \$12,000 to \$2 million. SBA currently has a loan business

⁵⁰ Much of these subsidies have been sustained by off-budget taxes such as FGTS (Fundo de Garantia do Tempo de Serviço, is the Employees Severance and Indemnity Fund) and the FAT (Fundo de Amparo ao Trabalhador, is a workers' support fund) and therefore are an implicit tax on recipients of funds.

portfolio of 219,000 loans worth \$45 billion. The venture capital program has extended loans worth \$30 billion, since 1958, to aid small businesses (SBA 2003). A study on SBIC programs during the 1980s finds bank-owned SBICs (that used less SBA leverage) were able to fund activities that would have been difficult to manage using traditional sources (Brewer and Genay 1994). The authors find SBIC programs to alleviate conflict between intermediaries involved and type of financing required in small businesses.

However, these figures present a biased picture, especially if they are considered in the context of outreach of the SBA. It actually supports less than 2% of the 800,000 new business established each year in the U.S and less than 0.5 % of total businesses (Bandow 2000, Stanstel and Moore 1997). Applicants are only considered if they have already been rejected by at least two banks. This screening procedure has meant that almost 15% of businesses selected to finance, in any year, become delinquent (Stanstel and Moore 1997). The outreach is low if we compare it to the budgetary costs of SBA, which stood at \$1,014 million in 2002 (SBA 2002).

1-b-iv Priority Lending

During the 1980s the distortionary effect of directed lending (priority lending) policies were slowly coming to the surface and led to a reconsideration of the rationale behind these programs. The general assessment was that (similar to DFIs) directed credit programs, suffered from misuse of allocated funds, increased the cost of funds to non-favored sectors and borrowers and were associated with weaker fiscal discipline and therefore, low repayment rates (Vittas and Cho 1995). Directed credit lines were channeled to priority sectors, which may or may not have the most productive investments. In countries such as Brazil, Colombia, India, Kenya and Mexico, government interventions were associated with large costs as they crowded out private credit intermediaries and funded inefficient borrowers. In countries where there was successful experience with directed credit policies, such as Japan, Korea and Singapore, the policies were part of a national plan and involved widespread participation (Caprio and Demirguc-Kunt 1998). Interventions that were unsuccessful were discontinued. However in countries, where the political climate is not hospitable for, it can be difficult for governments to effectively distribute industrial credit.

Example: Malawi (see Harvey 1991)

In Malawi, in 1970s, commercial banks were required to increase lending to agriculture to 50% of total lending. Between 1970 and 1980 the lending to agriculture increased from K2 million to

K93 million, rising to 54 % of bank advances. However, most of this was channeled to the larger farm estate sector, rather than poor farmers. The commercial banks began to suffer, as by 1980 most of the lending was being directed to cover losses caused by rapid over expansion and over-reliance on loan finance. The banks were forced to set up technical assistance for the failed estates, cross-subsidizing the costs at the expense of other efficient sectors.

Example: Russia (see Granville 2003).

Russia began its financial sector reforms in 1992 after inheriting a banking system from a centrally planned economy. As the banking system was a state-owned machinery, the central bank was financing activities through a 'directed credits' scheme. Either enterprises would directly receive subsidies from government budget or credit financing from banks in the form of subsidized credit. The credit was directly funded by the Central Bank of Russia and was not reflected in the budget. Directed credits were used to support liquidity at banks and to promote specific enterprises and sectors in Russia and Former Soviet Republics.⁵¹ They were allocated upon requests from enterprises to the legislature, the government or at times to the Central Bank of Russia. The commercial banks were merely passive instruments to channel the credit and did not have any say in the decision-making. A Federal Treasury Department was established in 1994 and became operational by 1998.

State enterprises were able to obtain subsidized credit as they also spent large amounts on social services such as healthcare and housing, which were beneficial for employees. The aim to keep employment stable was then used to justify the need for direct credit. In fact unemployment was kept artificially low using subsidized credit and remained between 1.1 and 2.6 between 1992-1998. However this had the adverse effect of reducing labor productivity. In some instances, wages were not paid to workers, which also reduced the tax base. The credit channeled through commercial banks totally Rbs 2,804 billion (15.5 % of GDP) in 1992 and Rbs 8,150 billion (5% of GDP). The central banks informed the commercial banks exact amount and interest rate at which credit was to be extended to specific state enterprises. If the allocation of credit by the central bank and explicit subsidies through the budget are also included, the financial transfer to state enterprises was almost 45% of GDP in 1992. The problem with the credit program also related to the low interest rates charged, which were substantially lower than CBR refinance rates. The difference was paid by the federal budget. Although firms had an incentive to repay the

⁵¹ Liquidity financing of banks was also used to justifying directed credits. Introducing a straight discount window may have resulted in a faster change in the banking system. Credit auctions were introduced only much later in 1994 and the first credit auction took place in April 1996.

loans, in order to obtain additional financing, non action was taken against banks or firms that did not reimburse the loans. Commercial banks in fact gained additionally from handling this credit and they usually did not disburse the loans immediately. They also received private benefits on the side from government sources.

The directed credit scheme was officially abandoned in October 1993 and centralized credits were officially cancelled by a Presidential decree in February 1995. Credit auctions were introduced instead with a purpose of supplying liquidity to banks, which was a significant step in the right direction. The Central Bank set a minimum rate on the auctions that exceeded the interbank lending rate. However, there was very little take-up except by financial institutions that had no access or little access to interbank loans (Tomás J.T. Baliño, David Hoelscher, and Jakob Horder 1997). Eventually the credit auction scheme was phased out and two Lombard facilities were introduced. These also had limited success. After the crisis in 1998, the government again introduced directed credit policies and tightened its control over the financial system.

Example: Colombia (Atiyas 1991, World Bank 1990a World Bank 1990b)

The financial system in Colombia was highly regulated during the 1960s and 1970s with both interest rate ceilings and directed credit policies. In 1980 deposit and lending rates were relaxed, but direct credit mechanisms continued. The main sources of directed credit was Banco de Republica credit lines which were intermediated by commercial banks, funds from international financial organizations channeled through commercial banks and credit from Institute de Fomento Industrial (IFI), a DFI. Between 1984-1987, directed credit was nearly 62% of total credit provided by commercial banks and financial corporations. Directed credit was a major source of long-term finance. Furthermore, it was heavily subsidized as interest rates on directed credit were 12 % lower than the rates on loans extended on commercial terms (World Bank 1990b). In order to qualify for subsidized credit, firms had to display that capacity constraints were binding on output. Therefore credit was only directed towards new capacity rather than to improving efficiency in sectors which had sufficient capacity. Although there were special lines of credit for small and medium sized firms, there was still a bias towards lending to large firms. A large proportion of small firms were completely cut off from subsidized long-term loans. Low margins were allowed to commercial banks that were channeling the credit, so they had a preference to lend to less risky clients and demanding high collateral. As credit extension was biased against new entrants, the program may also have reinforced the lack of competition in product markets.

Example: India (Hanson 2001)

In India, directed lending continues to be practiced although it has been dismantled for private sector participation in rural finance in many developing countries. All banks are required to lend 40% of their net credit to the 'priority sector' which comprises agriculture, agriculture processing, transport industry and small scale industry. These regulations have been in place since 1969 and were set out in minute detail of the size, rate and type of loans to be extended to each sector, until 1997. The priority sector limited was changed in 1998, allowed banks to focus on larger clients and draw from a larger pool of resources and be more exacting on the clients (Banerjee and Duflo 2002). The volume of priority lending made income distribution an important objective for the banking sector and relegated importance of channeling credit to its most productive uses. By 1990, nearly 80% of the total bank credit was under the directed credit scheme. Cash reserves and liquidity requirements were up to 53.5% of deposits. The remainder was reserved for priority and quasipriority sectors. The favored sectors were agriculture, particularly small farmers and public sector food procurement.

The main beneficiary of this system was the government through the cash reserve and liquidity requirements.. The other beneficiaries were poor farmers who received low interest loans, bank employees who received person loans and educated and unemployed who received loans under the program. The sectoral subsidies were high. For example, the interest rate on agriculture loans was 2 percent lower than average interest rate on bank loans. Subsidies on personal loans were nearly 3 percent, which were allocated as a perk to bank employees.

Although access to credit improved for agriculture and small scale industries, it was at the expense of credit to medium and large scale firms. Large and medium firms and wholesale trade suffered a decline in credit from 60% to 44% in this period. Although the large firms were able to raise financing through public debt and equity markets, the medium firms were the real losers.

These directed loans suffered from low repayment rates. Almost half of all non-performing loans in the 1980s came from the priority sector. This was an unusually high amount as the proportion of priority sector loans in total credit was only 40% (Reserve Bank of India 1998). Even if one-third of the non-performing loans were recovered, there is an implicit subsidy of at least 2-3 percent on priority loans. In total the subsidy of these directed credit scheme would amount of at least 2-3 percent of the GDP.

Finally the impact of directed credit on performance of the priority sectors and the economy are also unclear. It seems that the program only functioned as a transfer program without having any real effect on production in the targeted sectors. There was only a marginal

impact on growth in the agricultural sector, although it did extend the reaches of the banking sector to the rural areas and reduced influence of money lenders. The credit received by rural farmers was mostly used to increase capital intensity of production and did not impact growth (Binswanger and Khandker 1995). Furthermore most of the bank credit was allocated by size of borrowers, going to large farmers mostly. Family members also took credit under different names, which increased the concentration of credit extension.

1. b-v Credit Guarantees

Credit Guarantees are also commonly used to encourage lenders to lend to clientele groups of interest to governments and donors. Guarantee programs are funded usually by the government but recently, group-based savings deposited in a bank account have also been used to guarantee loans made to groups. Donor and NGOs also compliment local savings with a second tier guarantee to leverage the funds lent (Meyer and Nagarajan 1996). One of the few studies on credit guarantees find that it is difficult to ascertain effect on lending at most guarantees are for small and medium business loan guarantees (Levitsky and Prasad 1987). In Nigeria the credit guarantee scheme covered only a small portion of total lending. However the bad debt associated with agriculture also affected the guarantee fund. The Nigerian Agricultural Credit Guarantee Scheme was set up in 1977 with a fund of N100 million. It was decapitalized slowly as the operating costs were high and by 1988, 15% of loans were reported in default (Njoku and Obasi 1991). The programs in Colombia and Mexico also suffered from difficulties. It is typically assumed that programs funded by endowments have a zero opportunity cost. If they survive without the need for further capitalization then the implicit subsidy is assumed to be zero. However, a study that analyzes Fondo Nacional de Garantia in Colombia finds an implicit subsidy of 8% per year between 1982 and 1994 (Gudger 1993). The premium charged would have to be raised from 4.8% to 12.6 % for the fund to break even (also see example: Brazil). In terms of the effect of credit guarantees on behavior of lenders, there is mixed evidence. An evaluation of two participating banks in Philippines finds that banks were more likely to extend credit to borrowers who would not have qualified without credit guarantees (MSI 1990). It also finds that loan maturities and interest rates were nearly the same for guaranteed and non-guaranteed borrowers, although collateral requirements were less. However, a detailed examination of supply of agricultural credit in Philippines finds, that although guarantee schemes did serve to substitute funds and rose from 2 to 5% (of total agricultural loans) during the 80s,

participation was low due to additional transaction costs required for guaranteed loans (Magno and Meyer 1988).

Example: Brazil – Government Credit Guarantees (Kumar 2003)

The government initiated a program of rural insurance in the 1960s, which faced a stumbling block upon the failure of the National Insurance company. This initiative was revived again in 1973 under the Guarantee Program for Agricultural Activity (PROAGRO). The PROAGRO provided credit guarantees instead of crop insurance. However it was making losses of Rs. 150 million per year and the coverage had to be reduced. In the early 1990s, premia were raised substantially, which has meant an increase in profits, which stand at R\$6million on premia of R\$60 million, over 5 years. However the coverage is limited, with only 1.5 million contracts over 5 years.

Example: Indian Post System – Public and Private Partnerships

The objectives of state-owned banks in terms of providing rural finance can also be achieved in alternative ways. The India Post Office partnership with the private sector is an excellent example of use of the state structure and its extensive distribution network for providing financial services, without assuming state risk. The Indian postal system is one of the largest in the world, in terms of the population and area that is covered, with 154,000 post office branches and 1 million employees. The post office delivers 53 million mail items daily, each post office covering 6400 people. The number of mail items received per capita is 16, much lower than 734 for United States Postal Service (Sarma 2002). The Indian postal system operates as a department of the Government of Indian and like most government run institutions is heavily subsidized. The subsidy provided by the Government in 2001, was 33% of the revenue (India Post 2001). In fact the subsidy has been rising in recent years, as increase in costs have outstripped growth in revenues.

However, recently the India Post Office has developed significant alliances with the private sector, leveraging its wide outreach and distribution network as a channel for non-postal products and services. The main business partnership that has been successfully implemented is Western Union, that is an international money transfer agency. Western Union commenced with 100 postal outlets, which are being expanded each year. In light of this public-private partnership, insurance companies and financial service company providers such as IDBI Principle and ICICI

have also entered into agreements. ICICI is offering investment products through postal outlets. The India Post Office has also entered into an agreement with MasterCard, to offer pre-paid card service to the public (India Post 2001). These public-private partnerships will serve to improve financial viability and lower risk associated with services provided. It will also reduce the fiscal burden for the Government.

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IV 2 PROMOTE MICROFINANCE RATHER THAN STATE OWNED INSTITUTIONS

a. Microfinance

2. a-i Policy Points

Keeping in mind the goals of regulatory reform, and the distinction between prudential and non-prudential regulation,⁵² the following constitutes a potential reform agenda:

1. Permit “credit-only” non-depository MFIs to lend freely without prudential supervision

The majority of MFIs operating today do not take deposits; rather, they lend funds provided by donors, banks, or other sources that presumably have the right to place their own money at risk, and the wherewithal to monitor those investments. While certain non-prudential regulation may be called for, e.g. public registration, permitting, disclosure of major shareholders and/or management, audited annual statements, etc., these “credit-only” institutions should be allowed to lend freely without prudential supervision.

Example: Central and Eastern Europe (Foster et. al. 2003)

In Central and Eastern Europe and the New Independent States (NIS), “legal entities are generally interpreted to be permitted to exercise only those powers and engage only in those activities specifically provided for in applicable law and regulations.” For example, in Serbia, no institution can lend without a license from the national bank. In most other states in the region, the legal frameworks are such that authorization to engage in microfinance activities remains murky. NGO MFIs struggle to determine if they are permitted to lend at all; if they are permitted to on-lend capital from borrowings (or if this constitutes financial intermediation); if they can take cash collateral (“forced savings,” “compensating balances”); and if participation in microfinance endangers their non-profit status.

2. Relax prudential regulations on non-deposit taking institutions

A. Interest rate ceilings

⁵² Non-prudential regulation does “not involve the financial authority in vouching for or assuming any responsibility for the soundness of the ‘regulated’ institution.” Prudential regulation, on the other hand, involves just this sort of government “vouching” and is typically paired with supervision to ensure “soundness.” See CGAP (2000).

“MFIs must set interest rates that cover all administrative costs, plus the cost of capital (including inflation), loan losses, and a provision for increasing equity. Unless MFIs do so, they may only operate for a limited time; reach a limited number of clients; and will tend to be driven by donor or government goals, not client needs. Only sustainable MFIs can provide permanent access to financial services.”⁵³ In addition, because many costs of making a loan are fixed, costs constitute a higher percentage of a small loan than a large loan. Moreover, microcredit available at high costs compared to the formal financial sector nonetheless represents a significant improvement in the credit options available to the poor. “A standard moneylender loan in the Philippines is the ‘5/6 loan’—for every five pesos borrowed in the morning, six must be repaid by evening. This amounts to a *daily* interest rate of 20 percent.”⁵⁴ Conversely, “[i]nterest rate caps, where they are enforced, almost always hurt the poor through contraction of services far more than they help the poor by lowering rates.”⁵⁵ Finally, interest rate ceilings are often a greater disincentive for commercial banks to enter the microfinance field than for NGOs with a non-profit orientation. Banks operating in countries that undertook stabilization efforts and associated deregulation of interest rates in the 1980s were thereby encouraged to enter the microfinance sector (CGAP 1998). This dynamic was observed in India with the advent of financial liberalization in the 1990s and the entry of commercial banks ICICI and Citibank into microfinance activities.

Example: Bank Rakyat Indonesia (BRI) (CGAP 1997)

Now hailed as an example of best practice government-owned microfinance, BRI’s “unit *desa*” system had its roots in a largely unsuccessful government agricultural credit program. In the 1970s, “[l]ow interest rates had blocked outreach of these services to the poor, led to corruption, and resulted in huge operating losses.” BRI benefited from overall financial sector deregulation in Indonesia in the 1980s, and took the opportunity to redefine itself. More specifically, the removal of interest rate controls in June 1983 allowed BRI to experiment with new financial products, most notably market-priced working capital and investment capital loans. “By 1986, the unit *desa* system turned from chronic loss-maker into a profit-making entity.”

⁵³ “Making Sense of Microcredit Interest Rates,” *Donor Brief No. 6*, CGAP, September 2002, emphasis added.

⁵⁴ “Making Sense of Microcredit Interest Rates,” *Donor Brief No. 6*, CGAP, September 2002, emphasis added.

⁵⁵ “Consensus Microfinance Policy Guidance: Regulation and Supervision,” CGAP, September 2002.

B. High reserve requirements

High reserve requirements (often used to fund government budget deficits) play a similar role in terms of discouraging commercial entry into the microfinance sector. Reserve requirements restrict the proportion of deposits available for on-lending; with less credit to disperse, commercial banks are less likely to look beyond the formal financial sector.

Example: Latin America (CGAP 1998)

“The commercial banks from Latin America did not enter into microfinance until the early 1990s when reserve requirements declined from around 50 percent to more modest levels of between 10-30 percent.”

3. Adjust prudential standards to reflect the specialized nature of microfinance⁵⁶

Adjustments to existing prudential standards to accommodate the ways in which microfinance differs from traditional banking should be applied equally to depository MFIs as well as to microfinance divisions within commercial banks, and other NBFIs. While a number of areas may require attention, the most pressing issues include:

A. Higher capital adequacy requirements

Microfinance portfolios tend to be geographically concentrated, more volatile and subject to “contagious delinquency.” Given the cost structure of microfinance, non-payment results in decapitalization of an MFI more quickly than a traditional bank.

B. Relaxation of unsecured lending limits and loan loss provisions

Regulations limiting unsecured lending to, say, 100% of an institution’s equity base or requiring 100% loan loss provisioning for all unsecured loans (at distribution vs. when delinquent) are inappropriate for microfinance. However, once a loan is delinquent, loan provisioning for microfinance should be more conservative than for traditional loans, and based on number of missed payments rather than days (given the frequent repayment schedules associated with these types of loans, 30 days of delinquency could represent not one, but two to four missed payments) (Jansson and Wenner 1997).

C. Different loan documentation standards

Prudential logic requires some form of documentation for every loan. However, applying the same loan documentation standards as in existing banks would be inappropriate for

⁵⁶ Key ideas in this section are drawn from CGAP (2002) and Meagher (2002).

microcredit. For example, few microentrepreneurs have formally registered businesses, let alone financial statements.

D. Waived restrictions on co-signers as borrowers

Regulations that prohibit a bank from lending to anyone who has co-signed a loan from the same bank are at odds with the common microfinance practice of having members of self-help groups (SHGs) cross-guarantee each others' loans.

E. Simplified reporting requirements

Microfinance activities often operate in rural areas, and/or without the sophisticated communications infrastructure to report their financial position as frequently (e.g. daily) as may be required by traditional prudential regulation.

F. Shareholder suitability and diversification requirements on a case-by-case basis

While regulation aimed at ensuring bank owners can meet a capital call and at preventing the “capture” of a bank by a small number of owners serves legitimate objectives, these requirements would hinder the conversion of an NGO into a fully-fledged bank or require it to take on owner-partners who are not capable of providing good oversight.

➔ **Special Consideration: Lower minimum capital requirements**

Considerable attention has been paid to the idea of lowering minimum capital requirements to facilitate the transformation of MFIs into financial institutions. Acknowledging that a number of countries in Africa (Uganda, Ghana, Tanzania, Ethiopia, Zambia), Asia (the Philippines, Indonesia), Eastern Europe (Macedonia, Albania, Tajikistan, Bosnia and Georgia) and Latin America (Bolivia, Peru) have or are moving toward a tiered regulatory structure to accommodate specialized financial institutions, we still do not recommend this approach. Instead of focusing on creating new regulatory forms, “[m]ore attention needs to be paid to reforming regulations that make it difficult to do microfinance under existing forms of bank or finance company licenses” (CGAP 2000)

In most countries, minimum capital requirements to acquire a bank license are in place both to help ensure financial stability of new institutions, and to ration supervisory capacity. Lowering the minimum capital requirements could overwhelm the supervisory authority (in terms of capacity and/or skill), create moral hazard for MFIs not yet ready to face the discipline of the market, and present a regulatory arbitrage opportunity for undercapitalized financial institutions searching for a way around more rigorous prudential standards and supervision applied to banks. “[O]pening up a new regulatory option—particularly if existing MFIs are not yet strong

candidates for transformation—may result in a proliferation of underqualified depository institutions and creation of an undischageable supervisory responsibility.”⁵⁷

There is no reason to believe that opening a new regulatory window will enable MFIs to achieve profitability or afford commercial costs of capital if they are not able to do so prior to application or licensing; “[s]cale economies are important in microfinance, but most of them seem to be captured by the time the MFI moves through the 5,000-to-10,000 client range.”⁵⁸ Moreover, minimum capital requirements for a bank charter are less than \$10 million in many countries (often as low as \$1-3 million) (CGAP 2000). In a study of Latin American NGOs that had transformed into financial institutions, “[f]or most of the institutions, the minimum capital needed was the same or less than the amount of capital needed to achieve and maintain profitable operations, and therefore, it did not pose a binding constrain.”⁵⁹

However, tiered regulatory structures in Latin America have generally been well-regarded and a number of other countries are pursuing this approach to deepen the microfinance sector. What we do know is that “if countries reform their regulations to make them more accommodating, they must strengthen their supervisory capacity commensurate with the likely extent of entry.”⁶⁰ In addition, implementing tougher regulation in operational areas mentioned above, e.g. higher capital adequacy requirements and stricter loan loss provisioning, may help to offset the risks associated with lower minimal capital requirements.

4. Revise bank branching rules

One of the challenges of microfinance is reaching remote customers. In most developing countries, the populations are still overwhelmingly rural, and many villages do not have banking services. Bank-NGO or bank-self-help group (Bank-SHG) partnerships, in which the non-bank entity assumes the “on the ground” activities (including credit assessment, lending decisions, collection, etc.) while the bank provides the capital and takes the investment risk on its books have emerged as a mechanism for overcoming this spatial divide. This arrangement benefits the banks who do not have the infrastructure or knowledge to assess microcredit risk, as well as the MFIs by reducing capital constraints. However, in some countries branching rules originally designed to protect consumers may prohibit these types of creative, and pro-poor, arrangements.

⁵⁷ “Consensus Microfinance Policy Guidance: Regulation and Supervision,” CGAP, September 2002.

⁵⁸ “The Rush to Regulate: Legal Frameworks for Microfinance,” *Occasional Paper No. 4*, CGAP, April 2000.

⁵⁹ Elisabeth Rhyne, “The Experience of Microfinance Institutions with Regulation and Supervision,” Accion, 10 September 2002 (5th International Forum on Microenterprise, Inter-American Development Bank, Rio de Janeiro).

⁶⁰ Joselito Gallardo, Korotoumou Outtara, Bikki Randhawa, and William F. Steel, “Comparative Review of Microfinance Regulatory Framework Issues in Benin, Ghana, and Tanzania,” Africa Region Financial Sector Group, Financial Sector Operations and Policy Department, The World Bank, June 2003.

*Example: India*⁶¹

In India, a bottleneck for the use of bank agents in the type of bank-NGO scheme outlined above is the regulatory prohibition on cash handling by agents. “This prohibits bank agents from collecting on behalf of lenders” and forces individual borrowers or SHG representatives to travel significant distances (as far as two to three days time) to make loan payments.

5. Harmonize taxation

Regulation and taxation should focus on “the type of transaction being conducted rather than the type of institution conducting it.”⁶² “With respect to taxes on financial transactions, such as a value-added tax on lending or a tax on interest revenue, the critical issue is a level playing field among institutional types. In some countries, favorable tax treatment on transactions is available only to prudentially licensed institutions, even though the favorable tax treatment bears no substantive relationship to the objectives of prudential regulation.”⁶³

Example: Central and Eastern Europe (Foster et. al. 2003)

In Georgia and Tajikstan, microfinance institutions are not eligible for the same tax deductions as other financial institutions. In Tajikstan, VAT (value-added tax) is not assessed on financial services, but offering credit (a strategy to which many microfinance institutions resort to avoid constraints on NGO “lending”) is not classified as a financial service. In Romania, interest on microloans is not tax deductible.

6. Allow foreign equity participation in microfinance

In many countries, foreign equity participation in MFIs is limited or prohibited. As in other financial sectors, foreign presence in microfinance could have a catalytic and strengthening effect. “In general, most MFIs still do not have a capacity to bear foreign exchange risk associated with borrowing in foreign currency. On the other hand many social investors in the North are interested in investing their funds in the microfinance industry but are unable to make equity investments in MFIs because of the restrictions imposed by governments.”⁶⁴

⁶¹ Example drawn from “Improving Access to Rural Finance: Innovative Solutions to Improve Access,” The World Bank.

⁶² “Consensus Microfinance Policy Guidance: Regulation and Supervision,” CGAP, September 2002.

⁶³ “Consensus Microfinance Policy Guidance: Regulation and Supervision,” CGAP, September 2002.

⁶⁴ Nimal A. Fernando, “Do Governments in Asia Have a Role in Development of Sustainable Microfinance Services? Some Views,” Asian Development Bank, www.adb.org/Documents/Slideshows/Microfinance/Fernando_paper.pdf.

<i>Example: Shorebank Advisory Services (SAS) (Turnag News Agency 2003)</i>
Shorebank Advisory Services (SAS), a subsidiary of the U.S.-owned Shorebank Corp. has transferred its expertise in providing commercial and housing loans in underserved markets in the U.S. to the international development field. SAS' objective is to increase financing for SMEs, and it has ownership relationships with institutions in Asia, Eastern Europe, and Latin America. For instance, Shorebank began operations to finance new businesses in Azerbaijan in 1998. By 2002, their credit portfolio in Azerbaijan reached US\$1 million, and loan sizes increased from US\$4,000 in 1998 to US\$100,000 in 2002.

BUSINESS ENVIRONMENT

In addition to regulatory reform, there are a number of actions governments can take to improve the business environment for microfinance.

1. Focus on macroeconomic stability

The effect of macroeconomic factors on microfinance are similar to their effects on the rest of the financial sector. “Macroeconomic instability adversely affects overall economic growth and thus limits productive economic opportunities and potential for sustainable microfinance. High inflation in particular erodes the capital of financial institutions and makes it difficult to mobilize resources to expand services. In general macroeconomic instability increases the volatility of interest rates, exchange rates, and relative prices and impose additional costs and risks on the financial institutions and their existing and potential clients.”⁶⁵

<i>Example: Brazil (Fernando 2003)</i>
Despite having the largest number of microenterprises in Latin America, high poverty rates (by extension, a large potential client base), and little downscaling by commercial banks, microfinance failed to take off due in part to high inflation.

2. Strengthen the banking system⁶⁶

⁶⁵ Nimal A. Fernando, “Do Governments in Asia Have a Role in Development of Sustainable Microfinance Services? Some Views,” Asian Development Bank, www.adb.org/Documents/Slideshows/Microfinance/Fernando_paper.pdf.

⁶⁶ Nimal A. Fernando, “Do Governments in Asia Have a Role in Development of Sustainable Microfinance Services? Some Views,” Asian Development Bank, www.adb.org/Documents/Slideshows/Microfinance/Fernando_paper.pdf.

In general, the establishment of a sound traditional banking system should precede or take priority over the development of microfinance services. “Basic banking services are essential for the development of sustainable microfinance [even though] traditional banking institutions may not often provide microfinance services directly. NGOs and other non-bank MFIs need a safe place to deposit their funds. A less developed banking system also makes it difficult and more costly for MFIs to access funds from the banking system, while a more developed banking system can be a significant source of support.”⁶⁷

3. Develop infrastructure, especially in rural areas

Infrastructure enables financial service provision, e.g. by banks, as well as more productive use of these financial resources by customers, e.g. borrowers. The need for improved infrastructure is especially acute in rural areas. “Better rural roads, bridges, irrigation facilities, market facilities, primary health care and education facilities on the whole increase economic opportunities for the rural population, and thus enable productive use of basic financial services. Such infrastructure also reduces potential risks and transaction costs for financial institutions and provide incentives for innovations and to diversify and expand their operations.”⁶⁸ Information and communication technologies are especially important to enable rural institutions to meet prudential reporting regulations, and to incent commercial banks to expand into rural areas.

<i>Example: Bangladesh vs. Nepal (Fernando 2003)</i>
Microfinance spread faster in Bangladesh than in Nepal in the 1980s and 1990s due in part to the better rural road network in Bangladesh.

4. Encourage the development of credit assessment mechanisms

A. Improve credit information on borrowers

Credit bureaus are one of the best ways to improve the availability and quality of information about microfinance customers, e.g. cash flows, character, etc. (Yaron 2003a pp) “Regulated entities can be compelled to participate, while a credible credit bureau can persuade non-

⁶⁷ Nimal A. Fernando, “Do Governments in Asia Have a Role in Development of Sustainable Microfinance Services? Some Views,” Asian Development Bank, www.adb.org/Documents/Slideshows/Microfinance/Fernando_paper.pdf.

⁶⁸ Nimal A. Fernando, “Do Governments in Asia Have a Role in Development of Sustainable Microfinance Services? Some Views,” Asian Development Bank, www.adb.org/Documents/Slideshows/Microfinance/Fernando_paper.pdf.

regulated entities to join.”⁶⁹ Microfinance-specific credit information could be tracked by an existing consumer bureau, or through a specialized microfinance bureau. A private sector bureau would be preferable, but the public good aspect of credit assessment provision justifies government involvement if necessary (**Yaron 2003 PP**). The development of credit information about microfinance customers has three main benefits: raises the overall quality of loan portfolios and profitability of MFIs; incents existing financial institutions, e.g. banks, to offer microfinance products; and enables poor borrowers to build a credit history, facilitating their “graduation” to the formal financial sector.

Example: Microcredit bureaus in South Africa (Klapper and Kraus 2002)

South Africa has two private credit bureaus operating in the microfinance sector. The Micro Lenders Credit Bureau collects information from and provides it to microlenders in Western South Africa. “This information can be accessed by touch-tone phone, and the bureau charges much lower fees than larger bureaus—making it affordable even for small microlenders.” Another credit bureau, CompuScan, provides positive and negative information on microcredit customers to microlenders and banks via the Internet. The two bureaus provide additional information such as notification of credit inquiries, new loan burdens, or court judgments. The existence of these two bureaus has increased the size of the microfinance sector, fueled competition, and decreased fees.

B. Create greater transparency about lenders

Rating MFIs is one way to begin bringing market discipline to bear in anticipation of an increasingly commercialized environment. In the near-term, the logic for rating MFIs is similar to that for calculating the subsidy dependence of other state-owned, controlled or funded development finance institutions: “contribute to essential disclosure of basic data imperative to enlighten public debate on how scarce public funds are and should be used.”⁷⁰ Such ratings could also help donors to allocate limited wholesale funds to efficient, sustainable and profit-oriented (if not yet profitable) MFIs. In the longer-term, rating MFIs is aimed at providing the infrastructure necessary to ensure microfinance operates on market principles.

⁶⁹ “**Scaling Up Access to Finance: On the Critical Path to the MDGs: The Roles of Governments, Donors and the Private Sector,**” PowerPoint Presentation, The World Bank.

⁷⁰ Jacob Yaron, “State-Owned Development Finance Institutions (SDFI): Assessing Their Performance,” The World Bank, June 2003.

*Example: MFI rating agencies (Draft Note)*⁷¹

Three examples of independent agencies which rate MFIs are M-CRIL in India, the Credit Unions Rating System in Guatemala, and MicroRate in Latin America. M-CRIL has rated 88 MFIs in Asia, most in India for the purpose of on-lending by the state-owned Small Industry Development Bank of India, but some in other countries in the region as well. The Credit Unions Rating System in Guatemala uses data submitted by member credit unions to generate systematic and objective ratings. MicroRate is a private rating agency that has assessed 29 MFIs in Latin America and the Caribbean.

5. Encourage the establishment and streamlining of registration and titling systems for assets owned by rural and poor urban households (Woller and Woodworth 2001)

The poor have a range of assets—land, housing, crops, businesses/economic activities—that could be used as loan collateral if appropriate legal mechanisms were in place to verify, document and protect ownership. Provision of land title (Hernando de Soto) is the clearest example, but other options include warehouse receipt systems for post-harvest financing, and recognition of businesses operating in the gray market.

*Example: Business licensing in Peru (DRAFT NOTE)*⁷²

In 1990, the Government of Peru decided to make a major effort to facilitate the formalization of large microenterprises and small businesses operating in the informal sector. To do so, they slashed the time required for registration and permitting from 300 days to one day, created a single authority/point of contact for the transactions, and reduced the cost from US\$1,200 to US\$174. More than 670,000 previously informal operations became legal entities between 1991 and 1997. “Having formal legal status greatly enhances the ability of large microenterprises and small businesses to participate actively in the formal economy. Even where microenterprises continue to be serviced by non-bank MFIs, it makes it easier for the MFIs to refinance or rediscount with commercial banks their own loans to legally registered microenterprises.”

2. a-ii Origins of Microfinance

⁷¹ Example drawn from “Draft Note: Scaling Up in Microfinance—Evidence from Global Experience,” The World Bank, December 2002.

⁷² Example drawn from “Draft Note: Scaling Up in Microfinance—Evidence from Global Experience,” The World Bank, December 2002.

Microfinance was originally conceived of as an alternative to both banks which in most developing countries serve only 5-20% of the population,⁷³ and informal and semi-formal sources of finance for the poor such as moneylenders. Microfinance has been defined as “a credit methodology that employs effective collateral substitutes to deliver and recover short-term, working capital loans to microentrepreneurs.”⁷⁴ One of the key characteristics of microfinance is the use of substitutes for traditional collateral, such as joint-liability, access to future loans, more frequent repayment periods, etc.^(Gine 2003). For example, joint liability helps to overcome adverse selection (borrowers know who in their community is a credit risk) and moral hazard (borrowers can monitor each other), and to enforce auditing (by ensuring borrowers are honest in the case of default) and repayment (borrowers can impose social sanctions on defaulters).⁷⁵ These alternatives to collateral are especially important for borrowers who do not have assets to pledge, and for lenders who operate in countries with weak secured lending laws and enforcement.

Microfinance was initially developed by and is today still primarily deployed by non-government organizations (NGOs) who receive donor funds and on-lend to microfinance clients (often at subsidized interest rates). In many cases, governments also play a critical role—setting policy for the microfinance industry (most frequently vis-à-vis interest rates), providing lump sum grants to NGOs or other microfinance institutions (MFIs), or lending directly to the poor. Credit unions, cooperatives, commercial banks, and small informal groups (self help groups—SHGs) are other important players in microfinance.

The model of non market-based microlending has had mixed success—in terms of both financial performance metrics and broader social indicators. Numerous case studies demonstrate high repayment rates through effective screening of borrowers and the use of social capital to enforce repayment (see for example Wenner 1995, Wydick 1999) However, political interference in lending operations reduces recovery rates (**Yaron 2003 PP**). Similarly, researchers disagree over the extent to which access to microcredit impacts borrower welfare (Morduch 1999); for example, several studies in Thailand show little impact of microfinance loans on borrower welfare (Coleman 1999, 2001, Kaboski and Townsend 2003). However, a broad examination by the Consultative Group to Aid the Poorest (CGAP) concludes that microfinance has proven to be an effective poverty reduction strategy. Evidence from multiple programs across multiple regions

⁷³ Joselito Gallardo, Korotoumou Outtara, Bikki Randhawa, and William F. Steel, “Comparative Review of Microfinance Regulatory Framework Issues in Benin, Ghana, and Tanzania,” Africa Region Financial Sector Group, Financial Sector Operations and Policy Department, The World Bank, June 2003.

⁷⁴ “Microfinance Means Financial Services for the Poor,” *Donor Brief No. 11*, CGAP, March 2003.

⁷⁵ M. Ghatak and T. Guinnane, “The Economics of Lending With Joint Liability: Theory and Practice,” *Journal of Development Economics* 60 (1999), 195-228.

demonstrates that access to microfinance benefits the poor: “Microcredit enables borrowers to increase enterprise and household income; achieve higher savings rates; build and diversify their income-generating asset base; and smooth consumption during times of crisis.⁷⁶ Access to financial services also translates into broader social benefits, including improved health (better nutrition, better living conditions and preventive health practices, higher immunization rates); increased educational participation (children of microfinance clients are more likely to go to school, and drop-out rates of these students are lower than average); and greater gender equality (increased confidence and assertiveness, increased participation in household and community decision-making) (Littlefield et. al. 2003).

2. a-iii Current Challenges

By 2001, more than 1,000 microfinance programs around the world had reached approximately 20 million borrowers.⁷⁷ These large absolute numbers still represent a small percentage of the poor worldwide. It is estimated that in Bangladesh, one of the most well-developed microfinance markets, only 18.4% of the poor are reached; at the other end of the spectrum, microfinance services in Brazil are limited to 0.4% of the poor. (Yaron 2003 PP). The critical challenge now is to make microfinance a sustainable and ubiquitous methodology.

“Scaling up” will require increasing the scope (number of individuals reached), impact (effect on the well-being of borrowers), and depth (ability to reach the poorest of the poor) of microfinance. The idea is to make microfinance available not just to the moderate poor at whom it has traditionally been targeted, but also to the extreme poor and the vulnerable non-poor, and to expand the set of microfinancial products offered (CGAP 2003a). “All poor people, not just entrepreneurs, use and need financial services beyond working-capital loans, such as savings, credit, insurance, and money transfer services.”⁷⁸

The emerging consensus is that achieving an order of magnitude change in the scale of microfinance will require deposit mobilization. Continued reliance on donor or government funds is both detrimental and unrealistic. Availability of subsidized funds reduces incentives for MFIs to increase scale and efficiency of services (Morduch 1999). Access to savings—most likely the unmobilized savings of the same population targeted by existing microloans—will be necessary. “[T]he experience of microfinance practitioners in many different settings throughout the

⁷⁶ “The Impact of Microfinance,” *Donor Brief No. 13*, CGAP, July 2003.

⁷⁷ Alkman Granitsas and Deidre Sheehan, “Grassroots Capitalism,” *Far Eastern Economic Review*, 12 July 2001, 39.

⁷⁸ “Microfinance Means Financial Services for the Poor,” *Donor Brief No. 11*, CGAP, March 2003.

developing world underscores the proposition that the future for sustainable microfinance lies in a regulated, licensed environment—because there is no other environment that will permit massive, sustainable delivery of an increasing variety of financial services to the poor to effectively link them to the more developed sectors of an economy.”⁷⁹

While a small number of NGOs have transformed themselves into financial institutions (either full-fledged banks or “Tier 2” specialized banks or non-bank financial institutions (NBFIs)), and a small number of commercial banks have entered the microfinance field, the majority of providers are still MFIs dependent on donor and/or government funding. “MFIs organized as NGOs have the lowest level of leveraging of capital and the lowest percentage of external commercial funds relative to average total loans, because the legal format does not allow NGOs to mobilize voluntary deposits and restricts their ability to access commercial funds in the form of wholesale and institutional deposits or borrowings from commercial banks.”⁸⁰ Transformation into formal, prudentially regulated, deposit-taking institutions enables MFIs to access new funding sources (commercial funds and deposits), offer a broader range of microfinancial products, and achieve greater legitimacy in the financial sector (Rhyne 2002).

Traditionally, banks have shied away from microfinance for a number of reasons. In particular, the high costs of microlending compared to commercial lending, and the absence of credit scoring models have been major factors. In addition, uncollateralized loans are typically classified as risky by regulators, presenting prudential complications for banks. Finally, there may also be political/public relations risks involved if banks charge interest rates high enough to cover the costs of microfinance operations (**Yaron 2003 PP**). However, the entry of existing commercial banks into microfinance in a meaningful way could bring important advantages, including economies of scale; risk management expertise; physical infrastructure and branch networks; and information, administrative and accounting systems—as well as access to commercial funds, and multiple financial products (CGAP 1998). As discussed below, partnerships between banks and MFIs, NGOs, or self-help groups (SHGs) may prove particularly effective at bridging the gap between today’s microcredit practices and a sustainable, commercial future for microfinance.

Between 1992 and March 2003, 39 NGOs in 15 countries transformed into full-fledged banks while roughly another 200 have transitioned into supervised NBFIs (either permanently or

⁷⁹ Joselito Gallardo, “A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines,” Financial Sector Development Department, The World Bank, November 2001.

⁸⁰ Joselito Gallardo, Korotoumou Outtara, Bikki Randhawa, and William F. Steel, “Comparative Review of Microfinance Regulatory Framework Issues in Benin, Ghana, and Tanzania,” Africa Region Financial Sector Group, Financial Sector Operations and Policy Department, The World Bank, June 2003.

as an interim step in becoming a bank) (Kresbach 2003). By 2003, microfinance provision worldwide was split roughly in thirds between NGOs, microfinance divisions of mainstream banks, and local credit unions and cooperatives.⁸¹ The shift has been even more pronounced in Latin America where by 2001 commercial banks provided 29% of microfinance; and NGOs that had transformed themselves into licensed financial institutions along with other specially licensed financial intermediaries, an additional 45% (CGAP 2001).

Example: ProDem/BancoSol (DRAFT NOTE & CGAP 1997)

The transformation in 1992 of ProDem, a microfinance NGO, into BancoSol, the first commercial bank in Latin America dedicated to the provision of microfinance is one of the best known examples of commercialization. “Constrained by the limited availability of donor funding, ProDem’s directors decided to obtain a commercial banking license in order to be able to mobilize funds from the general public.” BancoSol was financially self-sustaining within two years; and by 1998, the most profitable licensed bank in Brazil. More importantly, the transformation enabled significant expansion of microfinance: in 1992, ProDem transferred to the newly-chartered BancoSol 14,300 clients and a loan portfolio of US\$4.0 million with a default rate of 0.2%; after 13 months of commercial operations, BancoSol had 44,000 clients, a loan portfolio of US\$11 million, and a default rate of less than 1%. Within five years, the client base had crossed the 70,000 mark.

2. a-iv Government Involvement in Microfinance

As mentioned above, governments play an active role in microfinance—setting policy for the microfinance industry (most frequently vis-à-vis interest rates), providing lump sum grants to NGOs or other microfinance institutions (MFIs), or lending directly to the poor. Prior to microfinance, governments also supported agricultural banks and promulgated regulations requiring commercial banks to direct a proportion of credit to particular economic sectors.⁸² These efforts failed due, in large part, to low repayment rates, politically-motivated loan write-offs, and capture of subsidized credit by wealthy farmers (Adams et. al. 1984, Besley, 1994, Yaron et. al. 1998). Similarly, government involvement in microfinance may crowd out private sector activity; this is most likely to be the case when government programs charge or mandate

⁸¹ Karen Kresbach, “Doing Good By Doing Well,” *U.S. Banker*, August 2003, 47.

⁸² “Scaling Up Access to Finance: On the Critical Path to the MDGs: The Roles of Governments, Donors and the Private Sector,” PowerPoint Presentation, The World Bank.

below market interest rates which render microfinance unviable for institutions concerned with sustainability, e.g. commercial banks.

Government involvement has had negative effects in many countries. However, there are best practice examples of government microfinance; not surprisingly, these operations tend to be more market-oriented:

Example: Bank for Agriculture and Agriculture Cooperatives (BAAC) (Yaron 1997, Yaron and Townsend 2001)

The BAAC was established in 1966 as a state-owned specialized agricultural credit institution to replace the Bank for Cooperatives which could only lend to cooperatives and suffered from low repayment rates. BAAC, by contrast, lends to farmers, agricultural cooperatives, and farmer associations—and recently began providing non-agricultural loans to farming households (up to 20% of total lending). Dependent for many years on government subsidies, BAAC began to mobilize new funding sources in the mid 1990s. By 1998, savings deposits from the general public and proceeds from bond issues accounted for 60% and 14% of total operating funds respectively.

As microfinance evolves, so too must the nature and degree of government involvement. More specifically, governments can encourage the shift toward sustainable, market-based microfinance through three specific roles: eliminating unfair competition from public institutions; undertaking regulatory reform; and improving the business environment.

UNFAIR COMPETITION

Ideally, governments should exit the microfinance sector. Short of this, they should act to ensure transparency and reinforce market mechanisms by providing for specific line item budgetary disclosure and annual reporting for all government microfinance activities, and lending only at commercial rates (wholesale and retail).

2. a-v Regulatory Reform

Regulation of the microfinance industry to date has followed a rough pattern in which institutions relying on other people's money (e.g. donor-supported NGOs) are legally registered, but not regulated or supervised; institutions leveraging members' money (e.g. credit unions) are overseen by a non-financial cooperatives authority; and institutions mobilizing the general public's money (e.g. banks) are subject to prudential regulation and supervision (van Gruening et

al. 1998). The changing nature of the microfinance industry—namely the move toward deposit mobilization—requires regulatory reform to maintain the prudential integrity of the financial system.

In addition to achieving this objective, regulatory reform should facilitate the scaling up of the microfinance industry and its integration with the formal financial sector. Particular attention should be paid to creating conditions conducive to commercialization of microfinance—MFI transformation and commercial bank “downscaling.” For example, regulatory reform that ensures that high interest rates will be tolerated by politicians, and that regulators will consider the riskiness of loans rather than whether they are collateralized or not would begin to address some of the factors that deter banks from entering the microfinance sector (**Yaron 2003 PP**). Experience supports the assertion that commercialization and regulatory reform can act as catalysts for development of the microfinance sector:

Example: Bolivia (Yaron 2003 PP)

In Bolivia, the transformation of ProDem into BancoSol discussed above was contemporaneous with two major changes in the regulatory environment which marked an inflection point in the development of the local microfinance sector. In 1995, a credit bureau was created, and in 1998, risk-based regulation of MFIs was introduced. Spurred by these developments, outstanding loans of all microfinance providers in Bolivia grew from less than \$10 million to almost \$300 million at the end of 2002.

Regulatory reform related to the microfinance sector should follow the fundamental tenant of prudential regulation: “deposit-taking institutions should be regulated and their supervision should be risk-based; non deposit-taking microfinance institutions should be disciplined by market-based transparency.”⁸³ In other words, “[i]t is the activities on the *liability* side of the balance sheet that trigger the need for registration, regulation, and/or supervision of the institution.”⁸⁴

Example: West Africa Monetary Union (Union Monétaire de l’Ouest Afrique) (Gallardo et. al. 2003)

The PARMEC Law (Projet d’Appui à la Réglementation sur les Mutuelles d’Epargne et

⁸³ “Scaling Up Access to Finance: On the Critical Path to the MDGs: The Roles of Governments, Donors and the Private Sector,” PowerPoint Presentation, The World Bank.

⁸⁴ Patrick Meagher, “Microfinance Regulation in Developing Countries: A Comparative Review of Current Practice,” IRIS Center, University of Maryland, October 2002.

de Crédit, Project to Assist the Regulation of Savings and Credit Cooperatives) passed in 1993 illustrates a situation in which prudential regulation was inappropriately applied, thus overburdening supervisory capacity. Under this law, financial intermediation can only be carried out by licensed banks, NBFIs, and cooperative financial institutions (CFIs). Not only does the law exclude small and informal institutions, including NGOs, from performing microfinance intermediation (exceptions under a five year convention-cadre agreement signed with member countries' Ministries of Finance), but it also subjects CFIs to far more stringent prudential regulation and supervision, and places this burden on ill-prepared member countries' Ministries of Finance.

2. b Risk Management Tools - Legal Framework for Alternative Instruments :Weather Insurance, Warehouse Receipts etc.

2. b-i Policy Points

- Fostering various financial market and product innovations to reduce default risk and improve the financial security of poor rural clients. This would require establishing an enabling legal and regulatory framework for a micro commodities futures market, development of micro life and health insurance products, weather index insurance, a warehouse receipt system, etc
- Warehouse receipts must:
 - Specify quality and quantity of stored goods. It should specifically grade the goods according to standardized ratings, which would indicate the market price.
 - The rights, liabilities and duties of each party i.e. the banks, producer and warehouse, must be defined
 - Receipts must be transferable by delivery and endorsement
 - Holders of receipts should have access to stored goods if the warehouse defaults or the business is liquidated.
 - Before making loans, lender should be able to ascertain if there is a competing claim on the receipt.

- Improving the legal framework for loan recovery and collateral, thereby reducing default risk.
 - Land titling and registration systems should also be strengthened, to facilitate use of land as collateral.
 - The possibility of introducing new forms of more liquid collateral could be explored.

2. b-ii Overview⁸⁵

In many developing countries, government interventions in commodity markets has resulted in a misallocation of credit. However, with opening up of markets, instruments such as weather insurance and warehouse receipts are becoming a popular way to reduce bank risk and improve access to finance. They also provide a much more efficient alternative to direct government intervention, through support prices and subsidized credit schemes.

One of the main sources of default risk of farmers, is a fall in commodity prices below production cost levels. Efficient price discovery—through the development of a commodities futures market—could help address this problem. Credible national commodity prices are essential for efficient agricultural lending, since they can reduce the risk of default by marginal and small farmers, and hence improve the terms on which they can access finance. Commodity price risk options would also allow better portfolio supervision and risk management by the banks. Market-based tools to insure against commodity price volatility (e.g. futures and options) already exist and are widely used in high-income countries, but they are not prevalent in most developing countries due to several reasons: First, the minimum size of contracts traded on organized exchanges far exceeds the annual value of production of individual small- and medium-sized producers. Second, small producers, as well as many market intermediaries in developing countries, lack knowledge of such market-based price insurance instruments and an understanding of how to use them. Third, the sellers of such instruments, generally international trading firms, are often unwilling to engage with a new and

⁸⁵ This section closely follows Hess and Klapper (2003)

unfamiliar customer base of small-scale producers, characterized by high transaction costs, credit issues, and performance risk (Hess and Klapper 2003).

Weather insurance and warehouse receipts are some of the financial products that have recently been introduced in some developing countries as risk management tools. Weather index insurance can be a good way for farmers to hedge businesses against imponderable weather risks and can be a cheaper substitute for crop insurance. The insurance is index-based and, therefore transparent, and free of moral-hazard and adverse selection, which makes the product cheaper. In addition, insurance payouts are timely and immediate. Weather index based insurance is settled on the basis of weather parameters such as cumulative rainfall during a certain period rather than individual loss adjustments. Since 1996, an international market for weather risk has emerged, and the total market transaction volume reached US\$12 billion in 2001. These weather markets were originally driven by weather hedges for the energy sector in the US, but have since expanded into other areas, applications, and sectors. Weather index insurance is now in place in the US and Canada, has been implemented in Argentina for a few years, and weather derivatives have been written for agricultural risk in Mexico and South Africa. Morocco plans to sell weather index insurance to farmers in 2003 (Hess and Klapper 2003). The World Bank is currently involved in the first ever sale of weather insurance policies to farmers in a developing country in Maboobnagar, AP, India (see example).

In order to encourage price insurance and discovery products, it is essential to strengthen the legal and regulatory framework. Financial sector laws and regulations in many countries, not only contribute to institutional and market inefficiency, they also tend to stifle market and product innovations (e.g., better commodity price discovery mechanisms, various types of micro insurance for risks related to life, health, commodity price fluctuations, weather, etc.) that could potentially help reduce default risk and strengthen the financial security of the rural poor. In order to support development of a commodities futures market, governments must develop strong forward market regulations. Banks should be allowed to trade derivatives as long as speculation and exposure to price movements are limited and well supervised. Appropriate supervision would need to be put in place to curtail the speculative use of these instruments and limit

exposure to more sophisticated structures with margin requirements. The supervisors would need to distinguish between simple straightforward hedging instruments, such as “put” options and futures, and more complicated and hard to track swaps, “collars”, “swaptions”. etc.⁸⁶ Authorities would also need to consider facilitating commodity producers’ and traders’ access to price insurance and price derivative instruments. In India, at present, the regulatory framework for forward markets seems to conflict with the rapidly liberalizing futures market regulations. One aspect of this conflict is the interpretation of section 8 of the banking law. Currently, the law does not allow a bank to buy commodity price derivatives, even if the bank does not take any exposure by retailing the derivative as price insurance to commodity producers.

2. b-iii Weather Insurance ⁸⁷

One of the factors contributing to the scarcity of credit in rural areas is the inability to secure loans with collateral. While land tenure constraints have been a major constraint in this regard, the lack of insurance opportunities available to potential borrowers has also limited access to credit by agricultural borrowers. If crops fail, the repayment capacity of borrowers may be uncertain. This makes lenders reluctant to extend credit to farmers. When insurance markets are working, borrowers can use private insurance as a risk mitigation alternative. For agricultural borrowers this insurance normally takes the form of “business interruption insurance” and primarily involves crop or weather insurance. Traditional multiple-peril crop insurance that indemnifies the individual farm loss is not likely to be a workable solution in the short term. Such insurance is subject to high administrative cost if it is to be free of adverse selection and moral hazard. And if investments are not made in monitoring and information on farm yields, the insurance will likely experience higher losses than the initial rating. This will result in serious actuarial problems. Further, since there are large correlated risk involved in multiple-peril crop insurance (i.e., drought, excess rain, and freeze), there is an extra cost of providing reinsurance. In short, there are two major added costs to traditional crop insurance: 1) administrative costs and 2) reinsurance costs. These extra costs can be quite high in an emerging economy with little or no

⁸⁶ In the case of weather insurance, there may be additional need to (i) ensure that those who would like to pilot this instrument are provided full access to historical and current weather data (which does seem to exist, but is not readily available at present); (ii) make available this data online (on the basis of specific agreements);

⁸⁷ This section closely follows Hess and Klapper (2003)

experience in providing multiple-peril crop insurance. One form of agricultural insurance that mitigates these costs is weather insurance. The monitoring costs of weather insurance should be less as there is no need to perform farm-level loss adjustments and the balance of information about the weather is equally shared by the insured and the insurer (unlike with traditional farm-level insurance where the farmer will always know more about the yield than the insurer). Further, the reinsurer is more likely to provide better terms when the insurance is based upon weather events and not farm-level losses. Thus, weather insurance could be a preferred alternative to crop insurance, as it avoids moral hazard problems. Payout is determined by an objective parameter. The combination of a series of weather-related metrics (e.g., mm of rain, soil moisture, etc).

Weather index insurance may be well suited to agricultural production in countries where there are wide spread crop losses, especially due to drought. Such insurance would cover the major correlated risk while avoiding many of the problems associated with farm-level crop insurance (Skees, Hazel, and Miranda, 1999). While weather index insurance is simpler than offering multiple-peril insurance, there are a number of preconditions for offering such insurance: 1) the historic weather data must be easily obtainable and reliable; 2) a sound infrastructure for providing secure and reliable weather data in a timely fashion must be in place; 3) local providers of such insurance must have ready access to international capital markets; and 4) there should be a strong relationship between economic loss and well-defined weather events (limited basis risk 2).

Example: Weather Insurance India (World Bank 2003)

In India, a key factor driving up the costs of rural finance associated with default risk relates to collateral problems. Most of India's rural inhabitants have no fixed collateral or only small plots of land that most often cannot be mortgaged. Identification of alternative collateral is costly and cumbersome. A pilot program for weather insurance was launched in July 2003, jointly by the World Bank, IFC and Indian insurer ICICI Lombard. Basix. Basix, which is one of the largest microfinance institution with almost 10,000 borrowers, sold 250 policies to groundnut and castor farmers in Andhra Pradesh. The scheme was launched through Basix's KSB Bank (Krishna Bhima Samruddi Local Area Bank) in Mahabubnagar, a region of Andhra Pradesh that has suffered from consecutive droughts in the past three years. KSB was eager to offer rainfall insurance as it can help mitigate their risk of lending in drought prone areas. Furthermore, other possibilities of loan diversification are low as local area banks in India are limited to operating in three adjacent districts.

250 policies were sold to a range of small, medium and large groundnut and castor farmers. Initially only farmers who were not protected under the governments crop insurance plan have been offered these policies. The plan of course is to expand the distribution. A weighted and capped rainfall index was used, where maximum rainfall is capped at 200mm and periods that are more important for growth of crops are weighted more heavily. The farmers who had bought the policy were aware of the system of index and valued the assurance of quick payout.

2. b-iv Warehouse Receipts⁸⁸

Another means of reducing the default risk in rural finance and promoting private credit, is through establishing warehouse receipt systems. Warehouse receipts have had a long history in the developed world, but have only recently been introduced in developing countries. These receipts backed by crops stored in a warehouse, serve as collateral for post-harvest financing. The basic idea is as follows: The warehouses store the produce for a fee and delivers a receipt to the farmer, and the receipt becomes immediately enforceable (similar to checks). The receipts can then be traded, sold, swapped or used for delivery against a derivative instrument. In this way, it not only serves to improve efficiency of the agricultural markets, its improves farm income and increases access to bank credit. It can be combined with price hedging instruments to

⁸⁸ This section closely follows Hess and Klapper (2003).

predetermine the cost of future purchases of sales. Finally it can provide a way to reduce the role of government in agricultural commercialization.

Certain preconditions must be met for the warehouse receipt system to work effectively. Firstly, it requires a viable storage industry that maintains farmers incentives for private storage. Government intervention in the form of fixed prices, can crowd out privately participation as farmers stand to lose by storing their crops when fixed prices are being offered. Secondly, receipts need to be recognized as legal instruments. Therefore the effectiveness of these instruments will require reform of legal and judicial systems for securitizing assets and enforcement of contracts. The grades and quality standards of the commodities would need to be defined centrally. Holders of receipts must also have the right to receive stored goods or their fungible equivalent in case of default. Thirdly, performance guarantees must be provided as a form of insurance that good exist in specified quantity and quality. Otherwise farmers will be unwilling to store their crops and banks will be reluctant to accept the receipts as collateral. Lastly, warehouse operation standards would need to be developed and effective supervision established. Operators and supervisors should inspect stored warehouse commodities to ensure warehouses are financially viable and able to maintain quality standard. Otherwise warehouse receipts will not be credible and not be considered as reliable liquid assets.

In the U.S. warehouse receipts have been used for four functions:

- As a collateral for 9 month loan programs (that ease cash flow constraints for framers), supported by the U.S. Department of Agriculture.
- To document grain inventory for government owned grain.
- To convert crops into an acceptable form of collateral, if they are held with grain milling companies.
- As a delivery document that is accepted for trading on futures exchange or against letters of credit in payment for exports.

Many Latin American countries have licensed warehouses that issue endorsable receipts. These are used by producers to obtain finance based on the amount of produce that have deposited in the warehouse. The low return from storage due to government policies, high real interest rates and weak collateral laws, liquidation procedures, property rights and uniform grades have been obstacles to their use in many countries. The Turkish Soils product office also initiated the scheme in 1993, where it accepts grain delivered by farmers and issues receipts in place. However, there were uncertainties regarding quality of crop and low returns from storage, which have rendered the system ineffective. Many of these failures also highlight the need to meet preconditions identified above. Ghana is a case in point where the system have proved to be

successful (see example). Similarly, many transition economies such as Hungary, Bulgaria, Poland, Kazakhstan have effective warehouse systems. In South Africa warehouse receipts are part of SAFEX, their successful commodity futures exchange (Varangis and Larson 1996). Experience has been that loan rates on warehouse receipts issued loans are 2-3% lower and default rate is 1% lower than other loans (Acdivoca 2003). Therefore, the programs reduce the burden on government to intervene in agriculture markets.

Example : India (Damodaran 2002, Varangis and Larson 1996)

India has also developed legislation and regulation for warehouse receipt systems. However government intervention in setting prices, lack of standardization of commodity ratings across regions and the incidence of corruption have limited the need for inventory based credit systems. There is no accreditation agency for private warehouses, so banks are reluctant when the receipts do not confer any legal recourse on the underlying goods. Banks have also been unwilling to accept the warehouse receipts especially if the holder is not the person to whom the receipt was originally issued. Banks accept transferred receipts when pledged loans of the original receipt holders have been cleared. Reforms are underway for legislations that ensure free transferability of warehouse receipts by endorsement. This would allow warehouse receipts holders to have right over delivery of grain on same terms and conditions as the original holder.

Example: Ghana (Coulter and Shepard 95, Giovannucci, Varangis, Larson 99, Technoserve 98)

In Ghana, a joint initiative by the NGO, TechnoServe and Department of Co-operatives and the Agricultural Development Bank (ADB) has served to encourage small-scale farmers to use warehouse receipts. Despite the dominant position of the local marketing board, the initiative has proved to be successful and a private bank and trading firm have also entered the business. Loans are provided to members who store their grain, at 75-80% of the current market price of the commodity. The grain is stored in cooperatively owned warehouses. The scheme has been concentrated in the Brong-Ahafo area of Ghana, where major proportion of agricultural surplus is produced. The region is also subject to high annual price fluctuations. The program has been highly beneficial for participating farmers. Between 1992 and 1996, farmers were able to increase the profits on the sale of their grain by 94% per year, by waiting to sell at higher prices and despite high interest rates of 42% that were being charged on short-term loans. By 1998, nearly 130 farmers were being assisted, whose loan repayments stood at 100%. Other benefits from this

program have included: increased food production, better food security for farmers who previously had to sell their crops at lower prices and high rural investment.

Example: Poland (UNCTAD 2001)

In 1995, the Warsaw Commodity Exchange was established as a joint stock company. The exchange was privatized in September 2000, when the controlling shareholders: Foundation for Establishment of Feedstuff and Grain Exchange sold its shares to private investors. The exchange organizes a spot market for agricultural commodities and a derivatives market for commodities and non-equity financial instruments. Options contracts have been traded since 1997, while the first futures contract were introduced in January 1999. Options are only traded on the agricultural commodities market and are issued in a series of intermittent periods. Futures contracts are trading on a continuous basis. The exchange also uses warehouses as a delivery point for spot options and futures contracts. Although most warehouses in Poland are privately owned enterprises, those warehouses which receive a license from a government agency will get status of a public warehouse. Therefore, they are legally allowed to issue warehouse receipts which can be used as a credit collateral instrument. These activities are regulated under the Law of Commodity Exchange, which was approved in 2000. Under the law, the commodity exchange is to be regulated by Polish Securities and Exchange Commission (KPWiG).

Example: Brazil (Kumar 2003)

CPR (Cédula De Productio Rural) is a title created to serve as an instrument for agriculture financing. The CPR is an obligation for the producer to deliver a specified quantity and quality of the agriculture produce on a given date. It can be issued by the rural producer, associations or cooperatives. This program was initiated in 1994, partly as a result of decline in rural finance and once these instruments were recognized by the entire financial system. The system depends on a performance bond that ensures delivery and a clearinghouse for liquidation of contracts. The use of CPR as a forward contract (and also for hedging) that provides additional liquidity has been recognized under the law in August 1994. It has been a much more effective alternative to the traditional barter system, that gained popularity when agriculture credit was declining. However, most of the transactions are handled outside the formal agricultural credit system. The agro-industry which has much better information on producers and access to financial markets, has become an important supplier of credit using this mechanism. Between 1995 and 2000, the cumulative value of CPRs sold is nearly R 5 billion. An important reason for the growth in CPRs has been its recognition as a self-executable legal instrument. Plans are underway for the BM&F

to introduce secondary market trading of CPRs. Guarantees for CPRs are given almost exclusively by Banco do Brasil, although some other banks are considering entering the market.

2. b-v Microloan Securitization

The creation of secondary credit markets, through the securitization of microfinance loans, may help lower interest rates charged to the rural poor. Even better microfinance institutions (MFIs) face severe capital constraints and are over-leveraged, and, therefore, are not allowed to take on more debt. If MF loans are transferred off the balance sheet of the MFI, it would not only help improve the leverage ratio, but would help create a new asset class for which there is demand among the more liquid investors. It can also help reduce fiscal costs for government refinancing schemes. While this may be possible for the larger MFIs on which credit ratings are available, scaling up would pose a serious challenge, given the paucity of reliable, independent information on the bulk of the MFIs and their loan portfolios. Most MFIs have been in operation for less than 5 years, which also prevents access to extensive long-term data for an accurate risk assessment. Furthermore, microloans are too non-standard offering a variety of interest rates, maturity structures, third-party guarantees and repayment options, which compounds the problem. Another constraint is the fact that most microloans are not collateral backed instead depending on personal relationship and peer monitoring to ensure repayment. Also, the small size of most microloans prevents cost-effective securitization. Government would need to put in place the necessary policy/regulatory framework to allow the development of these secondary credit markets (Aide Memoire 2003). Efforts are underway however, to put microloan securitization concepts into practice. In the US, Accion International a microcredit organization has begun to securitize its loans since 1997 (see example). Amongst emerging markets, India is one of the few that has begun to tap into the microloan securitization market.

Example : United States - Accion International (Communities and Banking 1998)

Accion International is a Massachusetts based global microcredit organization which has equity stakes in MFIs across the world. In June 1997, Accion New York sold 64 microloans worth \$272,000 in a private placement with Community Reinvestment Fund - CRF (since then the CRF has also entered into an agreement to purchase microloans from 5 MFIs in the state of Montana). Accion used proceeds from the sale to retire bank debt, which has improved its liquidity position. The organization has also received a grant from the Ford Foundation to create a wider involvement in microloan securitization.

Example: India – ICICI Bank (Microfinance Gateway 2003)

ICICI Bank is India's second largest bank, which has recently introduced innovative modes of financing the rural poor. In one of its earlier models on financing MFIs, ICICI Bank was providing credit to the NGO or MFI for on-lending to retail client base. However, due to undercapitalization of MFIs, this approach had to be abandoned. Currently, ICICI has introduced use of microloan securitization which will enable it to scale up operations of MFI, expand availability of funds and lower costs of funds for rural poor. The new approach involves buying out MFI portfolios and on-tap securitization, which is basically securitization on an on-going basis. It also works on a partnership model, as a loan service agent. These programs has served to provide MFIs access to loan funds as well as mezzanine capital. They will alleviate credit constraints for MFIs and allow them to increase outreach without being hindered by lack of resources. It will separate credit risk of the portfolio from credit risk of MFI, thus lowering MFI costs at which funds are provided. Furthermore, it will also provide collection incentives and provide triggers if case of poor portfolio performance. Since the new structure has only been recently introduced, its impact can only be evaluated after a sufficient period of time has elapsed.

2. b-vi Microloan Innovations

In order to support innovation and facilitate and accelerate adaptation of innovation, governments must create an enabling policy environment to support other models of microfinance (e.g., the Grameen replicator model). For example in India, high minimum capital requirements, prevent self-funded schemes. Institutions are restricted from mobilizing member savings (unless they transform into coop banks or non-bank financial corporations, for which minimum capital requirements are high). Such legal impediments to new innovations in microfinance must be overcome.

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IV-3 Promote Private Bank Ownership

3 a-i Policy Points

The policy implication from these results is the need to privatize state-owned banks or reduce their market share through other means. Policies that promote private banks (by reducing market share of state banks, privatizing state banks and allowing foreign banks to enter) in developing countries are likely to have favorable economic consequences. Perotti (2003) argues that both the state and private agents face incentive and commitment problems, due to incomplete contracts and legislation. However, the state being a sovereign institution faces a greater problem in committing to a specific action. Therefore, the state should be constrained by private ownership, which in turn is regulated by an effective regulatory authority.

- In 1999, nearly 25% of developing countries had banks with state ownership higher than 30% compared to 2 countries in the developed world (Clarke, Cull and Shirley 2003).
- Privatization has also varied across regions. Between 1999 and 2002, the highest reduction in state-ownership was in Africa, although Eastern Europe and Central Asia witnessed sharp reductions in an earlier decade . Surprisingly, there has in fact been a small increase in state ownership in South Asia and Middle East and North Africa countries, partly as a result of state intervention to rescue some distressed banks (Clarke, Cull and Shirley 2003)
- Encourage sale of state-owned banks as even if the process is costly, it is associated with substantial benefits and encourage sale to foreign banks, especially when there is concern over concentration of ownership in banks and concerns over regulatory apparatus.
- Importance of political environment for effective privatization. Clarke and Cull (2001) find fiscal burden, weak political influence and patronage to speed up privatization. If state banks are large, with greater stakes for political forces, the process may be can considerably delayed.
- Proceed cautiously with privatization, as speedy privatization does not necessary ensure success and may bring on a financial crisis. This is evident from the experiences of Chile and Mexico
- Strong regulatory environment prior to privatization
- When regulatory environment is weak – countries must more careful, as the process can be subject to regulatory capture, through corruption by insiders.

- In countries where institutions are weak, privatization should be accompanied with strengthening of institutional foundations (Nellis 2003). This involves establishing property rights, enforcing contracts, fair regulation, open entry and controlling market abuse to avoid state capture (Perotti 2003).

IV-3-a-ii Overview

In 1995, the world average of state-owned banks was 41.6 % in 1995. In 1970 it was even higher at 58.9 %, indicating that privatization has reduced state ownership (LLS 2002). However, even now, state-owned banks continue to have a pervasive influence in developing countries. In 1999, nearly 25% of developing countries had banks with state ownership higher than 30% compared to 2 countries in the developed world (Clarke, Cull and Shirley 2003). However, the extent of their penetration may also vary within developing countries. For instance state-owned banks have almost 52% of total assets in Brazil, but in Chile the proportion is only 32 % (Barth, Caprio and Levine 2001). Similarly, Jordan has no government ownership, while in Egypt state-owned banks hold over two-thirds of sector assets. However, in terms of regional distribution, the highest share of banking assets controlled by the state are in South Asia, following by transition countries, Africa, Latin America, East Asia, Middle East region and then OECD countries (Clarke, Cull and Shirley 2003) Privatization has also varied across regions. Between 1999 and 2002, the highest reduction in state-ownership was in Africa, although Eastern Europe and Central Asia witnessed sharp reductions in an earlier decade . Surprisingly, there has in fact been a small increase in state ownership in South Asia and Middle East and North Africa countries, partly as a result of state intervention to rescue some distressed banks (Clarke, Cull and Shirley 2003)

State-owned banks usually function with a stated policy agenda to develop a specific industry, sector or region, and they often make loans at subsidized rates. Proponents of the Gerchenkron (1962) view argue that state-ownership is beneficial and the government can better allocate capital to productive investments. State ownership may arise because of difficulty to regulate decisions of private owners, unless the state has direct control (Hart et. al. 1997, Shleifer and Vishny 1994). For instance in the case of banks, state-ownership may avoid moral hazard associated with deposit insurance and prevent banks from taking advantage of depositor (Perotti year). In project finance loans where investors and creditors are usually large multilaterals, publicly owned banks may substitute for an inefficient legal system, when resorting to the judiciary is typically the ‘last possible option’ (Pinheiro and Cabral, 1999).

However, most empirical research suggests negative consequences of large state-ownership, such as reduced overall access to financing, reduced competition, bad allocation of credit, increased likelihood of financial crises or diminished financial system development (e.g., Barth, Caprio and Levine 1999, Clarke and Cull 2002, La Porta, Lopez-de-Silanes, and Shleifer 2002). State banks are frequently associated with weak governance, problems of corruption state authorities, lack of aggressive collection procedures that encourage a poor credit culture or channeling of resources for political purposes are commonly identified (Sapienza 2003). This displaced incentive structure for political agents, frequently motivated by concerns of political future, explains poor performance of state banks.

IV 3 a iii Examples of Successful and Not-so Successful Privatizations

The above evidence reaffirms the need to sell state banks and limit problems associated with political and regulatory capture. Empirical evidence on performance of privatized banks also report privatized firms to be more efficient than similar public enterprises (Lopez-de-Silanes 1997, Mueller 1989, Vining and Boardman 1992) and that firms become more efficient after privatization (La Porta and Lopez-de-Silanes 1997, Megginson, Nash and Van Randenborgh 1994, World Bank 1995). Experience of countries that have undertaken privatization of their banking sector, also highlights costs associated with bank privatization. The success of privatizations does not merely depend on transfer or shift of ownership. The political and institutional environment strongly influences performance of banks post-privatization. Privatization can fail in poor institutional environments and where proper regulatory control cannot be established to monitor incentives of private agents. Dispersed ownership, entrenchment of interest, weak supervision, lack of competitive pressure are some factors that can weaken performance of privatized firms (Clarke and Cull 2003). Furthermore, political incentives that lead to privatization can affect privatization agreements. In Central and Eastern Europe, the persistence of insider control affected the poor performance of these firms post-privatization (Carlin and Landesman 1997, Pohl et. al. 1997, Frydman et. al. 1999, Jones and Mygind 1999). In Chile in late 1970s, attempts at privatization of banks were unsuccessful due to poor regulatory environment and enforcement, that allowed banks to be acquired by large conglomerates, which were then used to lend to these industrial groups on soft terms (World Bank 1989, Stallings and Brock 1993). Similarly, in Mexico in the 1980s the privatization process was captured by political forces. The state banks were grossly undervalued and sold on highly leveraged terms. The purchase payments were at times paid by loans from the banks themselves. The use of bank

resources for private purposes i.e. ‘looting’ eventually led to the Tequila Crisis. In both cases, many of these banks were forced to be renationalized (World Bank 2001, Perotti 2003). The Czech republic faced problems in design of privatization scheme, that allowed government to retain controlling interest in the banks (see example). Unlike these countries, privatization of banks in Argentina was largely successful, as prior to privatization the government undertook measures to improve regulatory environment (Clarke and Cull 1999). Governments only turn to privatization after long delays and are usually politically unacceptable. For instance, in Africa, the results from privatization were disappointing due to entrenched political interests that failed to create a conducive environment for privatization. Political forces continued to delay privatization, although state banks suffered from mismanagement and bad credit allocation.

Example: The Czech Republic : Privatization of Banking Sector (Bonin and Wachtel 2002)

Foreign investors, currently, hold 56 % of assets in the banking system, controlling the three largest banks in Czech Republic. Privatization of the banking sector took place between 1999 and 2001, after an initially unsuccessful history of voucher privatization banks. Prior to that, a state banking system apparatus existed which provided payments services and directed credits to state-owned enterprises according to guidelines set by economic planners. Credit evaluation and risk management did not play any role in the banking system. The first round of privatization was undertaken in early 1990s through voucher schemes. Three of the largest four banks participated in the mass privatization plan. However, financial distress of the corporates which were unable to service their loans, led to deterioration of the banks’ balance sheets. These banks were only rescued by government capitalization, which put them back into government control by late 1990s. These early experiences with privatization were unsuccessful due to features of scheme. The vouchers did not transfer control away from the government, as only a minority stake was allocated for transfer by the vouchers. Furthermore, ownership was also transferred through investment funds that were owned by the banks themselves. The indirect ownership of companies by bank controlled investment funds, strengthened the ties between banks and their clients. Consequently, credit continued to be directed at cheaper terms to favored clients, which had deteriorating performance. The weakening of clients resulted in financial distress for the newly privatized banks.

In 1997, the government sought to turn around its failed privatization plan, by re-privatizing the largest state-owned banks. Progress was initially slow, as the government and owners were unwilling to accept foreign ownership and bank management resisted change. The

first bank privatization, sold to foreign investors, was also unsuccessful, as the bank went into receivership two years later. Although lack of transparency made it difficult to attract foreign buyers, who were unwilling to acquire a stake in these banks, subsequently, the other three largest Czech Banks were successfully privatized (to foreign owners) between 1999 and 2001. For instance, Komerční Banka (KB), the largest Czech bank, was firmly under government control, after the voucher privatization. In 1995, it held 33 % of stake in the firm. Attempts by the CEO to sell the bank to a foreign investor, led to his removal, while the government continued to recapitalize the failing bank in the late 90s. However in 1999 and 2000, following a change in management, the bank was restructured and Societe Generale took over a 61 % stake in 2001.

Example: Argentina – Privatization of Banking Sector (Clarke and Cull 1999a)

In early 90s at least one of Argentina's 27 banks was owned by each of its 20 provinces, and was suffering from nonperforming loans (NPLs), inefficiency and weak portfolios. After the Convertibility Plan, cheap access to funds for provincial bank was virtually finished. The Tequila Crisis, further constrained financing for provincial banks. This reduction in access to finance, prompted the decision to privatize. By end of 1997, half of the banks had been sold and by 2000, it rose to two-thirds of the banks (Clarke and Cull 1999b).

There are two important lessons that are drawn from the experience of bank privatization in Argentina. Firstly, privatization is an important policy prescription to overcome problems caused by state-owned banks that misallocate funds and need recapitalize themselves to sustain operations. A study of privatized and public banks in Argentina finds allocation of credit by state-owned banks was poor in comparison with privatized banks and credit allocation improved as a result of privatization (Clarke and Cull 1999b). Before privatization, state banks were struggling to deal with their NPL. However as part of the sale agreement, NPL in privatized banks were essentially removed. Although NPLs rose post-privatization, they were only at levels comparable with other private banks (World Bank 2001). In terms of performance and profitability, between 1993 and 1996, the ratio of operating income to administrative costs for public banks was 0.77. A typical privatized bank generated 1.41 in income compared to a private bank that generated 1.44 in income for every peso spent on costs (World Bank 2001). Allocation of loans of privatized banks also began to resemble that of other private banks. Therefore, performance of privatized banks was much stronger than state banks, but similar to private banks.

The second important policy lesson relates to importance of sound policies for the success of privatization. Creation of the Fondo Fiduciario, a partly government owned fund (created in collaboration with the World Bank) that extended loans to provinces that privatized banks, made privatizations more politically acceptable and feasible. This is due to the fact that the provinces used loans to pay off their existing obligations, converting short-term obligations of banks into long term. The Fondo also laid down a condition that it would begin to extend loans only after a few strong banks were sold. In addition creation of sound regulation and supervision aided development of an independent banking system. In the 1990s Argentina raised capital adequacy requirements, stricter loan classification requirements, stronger limits on diversification of banks, limits on lending to single affiliate and strengthened supervision through Superintendency of Banking. Banks also had strict disclosure requirements and 20 percent liquidity requirements. In such a strong environment, the decision to privatize was made with greater confidence. It also played an important role in supporting strong performance of privatized banks. Therefore, privatization can only be successful if it is accompanied by regulatory reform.

3. a-iv State-owned banks and SMEs

A strong small and medium enterprises (SME) sector can contribute to economic growth through enhanced entrepreneurship and risk-taking, increased private ownership of businesses, high productivity of firms and increased competition that reduces market power of entrenched firms (Berger, Hasan and Klapper forthcoming). Greater financing opportunities through increased flow of credit to SMEs, can help build a healthy SME sector. Some studies show that state-owned banks in very underdeveloped financial systems direct credit towards small and micro enterprises that would not have received credit otherwise, but the proportion of non-performing loans at many of these institutions are very high (Hanson 2002). A study on relationship between SME growth and bank lending by type of banks for 21 developed and 28 developing countries, shows larger shares of state-owned banks are associated with worse economic performance in terms of GDP growth, growth of SMEs and overall banking sector credit extension (Berger, Hasan and Klapper forthcoming). A possible explanation is that state-owned banks therefore lend less to SMEs, while most credit is targeted towards politically connected firms. Another study however, finds weak macroeconomic effects of SMEs in terms of economic development and poverty alleviation. Although most strong economies have a vibrant

SME sector, the study does not support claims that SMEs can lead to economic growth (Beck, Demirguc-Kunt and Levine 2003). Therefore, even if state-owned lending does reach targeted SMEs, there may not be a clear benefit in terms of economic growth and reduction in poverty. The main policy implication of these empirical findings is that subsidized credit to SMEs is ineffective. Instead policymakers must focus on developing a competitive business climate, with enforces property rights and ensures a competitive environment.

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3 b. Promote Competitive Bank Services

3. b-i Policy Guidelines

The rapid changes in financial services industry, including removal of barriers between financial products, greater commercial presence and financial integration, have made empirical analysis of competition more complicated. Current research casts doubts on the link between concentration and competition, as it does not find the expected negative relationship. In contrast, some authors find concentrated banking systems contribute to greater financial stability (Beck, Demirguc-Kunt and Levine 2003b) and are positively related with competition (Claessens and Laeven 2004)⁸⁹. Therefore, the most surprising result from this research is that contestability of markets are unrelated or moves in opposite direction to its structure. Traditionally policymakers have concentrated on altering market structure and reducing competitive forces. However this research points out the need to concentrate on improving the wider competition policy, rather than trying to alter the market structure by affecting distribution of banks. Furthermore, the importance of a strong institutional environment cannot be neglected, as problems in competition policy are exacerbated if there are weak institutional arrangements.

- Over the 1990s, a trend of financial liberalization was followed by a transformation in the banking sectors of emerging market countries around the world. In general, assets at foreign owned banks increased and assets at state-owned banks decreased. For example, in Hungary the percentage of foreign banking assets increased from 20% in 1994 to 62% in 1998 and in Chile from 18% in 1994 to 32% in 1998 (Clarke, et al., 2003). In comparison, in Hungary the percentage of state banking assets decreased from 100% in 1970 to 36.56% in 1995 and in Chile from 91.49% in 1970 to 19.72% in 1995 (La Porta, et al., 2002).
- There are obvious benefits from greater competition i.e. access to credit, lower interest margins, greater access for SMEs, greater banking sector stability. – therefore regulatory restrictions that impede competition must be avoided.
- Focus on improving competition policy (including entry restrictions etc and licensing policies) rather than concentration of banks.
- While regulators cannot influence concentration ratios, they can affect overall institutional and regulatory environment, that can positively influence access to credit etc.

⁸⁹ Claessens and Laeven (2004) also find competition to be negatively related to number of banks in a country.

3. b-ii Benefits of Competitive Banking Services

Effects of banking sector concentration and competition credit availability and economy wide growth, have been the subject of recent analysis. The most recent studies focus on the effects of bank competition on fragility of the banking system, interest margins and access to finance. These studies differ from earlier work as they are international in their scope, covering both developing and developed countries. In addition, most earlier studies have used bank concentration as a measure of competition in banking system. However recent work recognizes the need to incorporate other elements affecting competition such as regulatory and entry restrictions and other impediments to bank competition.

On the question of competition and banking crises there is mixed evidence. One set of research supports the view that concentrated and hence more diversified banks promote stability (Allen and Gale, 2000) and a banking crisis is more likely under competition (Boyd, De Nicolo and Smith, 2004)⁹⁰, while the contrasting view predicts concentrated banks to be more prone towards failure as they take on greater risk believing they are protected by a ‘too big to fail’ policy (Boyd and Runkle, 1993 and Mishkin, 1999). Beck, Demirguc-Kunt and Levine (2003a) empirically examine bank competition in the context of banking crises during the 1980s and 1990s for a cross country dataset. Their evidence supports damaging effects of uncompetitive markets, as they find less entry restrictions are associated with greater financial stability. This strengthens the claims that promoting competition amongst banks can be healthy for the banking industry of a country⁹¹.

Another study examines a cross-section of 72 countries to test the relationship between net interest margins and bank competition (Demirguc-Kunt, Laeven and Levine 2004). They find stricter regulations and impediments to bank entry increase margins. Furthermore, although banks gain from higher concentration in terms of directing credit towards favored parties and through higher interest margins, customers face higher prices. However, this effect disappears upon inclusion of institutional factors. Their results also shed doubt over the use of bank concentration as a proxy for competition in bank environments since the relationship between concentration and bank margin breaks down if institutional development is included. Foreign bank entry in 5 Latin American countries also lowers interest margins by reducing administrative costs (Martinez Peria

⁹⁰ Allen and Gale (2004) find there is no tradeoff between competition and financial stability.

⁹¹ Beck, Demirguc-Kunt and Levine (2003) also find greater concentration to be associated with financial stability. However this result does not particularly contradict the competition and financial stability relationship, since concentration may not accurately proxy for entry restrictions and instead may indicate level of diversification.

and Mody, 2004). This supports Claessens and Laeven (2004) who compute a measure of competitiveness, which shows foreign bank entry to be associated with greater competition.

The perverse effects of concentration i.e. the SCP (structure conduct performance) hypothesis are supported by some studies that find bank concentration and other restrictions on competition are associated with slower economic growth, reduction in employment growth and slower exit of mature firms in concentrated bank markets (Black and Strahan 2002, Cetorelli and Strahan 2002, Beck, Demirguc-Kunt and Levine 2003a, Cetorelli 2003, Berger, Hasan and Klapper 2004). However, another set of studies document favorable effects of bank concentration such a high growth rates and greater access to credit (Petersen and Rajan 1995, DeYoung, Goldberg and White 1999, Bonaccorsi di Patti and Gobbi 2001, Cetorelli and Gambera 2001, Bonaccorsi di Patti and Dell'Arricia 2004).

A study that specifically looks at effect of bank market structure on access to finance, rather than growth of firms, for a unique survey dataset of 74 countries, finds obstacles to finance for firms reduce if the share of foreign owned bank is higher, share of state-owned banks is lower and the institutional environment is strong (Beck, Demirguc-Kunt and Maksimovic, 2004)⁹². This is consistent with findings on manufacturing firms in 29 OECD countries, where firms with the largest need for external finance, have a disproportionately larger size in countries with concentrated bank markets (Cetorelli, 2004). This effect weakens, when only EU countries are considered, where due to deregulation, banking industry is more competitive⁹³.

Recent research has also studied the impact of banking sector competition and concentration, disaggregate across larger and smaller sized banks, since they serve different markets and have different market outcomes.⁹⁴ A cross-country examination, which also includes developing countries finds, greater market shares of smaller banks to be associated with faster GDP growth, higher SME employment ratios and higher levels of bank lending (Berger, Hasan and Klapper, 2004).

Although research on developed countries has provided ambiguous evidence on effects of bank competition (see Allen, Gersbach, Krahnert and Santomero, 2001), the literature reviewed

⁹² Beck, Demirguc-Kunt and Maksimovic (2004) analyze impact of bank competition on access to finance by using a dataset comprising of 74 countries.

⁹³ Although another set of research finds entry restrictions and inter-border banking restrictions that reduce competition, also increase growth rates and access to credit for SMEs and new firm (Petersen and Rajan, 1995, DeYoung, Goldberg and White, 1999, Bonaccorsi di Patti and Dell'Arricia, 2004). However this literature only examines the US banking industry.

⁹⁴ For instance, smaller banks lend based on prior relationships, 'soft information', local customers and provide more retail-oriented services, while larger banks' lending criteria is based on financial ratios, 'hard information' and arm-length relationship with customers (Cole, Goldberg and White, forthcoming, DeYoung, Hunter and Udell, 2004, Stein, 2002).

above, which also incorporates developing countries provides a stronger view on whether bank competition is beneficial. It distinguishes between competition and concentration and therefore also helps to resolve research that finds concentration improves access to finance. The results with respect to concentration are weak and break down upon inclusion of institutional development factors (Berger, Demirguc-Kunt, Levine and Haubrich, 2003). The evidence with respect to other dimensions of competition, such as entry restrictions are stronger and robust. These results unambiguously indicate greater financial instability, higher bank margins and obstacles to credit availability in countries with greater entry restrictions and other policies that restrict competition. Therefore, policies such as entry restrictions, restrictions for foreign banks and state ownership of banks which impede competition, negatively affect financial system and economic performance (Berger, Demirguc-Kunt, Levine and Haubrich, 2003). Furthermore, they also highlight the need to distinguish across larger and smaller banks. Greater market share with small banks promote employment in SMEs and faster GDP growth, while greater shares with larger banks may not similarly affect credit availability for SMEs.

Example: Sri Lanka Automated Clearing House Privatization (Simon Bell –)

The privatization of Sri Lanka Automated Clearing House (SLACH) has been fairly successful and resulted in both operational efficiency and higher profitability of the organization. SLACH which was established in 1988, was under the direct control of the IT department of CBSL. In 2001, SLACH reported a loss of Rs. 8 million, which raised concerns and pressure from the business community and policymakers to tighten operations. The arguments were considered and a sub-committee by the Central Bank to weigh the available options. It was privatized in 2002 and renamed LankaClear Ltd (LCPL).

Presently, 52% of equity is held by private banks. The divestment process (financial restructuring) was concurrent with an operational restructuring of the firm. After the privatization, staff was transferred back to the central bank and present operators are now outsourced. Consequently, the staff costs were slashed by 1/3 after the privatization. They stood at 16.9 million rupees before the privatization, while presently the staff costs of LCPL are 6.1 million rupees. The privatized unit has also begun to invest excess funds, earning an investment income above 4 million rupees in 2002. An incentive scheme seeking to overcome low productivity of overtime policies was also introduced. Other achievements of efficiency improvement strategies include a reduction in processing time by 5 to 6 hours. The average cheque processing time taken under SLACH was a little over 12 hours, while average time taken under LCPL is 6.91 hours.

New services have also been introduced: such as a Colombo based dollar clearing system and other services on sorting and encoding of cheques. Finally, the divestment of SLACH has improved profitability, turning a net loss of 3.04 million rupees into a net profit of 16 million rupees by September 2002.

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IV-3-c Deposit Insurance

3. c-i Policy Points

This section is based on the literature that I have read and the recommendations by the International Stability Forum on Deposit Insurance 2001. (Deposit insurance, adversely affected NBFIs sector, therefore, it can allow NBFIs to develop, if it is removed.) – Mentioned in Footnote- need to highlight?

- Do not transplant safety net from other countries and develop your own scheme. The first step in designing a deposit insurance system is to define the objectives. Then authorities need to examine economic activity, monetary and fiscal policies, structure of the banking system and legal environment – so that gaps can be identified and dealt with before the safety net is established. Deposit insurance may not be effective if the relevant laws do not exist. Transition from blanket guarantee to a deposit insurance system, should a) allay fears of creditors as their protection is being reduced b) consider the ability of the banking system to fund deposit insurance c) consider the speed of the transition.
- Explicit insurance is better than implicit – as it reduces the scope for discretionary decisions and also reduces burden on government resources as explicitly defined system can limit the guarantee provided.
- Strong prudential regulation is also required so that it only allows well capitalized banks and those following prudent risk-management to operate. Encourage private monitoring, for example through banks by covering bank funds through funds of surviving banks – Need to involve private sector in management and administration, which can reduce impact on systemic risk and market discipline, but does not completely eliminate it (See example Germany of an effective privately managed scheme).
- Stronger institutions that support better accounting standards, legal systems or quality of government that will constrain risk-taking.
- Besides focusing on the institutional environment, market discipline can be strengthened through coinsurance, covering foreign currency deposits and private management of joint enterprises (Demirguc-Kunt and Huizinga, 2003).
- Coverage and funding of schemes are important features of success of deposit insurance. Coverage should be defined explicitly in the law – in order to foster market discipline coinsurance can be adopted. Although it should be applied above a certain amount, so that small depositors continue to be offered full protection against risk of loss. Coverage needs to

be adjusted periodically due to inflation, growth in real income, development of financial instruments and size of deposits. Decision to cover foreign currency may depend on proportion of usage of foreign currency.

- Ideal combination is to have low coverage and un-funded schemes. Unfunded schemes with access to the market are best (evidence given by Demirguc-Kunt and Degatriache)– although in U.S unfunded system raised cost of resolution during the savings and loans crisis (World Bank 2001). Funds can also be easily abused in weak institutional environments. Lower coverage also encourages market discipline.
- In case of a funded scheme, however, adequate funding must be available, so that prompt reimbursement can be given. Otherwise credibility of the system would be jeopardized. Member banks should pay the cost of deposit insurance as they are directly benefiting. However, determination of premium should consider the effect it can have on the financial health of the industry. Different kinds of premium systems, such as flat-rate or those that are differentiated on bank's risk profiles
- Failure resolution should effectively coordinate among financial-net participants. It should ensure effective reimbursement processes. Provide transparency of information and access to deposit data before the bank is closed. It reduces the risk of manipulation of records and preserves public confidence.
- Then authorities need to examine economic activity, monetary and fiscal policies, structure of the banking system and legal environment – so that gaps can be identified and dealt with before the safety net is established. Deposit insurance may not be effective if the relevant laws do not exist. Transition from blanket guarantee to a deposit insurance system, should a) allay fears of creditors as their protection is being reduced b) consider the ability of the banking system to fund deposit insurance c) consider the speed of the transition.
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3. c-ii Overview

There has been increased political pressure to adopt deposit insurance, with a large number of countries adopting deposit insurance during the 1980's and 1990's. The number of deposit insurance schemes have risen from 12 in 1974 to 71 in 1999 (Demirguc-Kunt and Kane,

2002). The expansion in deposit insurance schemes has largely taken place across transition economies and countries in Africa, subscribing to the notion that deposit insurance can lead to a safe financial system. In 1994, deposit insurance became a standard for the single banking market of European Union (Kyei, 1995). This prompted many Eastern European countries aspiring to enter the EU to adopt deposit insurance during the 1990's. Furthermore, the requirement for member states to cover a common euro amount of deposits has increased coverage levels for countries seeking EU membership.

Funding for explicit deposit insurance schemes come from the government or private sources or both⁹⁵. For instance, banks typically make a premium payment to a deposit insurance fund⁹⁶. In all countries that have some kind of deposit insurance scheme, 82.9% operate a scheme that is funded jointly by banks and the government (Laeven 2002a). The financial safety net in explicit schemes vary from full to partial deposit insurance. For instance, in Turkey, there is a full guarantee provided, although in most other countries there is coverage limit with insurance scheme covering mainly small depositors. A milieu of schemes exist, insuring a wide array of deposits and institutions⁹⁷

Deposit insurance has usually been adopted for either or both of the following reasons: to promote banking sector stability or protect small depositors. The IMF has also endorsed the need for limited safety net in its code of best practices (Folkerts-Landua and Lindgren, 1997). It is clear why deposit insurance would appeal to policymakers as it a costless way of protecting small depositors, that does not impose any costs on government budget in the short run (Laeven, 2002b). Most governments already provide an implicit form of unlimited protection to depositors. It is argued that by moving to an explicit system governments' can in fact limit their commitment to depositors (Demirguc-Kunt and Kane, 2002). Furthermore, it also prevents threat of a bank run and allows smaller more fragile banks to compete with bigger financial institutions (Demirguc-Kunt and Kane, 2002). Therefore, political considerations for adopting deposit insurance are certainly persuasive, as through prompt repayment of deposits, it provides valuable protection for small depositors and does favor small banks. However, many of these protections come at a cost, that must also be considered when government consider deposit insurance.

What is generally ignored by policymakers is the moral hazard associated with deposit insurance. Although theoretically speaking full deposit insurance may avert a bank run, it has the

⁹⁵ Chile is funded completely from government sources (Demirguc-Kunt and Kane, 2002).

⁹⁶ Austria, Chile, France, Italy, Netherlands, Switzerland and the United Kingdom do not have a permanent fund for deposit insurance.

⁹⁷ Most schemes deny insuring inter-bank funds, encouraging larger banks to monitor one another (World Bank 2001).

potential to create moral hazard, by reducing depositors incentive to monitor risk-taking by banks. Depositors by not monitoring imprudent activities by banks (since their deposits are insured) encourage banks to engage in high-return high-risk activities. Most empirical evidence unambiguously supports the moral hazard view. In practice deposit insurance encourages banks to finance higher risk projects and increases probability of a bank failure (Laeven 2000, Laeven, 2002b, Demirguc-Kunt and Detragiache 2002, Demirguc-Kunt and Huinga 2003)⁹⁸. A study on 14 developed and developing countries, finds countries which explicitly insure depositors tend to give higher subsidies to their banks (Laeven 2000). An econometric analysis of a dataset of banks in 43 countries, examines market discipline through sensitivity of interest rates to deposit insurance. The main finding is that illiquid banks pay a lower premium for funds in case of a generous deposit scheme (Demirguc-Kunt and Huinga 2003). The main conclusion from these empirical evidence is that deposit insurance increases instability in the banking sector and reduces market discipline. However, most of this evidence largely holds for countries with weak institutions. Consequently, good institutions, sound supervision and regulation can play a key role in reducing risk-taking opportunities (Demirguc-Kunt and Degatriache 2000). Many policymakers are quick to adopt deposit insurance because it may increase flow of bank credit as depositor confidence is restored in the banking system. However, financial activity only improves if institutional environment is strong (Cull, Senbet and Sorge 2001).⁹⁹ Cecchetti and Krause (2000) show that non-banking financing systems are in fact significantly slowed down as a result of deposit insurance. Explicit deposit insurance replaces private monitoring of banks by poorly placed government monitoring, which encourages bank risk-taking and is associated with a higher opportunity cost of value of deposit insurance (Laeven 2002b). Hence market discipline is weakened in countries with deposit insurance¹⁰⁰.

In times of crisis, governments need to have a credible policy of providing protection to deposits, in order to avoid a bank-run. However, this protection is hardly beneficial if deposit insurance is not credible or the government does not come good on the claims. In this case small depositors lose out more, because deposit insurance may create greater fragility in the banking system. Martinez-Peria and Schmukler (2001) in an examination flow of deposits in Mexico,

⁹⁸ Eichengreen and Arteta (2000) is the only study that questions these results. They claim that there is equal evidence that deposit insurance protects from bank-runs and increases stability in a banking system. However, this evidence is based on a much smaller sample of countries.

⁹⁹ It is possible that in weak institutional environment, tax payers realize that the environment will be unable to constrain costs associated with safety nets and prefer to keep their assets outside the banking system or outside the country (World Bank 2001).

¹⁰⁰ Although partial deposit insurance, compared to complete deposit insurance, induces a market discipline where depositors monitor banks (Bhattacharya, Boot and Thakor 1998).

Chile and Argentina during periods of banking crisis, suggest that the extent of market discipline depends on credibility of the guarantee. They find some evidence of market discipline, with interest-rates on deposits rising and level of deposits falling, in response to bank risk taking, despite different types of deposit insurance in each country¹⁰¹. The authors also find deposit insurance in both Argentina and Chile was not fully credible, although it is much less credible in Argentina relative to Chile¹⁰². A possible explanation for this lies in the fact that Chile has not been tested through a bank failure, while depositors in Argentina in the 1990's found that the government froze deposits of failed banks while it tried to find a buyer.

In terms of types of deposit insurance, funded systems provide a more credible guarantee intensify moral hazard (Demirguc-Kunt and Detragiache 2002)¹⁰³. Government managed systems have a higher probability of abuse and are associated with greater bank fragility. There is also a wide variation across explicit and implicit deposit insurance schemes.

The main message from these studies is that explicit deposit insurance schemes can increase fragility in the banking system and in countries with weak institutional environment it is difficult to design deposit insurance that will not increase probability of bank failure. If there are noticeable weaknesses in institutional environment, deposit insurance will only intensify moral hazard (Demirguc-Kunt and Degatriache 2002, Demirguc-Kunt and Kane 2002, Laeven 2002a, 2002b). Proper law and order is a pre-requisite towards design of any financial safety net. When an explicit financial safety net is provided, the role of monitoring the banking system is taken over the government. Any monitoring requires transparency of information to detect possible risk-taking and should be convincing for banks, that rules will be enforced.

Therefore, dimensions of institutional environment that are important include: complete transparency and disclosure of bank activities to creditors and supervisors and accountability for taxpayers to hold government officials responsible for their actions (Demirguc-Kunt and Kane, 2002). Countries need to determine level of transparency, deterrence and accountability, before adopting an insurance system as there is no evidence of costs of waiting to adopt deposit insurance. Furthermore, most developed countries reached high financial development without deposit insurance, so costs of waiting are not evident (World Bank 2001).

¹⁰¹ Argentina and Chile provide partial deposit insurance, with the former covering 25% of all deposits and the latter covering only 3-4% of deposits. Mexico does not have an explicit deposit insurance, but implicit protection is 100% (Martinez-Peria and Schmukler 2001).

¹⁰² This may be because of the following reasons: (1) perhaps due to prior confiscation of deposits by government, (2) depositors are concerned about costs (delay in) of repayments if a bank fails, or (3) if a scheme is underfunded.

¹⁰³ Demirguc-Kunt and Detragiache (2002) test for a panel of countries from 1980-1997.

There is no single best form of financial safety net that can be applied to every country, and will vary by performance of countries along the identified dimensions. Private monitoring is essential, in a system where incentive to monitor are reduced and government supervisions are inadequate and deposit insurance schemes that are managed or supervised by both government and private management can control moral hazard (Demirguc-Kunt and Kane, 2001). Although, it can be argued that deposit insurance is necessary for smaller depositors, other assets such as postal savings and money market funds backed by the government may perform a similar function (Calomiris, 1999, Stiglitz, 1992). In addition, there is also a need to encourage monitoring by banks of other banks, by covering bank losses through funds of surviving banks.

Example: Germany – Privately Managed Deposit Insurance Scheme¹⁰⁴

In Germany, 3 deposit insurance schemes were established in 1975 by the German Bank Association, under political pressure. The 3 main bank groups, savings banks, commercial banks and cooperatives, each have their own scheme. The insurance scheme for private banks was established to offset the advantage savings banks had due to their public ownership. The German insurance system, stands out from those of other countries, because besides being voluntary, it is privately managed without any government supervision. The funding for the system is raised from premium levied on participating banks. It therefore, operates as a ‘club’, which offers unlimited coverage, but also promotes peer monitoring and market discipline by members. Only 10 countries have unfunded schemes and only 11 have schemes completely managed privately, Germany being one of them.¹⁰⁵

Although membership is voluntary, there are very few private banks that have opted out of this system as non-participating banks face high barriers. There are varying reports on number of non-participating banks, which stand at either 5 (Dreher 1998) or 36 (Steuer 1998) of 300. Germany is one of the 13 countries that have a voluntary deposit insurance scheme, compared to 55 that have mandatory systems (Demirguc-Kunt and Sobaci 2001). It offers on average a coverage of almost 90 million euro, which is almost complete coverage on a wide range of deposits. The financing of the fund is done exclusively by the member banks, which pay a premium of 0.03% of liabilities to creditors arising from banking business, annually (Beck 2002). However the premium is revised in events if funds are considered insufficient. The Bundesbank is

¹⁰⁴ For details see Beck (2002)

¹⁰⁵ Most countries belong to Europe, although Tanzania, Argentina and Brazil also have privately managed safety nets.

prohibited by law act as a lender of last resort for deposit insurance, although it is expected that in the case of a major banking crisis, it would step in.

This system requires close coordination between the banks and government authorities (Federal Bank Supervisory Office - FBSO) in matters relating to auditing and licensing of the banks and in bank failure, which are the only interaction with the government. This is reflected in the failure of Schröder, Münchmeyer, Hengst and Co. (SMH) in 1983, where early problems were detected by the Banking Association rather than the FBSO or BundesBank. The crisis resolution was purely private, and the deposit insurance scheme put out 345 million DM for depositors and foreign creditors. The Bundesbank and FSBO pressured SMH to convert its claims into subordinated debt. The bank was split and viable part was taken over by Lloyds bank and the other was taken over and liquidated by the German Banking Association. This close cooperation a strength of the German system, and the coordination to support a failing bank is a result of high concentration in the sector which in turn is a result of absence of restrictions on branching and universal banking.

The effectiveness of the German model is evident from the low risk taken by German banks and the small subsidy that they receive from deposit insurance (Laeven 2000). The main features of the German environment for the success of this system are: strong institutional environment, rule of law and concentrated market structure, The private nature of funding, exclusion of interbank deposits and almost full insurance, encourage banks to monitor each other. The high concentration of private banks also achieve an optimal level of monitoring. An increase in number of banks would diminish effectiveness of peer-monitoring. Although peer-monitoring reduces risk-taking, other features of the system also diminish market discipline by depositors, for instance: lack of coinsurance, almost full coverage and broad coverage of accounts. However since the deposit scheme has reimbursed in 26 cases (Steuer 1998), with success, these flaws are not important. The ex-ante nature of funding, ensures credibility, while ex-post funding by banks reduces moral hazard. Finally, this system is strongly supported by the strong institutional environment and anti-bankruptcy bias. In Germany, bankruptcy is looked upon as a personal rather than economic failure. It is punishable by imprisonment of up to 5 years, if it is a result of fraud or hiding of assets. This has discouraged risk-taking by banks, although it has also negatively affected entrepreneurship.

However, now under the European directive in 1997, the deposit insurance scheme has come under government regulation, and premiums are also set by the Ministry of Finance. The private scheme operates, but only covers deposits over 20,000 euros and those that are not covered by the mandatory insurance.

3. c-iii References

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3.d Banking Crises

3. d-i Policy Points

- Accommodating policies such as liquidity support, regulatory forbearance and unlimited blanket insurance, increase fiscal costs of managing crises and also slow down economic recovering (Claessens, Klingebiel and Laeven 2003).
- Strong legal environments, enforcement and low corruption accelerate economic recovery
- Removing banks nonperforming loans and transferring them to a separate loan recovery agency is an effective arrangement as it can allow banks to concentrate on their core activities.
- Credible accounting and measurement of losses and injection of capital.
- Performance of AMC's is likely to be poor in countries with weak judicial system and legal rules. Associated laws must also be amended when establishing AMC's (such a regulatory rules on government acquiring assets of failing banks etc.).
- Transferring a large amount of resources to AMC's also politicizes the workout process and weakens ability of AMC's to make an efficiency disposal of assets.

3. d-ii Empirical Evidence on Resolution of Banking Crises

Since the late 1970s a total of 112 banking crisis episodes have been documented in 93 countries (Caprio and Klingebiel, 2003). The high incidence of such episodes highlights the necessity for an effective strategy to facilitate an efficient and successful recovery. Governments often become involved in managing and restructuring bank assets during periods of a banking crisis. When a banking crisis occurs authorities must decide whether to intervene and determine the extent of their intervention. If the crisis is non-systemic, authorities should leave settlement to creditors and supervisors¹⁰⁶. Governments are more likely to become involved during periods of systemic crises, significantly increasing ownership of troubled banks. Systemic crises usually involve a wide-spread banking system distress, characterized by large-scale defaults, increases in non-performing loans and an economic slowdown (Claessens, Klingebiel and Laeven 2003). The

¹⁰⁶ It is difficult to determine when a crisis is systemic or non-systemic. Mostly a percentage of GDP or percentage of troubled banking system deposits, is used to define the line between systemic or non-systemic. Announcement of such a strategy is likely to induce greater risk-taking, if agents are aware that the downside is covered. Usually authorities use their discretion on when and how to intervene.

extent of distress during systemic crisis means that they involve large coordination problems. Furthermore, the importance of the financial system for economic growth, means that government frequently intervene and take the lead in restructuring of the banking sector. Earlier discussion shows the government is not effective as a bank owner. Therefore, any government intervention during a systemic crisis should have a clear exit strategy which ensures the government leaves its temporary position as a caretaker as soon as possible and leaves the market forces to determine beneficiaries (World Bank 2001).

Research on resolution of systemic crises finds that managing a financial crisis in a developed country is much different from that in a developing nation, particularly due to the weak institutional arrangements (Caprio and Klingebiel 1996, Dziobek and Pazarbasioglu 1998, Lindgren, Garcia and Saal 1997). Therefore, best practices from experiences of industrialized countries cannot easily be used as a blueprint for emerging markets as response to policies depends on conduciveness of legal, accounting and political environment at the time. However more general recommendations remain the same: entailing an early diagnosis to confirm the problems, comprehensive restructuring programs and a need for both financial and operational restructuring (Dziobek and Pazarbasioglu 1997). Specific features of resolution process vary partly as a result of trade-off that exists between varying objectives: reduction in fiscal costs, economic costs, accelerating restructuring or long-term structural reforms.

Countries can implement either stock or flow strategies to deal with bank distress.¹⁰⁷ However, flow strategies are mostly effective when the bank distress is non-systemic, as it seeks to build up the capital base over time without dealing with the bad loans in the banks portfolio (Klingebiel 2000). Furthermore, they also requires supervisory forbearance to deal with banks whose capital has sharply deteriorated. Hence, in the case of a systemic bank crisis, stock measures become extremely important in restructuring viable banks or liquidating insolvent ones (Klingebiel 2000).¹⁰⁸

The key policy measures to resolve a financial crisis include: liquidity support; blanket guarantee for depositors; measures of forbearance such as allowing insolvent banks to operate or redefining measures of solvency by relaxing prudential regulations; repeated recapitalizations; a

¹⁰⁷ Stock strategies deal with financial restructuring and involve liquidation of assets, closure of banks or restructuring of potentially viable banks, while flow strategies involve operational restructuring, with improvements in profitability of banks and reduction in expenses (Dziobek and Pazarbasioglu 1997, Klingebiel 2000).

¹⁰⁸ Two raw indicators of distress are the size of non-performing loans (as a percentage of total banking system assets) and the number of corporate bankruptcies that may increase during an episode of corporate distress. Hence most resolution processes will involve bank restructuring due to high non-performing loans and corporate restructuring of non-financial institutions which are unable to service their debt.

public debt relief program or creation of asset-management companies (AMCs)¹⁰⁹. Most literature is largely silent on the issue of effectiveness of these policy measures across countries. One such study, however shows that accommodative policy measures such as unlimited guarantees and liquidity support, have high fiscal costs and appear to slow down economic recovery (Claessens, Klingbiel and Laeven 2003). They are associated with higher output losses, as banks' incentives to restructure debt are displaced. The policy implication from these results is the need for strict resolution policies and institutional development.

Dziobek and Pazarbasioglu (1997) analyze of bank restructuring in a sample of 24 countries post 1990. They find the most commonly used tools include asset management companies to deal with loan collection problems, merger with other banks, splitting the business by eliminating the problem or least profitable areas and operational restructuring through use of consulting services¹¹⁰. The countries in their sample exhibited varying speeds in taking up restructuring efforts after the surfacing of problems, with some countries taking more than 3 years to implement measures. Slowest progress was evident in countries where the Central Bank led the restructuring efforts on its own (Kuwait, Mauritania and Tanzania).

The main message from this study is to reduce central bank long-term financing to distressed banks. For instance in Peru and Sweden (1991), restrictions were placed on both short-term and long-term lending by the Central Bank, resulting in substantial progress. In fact in Peru, central banking laws were changed to restrict its degree of involvement. Similarly in the case of Cote d'Ivoire and Philippines (which also had significant success in restructuring), although the Central Bank initially lent to the government to support its arrears, its role was phased out. Hence any role of the central bank should have an exit strategy. In contrast there was slow progress in Kuwait (1992), where the Central Bank played a major role in providing liquidity, through special deposit and repurchase facilities, and in debt collection. Another common element in countries that expedited resolution of financial distress has been the use of mergers or closure of insolvent banks. In the Dziobek and Pazabasioglu (1997) study, in almost all 24 countries in the sample financial distress was largely caused by presence of state-owned banks and in some cases non-financial institutions. Cote d'Ivoire, Peru, Philippines, Spain, and Sweden, the countries which made swift progress in restructuring banks, undertook appropriate measures (to deal with problems of state banks) such as closure, restructuring and most importantly privatization¹¹¹.

¹⁰⁹ Honohan and Klingbiel (2003)

¹¹⁰ The sample covers developed, developing and transition economies.

¹¹¹ Although privatization was an effective measure, its design is also important. Badly designed bank privatization programs in 1974 and 1991 in Chile and Mexico, respectively, were precursors to banking crises that occurred later on. The bidders in the auctioning process, were given priority in access to credit.

However, in countries with low success in restructuring, these tools were not implemented and insolvent banks were allowed to operate, spreading the problem to more institutions in the financial system.

The government may be required to provide capital to strengthen banks loss absorption capacity, if private options for banks do not exist. However, public funds can typically create a moral hazard and may not guarantee restructuring to take place, which is highlighted in the case of Hungary, Japan and Thailand. In Hungary, three injections of capital were given, but they remained insufficient to allow banks to engage in restructuring (World Bank 1999a, 1999b). Furthermore, banks and debtors began to expect a bail-out from the government and lacked any incentive to engage in restructuring. In Japan two rounds of recapitalizations were given in 1998 and 1999 which were 7 years after the onset of the crisis and the banks are still undercapitalized (Goldman Sachs 2002). Although support of the government in terms of recapitalization of insolvent banks is unavoidable, the countries in Dziobek and Pazarbasioglu (1997) sample however did not show much success in using bond and other financial instruments of government support.

3.d-iii Political Economy of Banking Crises

In a systemic bank crisis, restructuring usually means a bigger role for the state. If centralized control of resolution is in the hands of the government, institutions are more likely to suffer from regulatory capture and political considerations. Although initially a large role of the government may be beneficial, its continued presence will not achieve a market based resource allocation (Claessens, Djankov and Klingebiel 1999). In the case of East Asia, the increased government intervention meant that the state controlled almost 50 percent of all banking assets, although in Indonesia, most than 70 percent of bank assets were in control of the government. During episodes of systemic banking crises, government divestiture of assets is essential with an aim to change the corporate governance and improve resource allocation. During and following the 1997 East Asian crisis, over 29 financially distressed banks in Indonesia, Korea, and Thailand were nationalized, closed, merged, and/or sold to foreigners. In addition, all three-crisis countries reformed existing bank regulations to permit foreign banks to purchase domestic banks.

Furthermore large business groups managed to acquire a large proportion of stakes due to weak laws against ownership concentration. Subsequently, the government had to bail-out these banks due to large amount of 'related lending' or for insolvency.

Increased state involvement also means that closure decisions or decisions to liquidate assets become a public choice rather than an economic one (Kane 1988). Since closure of particular institutions may have an economy wide impact, governments may be averse to using this option. As an alternative they may convince other banks to acquire distressed financial institutions in order to avoid a closure, or tax allowances may be given to favored institutions. Hence closure decisions may be independent of level of insolvency of the institutions, especially since during a systemic financial crisis most banks may be technically insolvent (Bongini, Claessens and Ferri 2000). Bongini, Claessens and Ferri (2000) investigated financial distress during the East Asian crisis. Large financial institutions were more likely to be distressed, but less likely to be closed indicating presence of ‘too big to fail’ policies. However, contrary to beliefs, closures were transparent as political connections in fact increased probability of closure.

3. d-iv EXPERIENCE WITH AMCs

Two types of resolution approaches are adopted by countries that have faced banking crises: either a centralized approach with government controlled asset management company (AMC), or a decentralized solution where restructuring and selling of assets is taken up privately by the banks and creditors. Asset management companies are a centralized agency where all expertise and information is housed within one unit. Hence they can have economies of scale benefits. A transfer of non-performing loans from banks to AMCs allows banks to focus on their day to day operations. It can also break an ownership links between banks and corporations, speeding up loan recovery. Furthermore, they are typically given special powers for loan recovery (Klingebiel 2000). However, a strong legal system that provides bankruptcy protection and creditor rights is essential for the operation of both a centralized or decentralized management approach. AMCs are a common tool of dealing with banking distress, and were used most recently in the East Asian crises (Claessens, Djankov and Klingebiel 1999).

An asset management company may serve two functions: to expedite financial restructuring or to aid asset disposition and resolve insolvency, with the latter being a more narrow objective. Hence two types of AMCs have been setup for distress resolution. Klingebiel (2000) reviews role of AMCs in seven episodes of banking crises, four of which set up asset disposition vehicles (Mexico 1994, Philippines 1981-86, Spain 1977-85, US 1984-91) and three were broadly functioning restructuring agencies (Finland 1991-94, Ghana 1982-89, Sweden 1991-94). The AMC established in Philippines had to deal with the largest size of non-performing loans as a proportion of banking system assets (22 percent), while Spain’s AMC dealt with 1

percent of assets. The case study examination finds that they have a mixed record and suggests that AMC's are rarely effective tools for successful corporate restructuring as they are highly susceptible to political pressures and lack independence (Klingebiel 2000).

The AMCs set up as asset disposition vehicles were relatively more successful compared to the restructuring agencies. AMCs in Spain and US achieved their objective of resolving insolvency, by disposing off 50 percent of its assets within the first five years. In the case of Spain, the fact that it had to resolve only a relatively small share of assets was also a reason for its success. In addition, both the US RTC and Spanish Deposit Guarantee Fund particularly benefited from special circumstances such as easily liquifiable assets, independence from the government, professional management with a good resource base, good bankruptcy and credit protection laws and disclosure and transparency of information. Mexico fared badly, particularly due to excessive political interference. Most politically connected non-performing loans were transferred to AMC, which were difficult to transfer to the private sector or resolve due to political pressure. The Mexican AMC, Fobaproa, only managed to transfer 0.5 percent of its assets, four years after its establishment. In addition, the agency was underfunded which made it more difficult to initiate rapid sale of assets. As a large share of assets were transferred to Fobaproa, it impaired the restructuring process by a) depressing market value of bank assets, b) giving control to government of a large share and c) the recurring asset sales reduced bank incentives to aid the process. Similarly, the Philippines also failed to achieve its objective. The APT carried 50 percent of its assets, twelve years since establishment. They were also unable to achieve broader objectives of developing a stable financial system, as both Mexico and Philippines banking system remains weak.

The AMCs established in Finland, Ghana and Sweden during their periods of banking crisis were restructuring agencies with narrow objectives of managing non-performing loans and rapid corporate restructuring. The Finland Arsenal and Sweden Securum were successful in speeding up restructuring of the banks. In the case of Sweden, factors in favor were the fact that the assets to be restructured were real estate and were a small proportion of the banking system, which also allowed AMCs to be politically independent. The Finland Arsenal disposed off more than 50 percent of its assets within first five years. Similar to Sweden, Finland Arsenal the fact that the assets were only 5.2 percent of financial system assets and that most of them were real estate loans were a key factor of success.

However, the Ghana N-Part was largely unsuccessful in expediting corporate recovery and financial restructuring. It was involved in lengthening maturity of assets, collecting defaulted payments and in lowering interest rates, which did not have a significant effect on the resolution

process. The main reason for its ineffectiveness was the lack of political independence and a skilled resource base. Since a large share of loans were transferred to these units, which were primarily loans to state-owned corporations, it became difficult for N-Part to extricate itself from political forces. The courts in Ghana were favorable towards debtor and The government attempted to overcome the weak legal environment by giving N-Part collection powers. However, since the courts in Ghana were favorable towards debtors, N-Part still needed the approval of the borrowers in order to liquidate assets, which became an obstacle.

These case studies reveal AMC's were largely unsuccessful in realizing their wider goal of bank or corporate restructuring, but as asset disposition vehicles their performance was slightly better. However in the case of the latter, independence from political intervention was essential towards performance of AMC's. AMC's are in a better position to collect loans from bank debtors, as by controlling non-performing loans of banks they can break ties between banks and corporations which may be impeding loan collection in the first place (Dado and Klingebiel, 2002). However, experience with AMC's suggests that this advantage is also the biggest problem with these agencies, since they are unable to insulate themselves from political claims. Furthermore, by breaking linkages between banks and corporations, banks' access to private information about corporations also breaks down. If AMC's are unable to manage assets, credit discipline in the financial system can be severely affected. (Dado and Klingebiel, 2002). It would be expected that in countries where the legal and regulatory framework is weak, granting powers to a special government agency should expedite resolution process. However, this very feature can be potentially detrimental. For instance, uncooperative borrowers or banks may have little incentive to participate in a resolution process if it can influence politicians for its own purposes. AMC officials may also seek to favor certain borrowers or avoid layoff and can be less willing to push for a solution. Transfer of a large size of assets to AMC's also politicizes the workout process (as was the case in Indonesia, see example).

Due to these reasons, it may be argued that since banks have access to institutional knowledge about borrowers and are independent from political pressures in restructuring decisions, it may be the preferred approach to allow banks themselves to deal with the non-performing loans. By allowing banks to retain their non-performing loans, a decentralized approach offers banks incentives to avoid future bad debt by actively monitoring and screening loan applications and to assist in restructuring by providing new loans (Klingebiel 2000, Dado and Klingebiel 2002).

However there are certain prerequisites that a decentralized process also requires. The incentives of banks to engage in restructuring depend on capitalization of banks as non-

performing loans are written off against capital. In the case of private banks, there should not be ownership ties with non-financial institutions. In Japan, the restructuring process was significantly delayed due to ownership links between the banks and corporations (IMF 1999).

Decentralized, private creditor led restructuring may have its disadvantages. For instance it cannot be denied that any resolution process requires professional management and a skilled resource base, which banks may lack as restructuring requires different kinds of skills (Dado and Klingebiel, 2002). However, it seems to have fared better than AMCs, especially if banks are adequately capitalized, have incentives for banks and borrowers to privately engage in restructuring and there are no ownership links between banks and borrowers.¹¹²

Example: AMCs in Indonesia (Calomiris, Klingebiel and Laeven 2003, Enoch et. al. 2001, IMF 2000, Lindgren et. al. 1999)

The Indonesia Bank Restructuring Agency (IBRA) was set up in 1998, which was a sharp shift from the existing ad hoc approach to a centralized and well-defined program of resolution. The main functions of IBRA included: restructuring of banks that were transferred to it, recovery and restructuring of bank assets and recovery of state funds that were disbursed to these banks. The IBRA immediately took over surveillance of 54 banks, which comprised 4 state banks and the rest were private and regional development banks that had a capital adequacy ratio of below 5% and had borrowed from Bank Indonesia (BI) in excess of 200 % of their capital. The takeover of these banks which government did not want to be publicized, termed as soft intervention, led to placement of many IBRA staff at the banks. In effect IBRA was controlling 36.7% of the total financial systems assets. 7 of these banks had the largest borrowing from BI, accounting for more than 75 % of BI's liquidity support. By early April, IBRA took over 7 more banks that had borrowed more than 2 trillion rupiah from BI and comprised 16 % of assets. It also closed 7 small banks, transferring their assets to a state bank, available for customers the following Monday. At this time, when the reaction to these moves tapered off, the IBRA acquired direct control of the banks that were previously under surveillance. Owners' rights were suspended and managers excluded. The banks that were taken over were attached with a designated state bank "twinned",

¹¹² Dado and Klingebiel (2002) study decentralized approaches undertaken in 7 countries: Argentina, Chile, Hungary, Japan, Norway, Poland and Thailand. Their study suggests that decentralized restructuring was only successful in Chile, Poland and Norway. Corporate distress was reduced and financial structures in these countries became viable. This was due to the fact that these countries developed environments that were conducive to decentralized approach although initially they also suffered from problem of weak incentives. Improvement in conduciveness of the environment towards corporate restructuring, took place along the following dimensions: terms of judicial enforcement, accounting framework, creditor rights and ownership links (Dado and Klingebiel, 2002).

which provided the replacement management. The banking law was amended in late 1998, to give IBRA powers required to carry out its functions. These amendments allowed it to take control of loans and assets of failed banks without requiring prior approval of the owners.

The IBRA divided its functions into : asset management of credits and asset management of investments. All loss loans from state, acquired and jointly-recapitalized banks were transferred to IBRA at book value, which came to over 400 trillion rupiah. The transfer at book value created incentives for IBRA to retain rather than dispose of the assets, although in reality their value was much less. The strategy adopted by IBRA involved sale of small retail and SME loans through open auctions and outsourcing of medium sized commercial loans sales through servicing agencies that arranged a competitive bidding. The sale of non-core assets such as motor vehicles from failed institutions was successful. The loans of largest borrowers were either restructured or legal action was taken against non-complying debtors. Sales of restructured loans took place through a competitive bidding process. However due to the slow disposal rate of loans initially, later on they were being sold at sharp discounts.

The slow disposal rates and other factors of poor performance of the IBRA were largely a result of the weak legal framework. Delays in securing legal framework to prepare for sale of assets, created long delays. IBRA's legal powers were initially rather limited and authorities had to use a set of contracts to establish its control over banks, but it did not have such power over bank borrowers. Other impeding factors were the type of assets to be transferred (which were mainly corporate loans from state banks) and the amount of assets to be transferred (which comprised over a third of the total system assets). Bank credit to the private sector which represented 60% of GDP in 1997 has also fallen tremendously to 20% in 2001. The Indonesian government has been slow to sell banks compared to Thai or Korean government. Only 2 state-owned banks have been sold to foreign investors, while 5 continue to remain in government hands.

Example: Cameroon – Successful Government Restructuring¹¹³

Until the late 1980s Cameroon's banking system was dominated by 4 French-based banks which controlled 75% of the bank credit. These were: Credit Lyonnais (SCB), Banque Internationale de l'Afrique de l'Ouest and a consortia headed by Societe Generale (SGBC) and by Banque Nationale de Paris (BICIC). Other smaller banks included affiliates of BCCI, Paribas, Zambian-based Meridien group, a national development bank and Cambank. The banking system suffered

¹¹³ For details see Honohan (2003)

a deep crisis during the 1990s. However the reforms undertaken have been largely successful, partly due to the strength of resolve of the Government and partly as a result of use of sophisticated financial devices. At present all banks in Cameroon are solvent (meeting the 8% capital adequacy requirement also on an unweighted rule), liquid and profitable. All the banks are privately owned and foreign banks such as Citibank and Ecobank have also entered the market.

Problems in the banking system were coming to the surface by the late 80s, when four banks left the market and other banks were liquidity constrained, inhibiting ease of withdrawal for depositors. The failure of SCB, BCD, Paribas and Cambank, along with worldwide collapse of BCCI and BIAO in the early 1990s propelled the financial system into a deeper turmoil leading to drastic cuts in liquidity and restriction in deposit withdrawal. The non-performing loans were acquired by a debt recovery agency Societe de Recouvrement des Creances (SRC). The SRC was initially unsuccessful, having recovered on 3% of the loans transferred to it, by 1994. The Government's unwillingness to layoff staff necessary to restore bank finances further worsened the solvency position of the banks. These circumstances prompted exit of BNP, which ceded its 36% shares in BICIC to the government. A deposit run on BICIC ensued, resulting in its eventual closure.

In 1995, the government began another round of restructuring. More non-performing loans were placed under the management of the SRC as government obligations. At this stage only two banks, one private and restructured SCB, that were considered solvent. Three different strategies were adopted to deal with the banking crisis. It involved absorption of loan losses by exist shareholders on a prorata basis of their equity share and recapitalization by the private bank, for Societe Generale and Standard Chartered. Banks were split into 'good banks' and 'bad banks', with the latter being liquidated (BICEC/ BICIC). In the case of Credit Agricole and Meridien bank, the entire banks were liquidated, as they had large losses to depositors. The depositors were reimbursed through loans that were recovered, with small depositors being given a preference.

Concurrent with these strategies, institutional weakness were also overcome. A regulation was passed preventing delinquent borrowers from obtaining further finance from banks. The governance structure of SRC was also strengthened. Under the reforms, 40% of the board would come from the private sector. The general manager and deputy would also be appointed by a 2/3 majority of the board. After these changes, there was a notable increase in recovery rate of the SRC. They increased to 18 billion dollars in 1998. Another notable initiative during this period, was securitization of banks claims. The claims were converted into either bonds of 4.5 to 12 yrs or longer term bonds with maturity of 30 years. These bonds were backed by an escrow account at the BEAC and a 30 year zero-coupon bond of the French Government. Enhanced rated

instruments were used as sovereign debt was non-credible. This securitization and use of sophisticated financial tools to restructure the banks' claims on government provides a workable solution of dealing with government arrears.

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IV-4 Foreign Entry

4 a-i Policy Points

Foreign banks are largely beneficial for consumers, by improving quality of service and reduction in interest rate margins. They also force an improvement in efficiency of local banks. However many countries may be unable to choose whether to allow foreign banks to enter or not. If the market is small and costs of setting up large, countries may have difficulty in convincing foreign banks to enter, especially in case of acquiring owners for local banks. Furthermore gains from foreign bank entry if the bank is relatively inexperienced, are likely to be limited. For such banks, the need for prudential regulation and supervision to ensure their structure is adequate is important.

- Permitting foreign bank entry is the best policy prescription – but there are caveats post Argentina (see example). Furthermore countries encouraging foreign entry must also develop the appropriate business environment (along with credit bureaus and good accounting standards) that encourages foreign banks and domestic banks to move downstream, and increase lending to SME. In order to encourage foreign bank entry, countries may need to develop a stronger market environment, reduce setting up costs and improve the institutional environment.
- Foreign banks can greatly contribute through more sophisticated financial products. However, developing countries lack expertise to regulate and determine riskiness of these financial products.
- Legal reform should also be paced up, when foreign entry is encouraged. In Mexico, the slow pace of reform has contributed to slow growth in credit.
- Presence of foreign banks improves regulatory structure – they make it more likely that bank supervisor and regulators will remove forbearance and introduce regulations that encourage competition.

4. a-ii Overview of Foreign Bank Entry

Currently, more than 50 percent of financial system assets in Latin America and Eastern Europe are in the hands of foreign banks. Some countries have been better able to attract foreign banks, than others. For instance, Argentina, Chile, Hungary and Poland saw an increase of bank assets from less than 20 percent to more than 50 percent between 1994 and 1999. In contrast, share of bank assets in East Asia, during the same period, rose from 3 percent to 7 percent. There

are wide variations in presence of foreign banks, across the developing world, with countries like Bangladesh, India and Egypt having less than 10 percent of assets in foreign banks, and Cambodia, Hungary and Turkey having a strong presence of foreign banks (Clarke et. al. 2003).

4. a-iii Empirical Evidence on Effect of Foreign Banks on Domestic Markets

The influence of foreign banks on the domestic banking environment is important to recognize, to assess whether open door policies of permitting foreign bank entry should be initiated. Entry of foreign banks is a deeply political issue, as most countries are threatened to see foreigners own financial assets in their country. There is also a fear that foreign banks will drive local banks out of the market, restrict lending during periods of crisis and concentrate lending mainly to larger firms (Clarke, Cull, Martinez Peria and Sanchez 2003). Therefore, emerging countries have typically had strict barriers to entry for foreign banks. There certainly exist drawbacks to excessive reliance on foreign banks. It can induce credit contraction as a response to poor domestic conditions, as was done by Japanese banks abroad (Peek and Rosengren 2000). It is also possible that foreign banks would have a lower long-term commitment to the host country (World Bank 2001).

However, there is very little evidence to support these arguments, instead most evidence suggests entry of foreign banks as a positive development. Foreign entry has been associated with improvement in competitive environment and quality of regulation and disclosure. Many case studies document the positive effect of foreign banks on domestic banking environment (See Claessens and Jansens 2000). Although foreign banks may be beneficial to domestic consumers by providing more sophisticated financial services, their effect on interest rate margins may hurt domestic banks, which is usually a prime concern for policymakers. Empirical evidence suggests that foreign banks improve efficiency and performance of domestic firms through greater competition. In Philippines, greater foreign bank competition reduced interest rate spreads and improved efficiency of domestic banks (Unite and Sullivan 2001). An improvement in administrative efficiency of local firms, suggests that foreign banks can also help benefit small customers who may be unable to access their sophisticated financial products. However in Colombia and Argentina, evidence indicates foreign banks did not compete with domestic banks in all financial services (Barajas et. al. 2001, Clarke et. al. 2000).

The only comprehensive study on access to credit and foreign bank entry by Clarke et. al. (2001), finds improved access to credit as a result of foreign entry, where small firms had a net

gain¹¹⁴. Although many studies argue that foreign bank lending to SMEs is lower than domestic firms (Berger et. al. 1995, Berger and Udell 1996, Goldberg 1992, Keeton 1995)¹¹⁵, another stream of evidence for Latin America finds that foreign banks lending to small business is not necessarily lower than domestic firms (Clarke et. al. 2000, Escude et. al. 2001)¹¹⁶. For instance in Argentina, Chile, Colombia and Peru, although foreign banks allocated a smaller share to SMEs there is little difference in credit extension by larger banks, with both foreign and domestic banks extending relatively similar amount to small and medium firms (Clarke et. al. 2000)¹¹⁷. In Chile and Peru, foreign banks lent a larger amount to small firms than domestic banks and in Argentina and Chile real growth in lending to small firms was higher for foreign firms (Clarke et. al. 2000)¹¹⁸. However, even if foreign banks continue to concentrate on larger firms, they may displace domestic banks, who may carve out a niche for themselves in lending to smaller enterprises (Clarke et. al. 2003). The only caveat to banks moving downstream is the need for good accounting standards, credit bureaus and improvement in overall business environment. If the correct sequencing is not in place, SME are bound to suffer.

Furthermore, while foreign banks may be beneficial in the long-term, it may take them time to develop information linkages about borrowers and gain familiarity with local environment (Calomiris, Klingebiel and Laeven 2003). This again reiterates the need for credit bureaus and transparency of information through better accounting standards. In the U.S., foreign banks in the 1980s extended loans primarily to low-risk borrowers, purchased rather than originated loans and were partners in syndicates rather than lead managers (Calomiris and Carey 1994).

Factors encouraging entry

Foreign banks may enter by establishing a subsidiary, branch or acquiring a local bank. The former route has been the most commonly followed. Foreign bank participation is higher in

¹¹⁴ Survey respondents rated interest rates and obstacles to long-term finance as a bigger constraint in countries with less foreign bank presence. There is limited evidence for Hungary that as a result of foreign bank presence, domestic banks sought to explore new market areas (Bonin and Abel 2000).

¹¹⁵ These studies study foreign bank lending in the U.S.

¹¹⁶ Berger et. al. (2001) findings for Argentina are consistent with claims that small banks are less likely to receive credit from foreign banks.

¹¹⁷ Clarke et. al. (2000) also find foreign banks allocated 35 percent of loans to manufacturing, compared to 20 percent by domestic private firms.

¹¹⁸ Technological innovations, that may not require presence of banks in each geographical location to carry out lending operations and improve credit analysis processes, may explain an increase in lending to small and medium enterprises (Mester 1997, Petersen and Rajan 2000).

countries with stronger legal rules and underdeveloped financial markets¹¹⁹. However in developed countries, quality of legal environment does not appear to be an important criterion (Clarke et. al. 2003). In countries with an underdeveloped financial system, but strong legal system, banking system is likely to be equally dividing between state-owned, private and foreign banks. However in countries with underdeveloped financial sectors and poor legal institutions, the banking system is likely to be heavily dominated by state banks (Clarke et. al. 2003)¹²⁰.

The factors that encourage foreign banks in developing countries appear to be different from those of developed economies, although most earlier empirical studies provides evidence for developed countries, particularly the United States. For instance, many US or UK based studies have found a positive relationship between foreign direct investment and presence of foreign banks i.e. foreign banks follow their customers (Budzeika 1999, Fisher and Molyneuz 1996)¹²¹. However, greater profit opportunities and weaker local banks (which make an inefficient use of capital) in the host country are found to be stronger reasons for foreign bank entry in developing countries (Bonin and Abel 2000, Claessens et. al. 2000, Focarelli and Pozzolo 2000) than the motivation to follow customers. Regulations and entry restrictions are also negatively associated with foreign bank presence in a cross-section of countries (Focarelli and Pozzolo 2000)¹²². Tax laws and weaker regulations on foreign bank activities ease entry¹²³. In the case of developing countries, Argentina and Chile have had a policy targeted towards attracting foreign banks, while Egypt and Korea have had limited foreign entry through restrictions on foreign bank activity. Effects of these government regulations has been that in the case of Korea, foreign entry has been associated with minor improvements in the efficiency of the banking sector (Hao et. al. 2000).

4. a-iv Political Climate

¹¹⁹ Clark, Cull, Martinez Peria and Sanchez (2003), measure development of financial sector as the ratio of M2 to GDP.

¹²⁰ State-owned banks control almost 30-35 percent of financial system assets in countries with a weak financial system, while in well developed markets their share is much lower (2-4 percent) (Barth, Caprio and Levine 2001).

¹²¹ Seth et. al (1998) findings do not support a positive link between foreign direct investment flows and foreign bank entry. They examine banks from Canada, Japan, The Netherlands and United Kingdom in the US, and find that they extend higher credit to non-home country firms. Similarly, Miller and Parkhe (1998) find a positive relation between foreign direct investment and foreign bank entry, but not for developing countries.

¹²² Focarelli and Pozzolo sample covers 28 countries, most of which are developed, but it also includes some developing countries : Czech Republic, Hungary, The Republic of Korea, Mexico, Poland and Turkey.

¹²³ Most literature on entry restrictions examines state regulations in the US (Goldberg and Grosse 1994, Hultman and McGee 1989), which find greater foreign bank participation in states with relaxed restrictions.

In the early 1990's, governments began to privatize state-owned banks that may have been created or nationalized by the state to serve a social or political purpose, and former privately-owned banks that were nationalized during a period of distress for the bank or a systemic financial crisis. In addition, a large number of banks around the world were purchased by foreign banks and financial intermediaries (such as G.E. Capital), in part because of the increasing globalization of financial services, the removal of barriers to direct foreign ownership of financial firms, bank restructurings, financial crises, and state-owned bank privatizations. For example, during the 1990's many banks created by socialist governments, such as the transition countries in Eastern Europe, were privatized and/or sold to foreigners. In addition, mergers and acquisitions followed the initial privatizations, leading to further ownership consolidation. Currently, foreign owners dominate the banking systems in Hungary, Poland, the Czech Republic, Croatia and Bulgaria. For example, in Bulgaria, the government rehabilitated state-owned banks and introduced macroeconomic stabilization to encourage foreign bank entry. By year-end 2000, over 80% of bank assets were at private banks and foreign-controlled banks accounted for 74% of total banking assets. In Hungary and Poland, foreign-controlled banks held over 60% of bank assets in 2000 (Bodin and Wachtel, 2002).

During and following the 1997 East Asian crisis, over 29 financially distressed banks in Indonesia, Korea, and Thailand were nationalized, closed, merged, and/or sold to foreigners. In addition, all three-crisis countries reformed existing bank regulations to permit foreign banks to purchase domestic banks, with the expectation that foreign banks would infuse foreign capital, bring banking expertise, and bring in management that are free from political influence (Moody's, 1998). By January 2000, Indonesia had one foreign bank purchase, Korea had two foreign bank purchases completed and one pending, and Thailand had two foreign bank purchases completed and four pending (Djankov, Jindra, and Klapper, 2002).

In Argentina the authorities were committed to allowing foreign banks to operate in tandem with domestic banks. During 1994-1997, numerous regulatory changes and specifically changes in entry restrictions, eased entry of foreign banks into Argentina. One major legislative change was the 1991 Convertibility Law that pegged the Peso to the Dollar. Between the first quarter of 1995 and second quarter of 1997, there was a sharp rise in total deposits, rising from 42 billion pesos to 65 billion pesos. Most of this increase was a result of rise in foreign deposits, which came at the expense of private domestic banks. Private domestic bank deposits fell from 136 billion pesos to 92 billion pesos, as a result of mergers and closures after the Tequila crisis. Foreign banks exerted significant pressure on domestic banks in their areas of operation. For instance, in mortgage lending, where both foreign and domestic banks were operating, domestic

banks faced declining interest spreads and profitability. However in commercial lending (heavily dominated by domestic banks) there was little change in profitability and interest margins (Clarke et. al. 2000).

Example: Tanzania (see Tschoegl 2003)

In 1967 all banks in Tanzania were nationalized. The assets of these 7 foreign and two domestic banks were consolidated into a single bank known as the National Bank of Commerce which was not to hold 90% of all deposits. The bank had a poor performance, as a result of its bad lending policies. Almost 30% of its loans were to the National Milling Corporation that was suffering large losses (Harvey 1991). The government liberalized the banking sector in 1991, opening it to private banks. The first foreign bank to enter the market was Standard Chartered Bank Tanzania, which was a subsidiary of Standard Chartered Bank of UK. It began its operation in 1993, although Standard Chartered UK had been in operation between 1917 and 1963. By mid-2000, Standard Chartered bank was the sixth largest bank in Tanzania. Another foreign bank to enter was Citibank, in 1995. In mid-2000 it was the third largest bank. It mainly is involved in wholesale commercial bank and serves large institutional investors.

As part of its efforts, to encourage foreign entry, the Tanzanian government recapitalized and privatized CRDB in 1996. The Danish International Development Agency is the largest shareholder and provides both technical and financial support. Although the National Bank of Commerce, continues to remain the largest bank in the country, it has been significantly reorganized. A separate spin-off microfinance unit has also been created which serves SMEs and is the fourth largest bank in the country. In early 2000 its 55 percent of shares were sold to Amalgamated Banks of South Africa (ABSA) and 15 percent to International Finance Corporate. In summary, as of mid-2000, foreign banks account for more than 55 % of assets in banking system and 89% of assets of banks and non-bank financial institutions. Out of the 6 largest banks, 4 of them are foreign owned.

4. b Sale of Distressed Banks

Another approach that has been taken to resolving financial distress has been government-assisted sale of financial institutions to foreign investors. This typically involves relaxation of limits on foreign bank entry and government sharing some of the loan losses. The expected benefits of this measure are an addition source of capital that is less likely to be diverted to inefficient uses. Foreign banks also have a lower cost of capital, as they do not have huge loan losses which

allows them to raise new capital and markets will not impose large discounts on them (Calomiris and Wilson 2003). Better management of foreign banks can also improve operations and valuations of distressed related firms. Djankov, Jindra and Klapper (2003) examine 31 insolvent banks in Indonesia, Korea and Thailand, that were creditors to 269 public traded companies. All three-crisis countries reformed existing bank regulations to permit foreign banks to purchase domestic banks. They find, announcement of foreign sale of bank, initially led to a valuation discount if related firms, but expectations of improved management quality, led to investors revising expectations of foreign capital. Moody's "Banking System Outlook: Korea" (1998) states: "Foreign Acquisition is the option of choice for the government because it will bring in badly needed foreign capital, thus reducing the burden on the public sector, while providing technical expertise and enhancing the quality of management. In Moody's view, improving management quality that is free from political influence is an especially critical aspect of the banking sector reform." Foreign ownership can also bring a change in lending policy by reducing or ending lending to prior politically connected customers (Tschoegl 2003). Korea First Bank was deeply troubled when it was acquired by the government. However, it was becoming a huge drain on government resources, requiring recapitalization and also destabilizing the banking system, which motivated its sale to a foreign investor (see example: Korea First Bank).

Case study literature on activities of foreign banks in Argentina and Mexico, highlights the favorable effect of foreign banks in resolving bank distress. Sale of failing banks to foreign investors is an effective way to infusing capital into banks and bringing good management expertise. The access to capital that foreign banks generally have and their willingness to invest it in long-term relationships allows them to compete effectively for loans. However, any advantages that foreign banks have are dependent on strength of legal institutions. The slow pace of legal reform in Mexico has been one of the factors for slow growth in credit. If this had been predicted, it is possible that less foreign investors would have entered the market.

Example: Korea First Bank (Risk Exposure and Risk Management at Korea First Bank – Darden Business School Case UVA-F-1386)

The Korean banking system is modeled on the relationship banking structure in Japan. It is based on close relations between borrowers and lenders, allowing lenders access to private information on borrowers. However, it is open to manipulation, which also slows down transfer of information to lenders, as became evident from the case of Korea First Bank. Korea First Bank (KFB), a private bank, was performing well domestically having produced its highest profits for 3 straight years in the early 90s, despite increased foreign competition. However, KFB was heavily

exposed to Hanbo Steel, a member of Hanbo Chaebol, at the time of the financial crisis. It was also a major creditor for Daewoo group, considered the weakest of the big five chaebols. Although signs of the financial crisis were visible in 1996, bankruptcy and default of prominent Korean firms was an awakening for banks which were overly exposed to these failing chaebols and had also sustained losses on their equity investment. In January 1997, Hanbo chaebol, that was the 14th largest chaebol in Korea, went bankrupt. Hanbo Steel's bankruptcy, exposed KFB's troubles. KFB's exposure to Hanbo Steel amounted to over \$1 billion out of a total of \$6 billion (Korea First Bank (A), Harvard Business School, Case 9-701-022, Exhibit 3). KFB and other Korea banks had continued to lend to Hanbo steel for an ambitious steel mill project, without evaluating its feasibility. They had also ignored government restrictions on overlending to chaebols¹²⁴. Two KFB officials were also convicted of receiving bribes for credit facilities.

As part of a rescue effort, KFB was acquired by the government at the height of the crisis. Concerns about KFB and SeoulBank (another troubled government acquired bank) were so high, that the IMF laid down their sale as a condition for its \$60 billion rescue package. The governments continued efforts for an economic recovery and regulatory reform allowing foreign banks to acquire domestic banks, allowed a deal to be negotiated. A 51 percent share of KFB was eventually sold in 2000, after 15 months of repeated negotiations to an American investment firm: Newbridge.

4.c Performance of Foreign Banks during Systemic Crises

The biggest fear of foreign banks is that they may export their resources when host countries are under pressure. There is little systematic evidence on activities of foreign banks during periods of crisis in host countries. However, most case study literature prior to Argentina Crisis in 2001, reveals that foreign banks are less vulnerable to a crisis. For instance, foreign banks in Argentina used their external credit lines to support themselves during the Tequila crisis. Foreign subsidiaries are less affect by a crisis because they have been more conservative in their lending. In Argentina, Brazil and Mexico, during and after Tequila crisis, foreign banks showed less volatility in loans growth, relative to domestic banks (Dages et. al. 2000, Peek and Rosengren 2000). In 1995, foreign banks in Argentina and Mexico did not leave the market, and instead increased their investments. Although recent events in Argentina presents a different picture, this is due to poor government regulations that forced heavy losses on foreign banks and rendered them insolvent (see example).Therefore, foreign banks have been a stabilizing force for credit flows (Cull, Senbet and Gorge 2001, Dages et. al. 2000). Similarly, in Malaysia, foreign banks

¹²⁴ See Financial Times, January 28, 1997.

did not abandon the market and increased their market share, following the crisis (Degatriache and Gupta 2002). In a few cases it has also been documented that depositors have turned to foreign banks in a crisis, instead of shifting their funds abroad (Claessens and Glaessner 1998). In the Pacific Islands, crisis were limited to need to bail-out depositors in state banks, while depositors in foreign banks were unaffected (Tschoegl 2003). As most crises are associated with huge depreciations in the local currency, which indirectly benefit exporters, the specialization of most foreign banks in trade finance, in fact benefits them during crisis (Tschoegl 2003). Although it is argued that foreign banks can assist during crises by rehabilitating ailing banks or as an instrument of financial sector reform, this has not been the case in recent crises.

The activities of foreign banks in Argentina, however contrast the above claims and are likely to create a backlash against foreign entry in other countries. It certainly requires a re-evaluation of pros and cons of foreign entry.

Example: Foreign Banks in Argentina (Clarke et. al. 2003, Tschoegl 2003)

A run by investors in Dec 2001, led the government to freeze banks deposits, devalue the peso, introduce capital controls and default on its \$141 billion external public debt. Before these Before the onset of full-scale of the crisis, foreign banks had participated in several rescues of local banks. In 1999, Banca Nazionale del Lavoro, Banco Bisel, Banco Macro Misiones, Banco Sudameris Argentina, Banco Supervielle and Banco del Suquia acquired branches of a public bank Banco Israelita de Córdoba. In late 2001, the government suspended license of Scotia Quilmes Bank due to concerns about its liquidity. The 97 branches had been acquired by the Canadian Scotiabank in 1997. Scotiabank was reluctant to pump in more capital and abandoned Scotia Quilmes writing off C\$540 million. Scotiabank did offer to make severance payments to workers and also did no claim present assets of Quilmes to help depositors. Other arrangements included an offer of C\$36 million to pay 20 cents on the dollar holders of Quilmes' medium term notes. Similarly Credit Agricole also abandoned its three subsidiaries, upon refusal to inject \$200 million required for them to stay afloat. These subsidiaries had a total of 353 branches which mainly served farmers. The government owned Banco de la Nacion Argentina, became a temporary caretaker of these banks. Finally, most recently in 2003, IntesaBCI sold Banco Sudameris Argentina (BSA) to Banco Patagonia, which is a provincial bank. However IntesaBCI will take up a 20% stake in the new entity and contribute towards working capital operation of the bank.

Although other banks have not left the country, they have threatened that they may not recapitalize their subsidiaries. However, this behavior of foreign banks during the Argentine crisis

is justified as response to poor government policies. The banking sector had largely financed government debt, therefore the debt default and fall in government bond prices, adversely affected them. Furthermore, prior to this event, the Argentine Peso was pegged to the dollar on a one on one basis. Upon freezing of the bank accounts, the government only allowed dollar denominated loans to be converted to pesos on a 1 to 1 basis, while deposits were converted at 1 to 1.4. This 'pesification' of banks' assets and liabilities is commonly suggested as a primary reason that forced foreign banks to leave.

4. d Proceeding with Caution

There are clear benefits to foreign entry, which can bring good skills and capacity to train local bankers. In order to protect their reputation, they will also be motivated to behave in line with highest fiduciary standards (World Bank 2001). However, concurrently, governments should not abdicate their regulation. There can always be possibilities that foreign banks are involved in risky or criminal activities (for example BCCI). Regulators in the home countries, can also play their role in altering developing countries of any concerning activities and operations of their banks.

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