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LIBERALIZATION AND PRIVATIZATION OF THE FINANCIAL SECTOR:

GUIDELINES AND CASE STUDIES

FINAL REPORT

Bureau for Private Enterprise
U.S. Agency for International Development

Prepared for: *Office of Policy Development and Program Review*
Bureau for Program and Policy Coordination

Prepared by: *SRI International*
1611 North Kent Street
Arlington, VA 22209

Sponsored by: *Private Enterprise Development Support Project II*
Project Number 940-2028.03
Prime Contractor: Ernst &Young

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Foreword

One of the key constraints to accelerated economic performance in developing countries is the absence of strong, dynamic financial systems. Healthy capital and credit markets serve the vital functions of attracting savings, intermediating funds, and allocating credit to productive uses. Development practitioners are unanimous in their identification of capital formation as one of the most important components in the development process.

Unfortunately, many if not most developing countries suffer under the yoke of repressed financial systems which have been assaulted by the worldwide debt crisis and subjected to excessive regulation and government interference. Until these markets are released from these conditions and allowed to carry out their appropriate functions, entire economies will suffer.

The purpose of this report is to provide analysis and guidance on alternative efforts to reform capital and credit markets and to privatize government-owned and operated financial institutions in developing countries. The central objective is to provide relevant information to government officials, private sector leaders, and donor agency professionals on alternative means to bring financial systems into a framework in which decisions and performance are driven by market forces rather than by government directive.

The AID policy determination on "Implementing AID Privatization Objectives" outlines for AID missions some of the benefits of privatization. The Financial Markets Development Policy Paper (FMDPP) lays out the groundwork for financial sector liberalization. This report is designed to build on the foundations laid in PD-14 and FMDPP, and provide missions with case studies of actual bank privatizations and practical guidelines to follow in designing and implementing financial reform and privatization programs.

The project on which this report is based was undertaken on behalf of the Bureau for Program and Policy Coordination (PPC) of the United States Agency for International Development (AID). The project was carried out jointly by PPC and the Private Enterprise Development Support Project of A.I.D.'s Bureau for Private Enterprise (PRE).

The project was conducted by SRI International and Arthur Young and Company. The authors were Kathleen Vickland, International Economist, Frank Nieder, Senior International Economist, and John Mathieson, Director, all of SRI's International Policy Center, and Ronald J. Ivey, Principal of the International Management Consulting Group of Arthur Young.

Section I of this report presents the argument for financial sector reform and privatization. This is followed in Section II by an overview description of the operating components of financial markets in developing countries, and an assessment of variables which collectively lead to a underdeveloped financial markets. Section III discusses criteria to apply in order to determine appropriate financial reform and privatization activities to undertake. Section IV presents recommendations and a privatization checklist for use by development practitioners who wish to address the important issue of financial market development. Section V offers recommended areas for financial policy reform. Section VI presents a series of methods and guidelines to employ in efforts to privatize financial institutions. The various positive and negative effects of these types of initiatives are examined in Section VII.

The chapters of the central report are followed by Annex A, containing a series of seven country case studies of actual privatizations and accompanying financial policy reforms. These case studies include privatizations and financial reform in Bangladesh, Chile, Guinea, Jamaica, Mexico, New Zealand, and the Philippines. These studies seek to bring out the methods and strategies used in each of these countries, as well as lessons which can be drawn from their experiences. Annex B lists other financial institutions privatizations which have taken place around the world, and is as comprehensive as possible. Annex C presents government-owned financial institutions in countries of interest to AID.

Executive Summary

The financial market is probably the single most important market in any economy. The financial sector is the marketplace for capital and credit, where funds are allocated and distributed, and where the price of money (interest rates) is determined. The financial marketplace can encourage local savings or discourage it, can encourage local investment of funds or capital flight, and perhaps most importantly, can lead to productive investment or wasteful speculation. Given the primacy of capital -- both its availability and terms -- in determining the success of business ventures in the entire economy, a dynamic and efficient financial market is key to economic growth and development. Given the critical function that financial markets play in economic growth, financial reform and privatization of financial institutions merit careful consideration.

Government and privately-owned financial institutions can be expected to diverge on a number of areas of behavior and performance. Because of the incentive structure private banks face, they tend to be more efficient, offering higher quality service with lower administrative costs. Private banks tend to respond more rapidly to opportunities to increase market share by introducing new, attractive financial instruments. They are generally more diligent about collecting loan payments. Mindful that in competitive markets, "the customer is king," private banks in general carefully cultivate confidential relationships with their clients, especially large depositors and borrowers.

On the other hand, managements of government banks are driven by a different set of incentives and directives, many of which are politically rather than commercially motivated. As a result, loans are directed toward uneconomic but politically desired projects, and decisionmaking is bureaucratic. Staff sizes tend to be bloated and filled with unqualified and unmotivated personnel. Consequently, the performance of such banks and the economy as a whole suffer from inefficiency and inappropriate allocations of scarce capital.

Many forces work to "repress" financial markets. These typically include economic, social and policy factors such as low per capita income, the political power of economic elites, currency overvaluation, excessive government spending, ineffective bank supervision, and weak or unenforced contract law.

The macroeconomic implications of bank ownership heighten the importance of bank privatization. Each of the divergences between publicly and privately owned institutions affects the efficiency and dynamism of the entire sector, and in turn, the economy as a whole.

This report suggests that laying a foundation of sound macroeconomic, sectoral and regulatory policies conducive to financial sector development is in most cases the most important step to effective capital markets development, and should precede or at least accompany privatization. Privatization, in the absence of policy and regulatory reform, is no panacea for the myriad problems facing financial sectors in developing countries. A transfer of bank ownership from public to private in a context of negative real interest rates, an overvalued currency, extensive government credit controls, and ineffective bank supervision is likely to produce few discernible benefits. Nevertheless, privatization is an important tool available to developing-country decisionmakers to complement financial liberalization and to improve the performance and efficiency of the financial sector.

A concerted program of macroeconomic and regulatory reforms and privatization will encourage healthy financial sector development. Macroeconomic reforms such as implementing positive real interest rates, controlling the government deficit, maintaining low inflation, and encouraging a competitive exchange rate will create a context conducive to financial sector growth by encouraging saving and productive investment (See Chapter III). Regulatory reforms, which include reducing directed credit and excessive reserve requirements, lifting interest rate ceilings and improving bank supervision, will also bring about a number of benefits, including a more efficient allocation of capital, greater domestic resource mobilization, and reductions in fraud in banking.

The various steps involved in undertaking reform and privatization are illustrated in a Financial Liberalization and Privatization Checklist (see Chapter IV). The Checklist is designed to serve as a practical guide for policy markets. While not all inclusive, it was designed to "flag" the major issues that emerge in the process of drafting and implementing reform and privatization plans.

By providing incentives for efficiency and profitability, privatization will bring about many of the same benefits as reform, but also will encourage administrative efficiency and careful personnel recruitment and supervision, two benefits not created by reform. Each of these components -- privatization, macroeconomic reform and regulatory reform -- can contribute to both improved financial sector performance and the achievement of national economic and social objectives (see Chapters V and VI).

Privatization does not refer to a single transfer mechanism, but to a host of alternative measures. One commonly cited reason for not privatizing is the lack of functioning capital markets. As the case studies appended to this report indicate, many privatization options exist which do not require capital markets,

including corporatization, reduction of barriers to new private banks, and joint ventures with foreign banks.

For several reasons, bank privatization is a more delicate task than privatization of other government-owned enterprises.

- First, because of the primacy of financial institutions in an economy, anything that affects the financial sector reverberates and is often even magnified in the rest of the economy.

- Second, because many financial institutions accept deposits, they have a fiduciary responsibility to protect the deposits of savers. Therefore, savers have a clear and direct interest in the financial soundness and ownership of the institution over which they have no or little control.

- Third, since confidence is a key factor in financial markets, any measures taken by government or private sector leaders which has the potential to undermine confidence in the system must be carefully planned and executed.

- Fourth, in comparison to privatization of nonfinancial entities, bank privatization deals directly with money and the extreme rapidity with which financial assets can be moved from one institution to another, or even out of the country. Millions of dollars in local or hard currency can flow out of a financial system in a matter or days or even hours in response to a government measure which appears threatening.

To assist governments to avoid these problems, and design reforms and privatization packages, this report proposes a two-pronged approach, illustrated in Figure 1. The steps in the approach are as follows.

Financial Sector Diagnosis. The first task is to assess the current performance of both the formal and informal financial sectors, and determine the causes of system limitations.

Target Specific Policies and Institutions. Once policymakers set overall goals, they should select key policy constraints to remove, and identify prime candidates for privatization, based on both technical and political criteria.

Macroeconomic Reforms. Policymakers should strive to create a policy framework conducive to financial sector growth. The desired environment should have the characteristics of positive

real interest rates, low inflation, and a competitive exchange rate.

Bank Regulation and Supervision Reform. When necessary, the government should work toward lowering barriers to entry by private and/or foreign banks, reducing the scope of government-mandated portfolio allocation guidelines, and encouraging the use of standardized financial audits of banks and their clients.

Privatization. The lack of developed capital markets does not preclude privatization, given the host of alternative methods which exist. Any opposition to privatization should be closely monitored, and educational and promotional campaigns regarding the benefits of privatization should be launched. While widespread stock ownership is likely to engender popular support for privatization, it should often be tempered by assurances that institutional investors such as pension funds, insurance companies or foreign banks hold a small but significant portion of total shares. The relatively large stake of institutional investors, combined with their knowledge of the technical aspects of operating a financial institution, will improve oversight of management decisions.

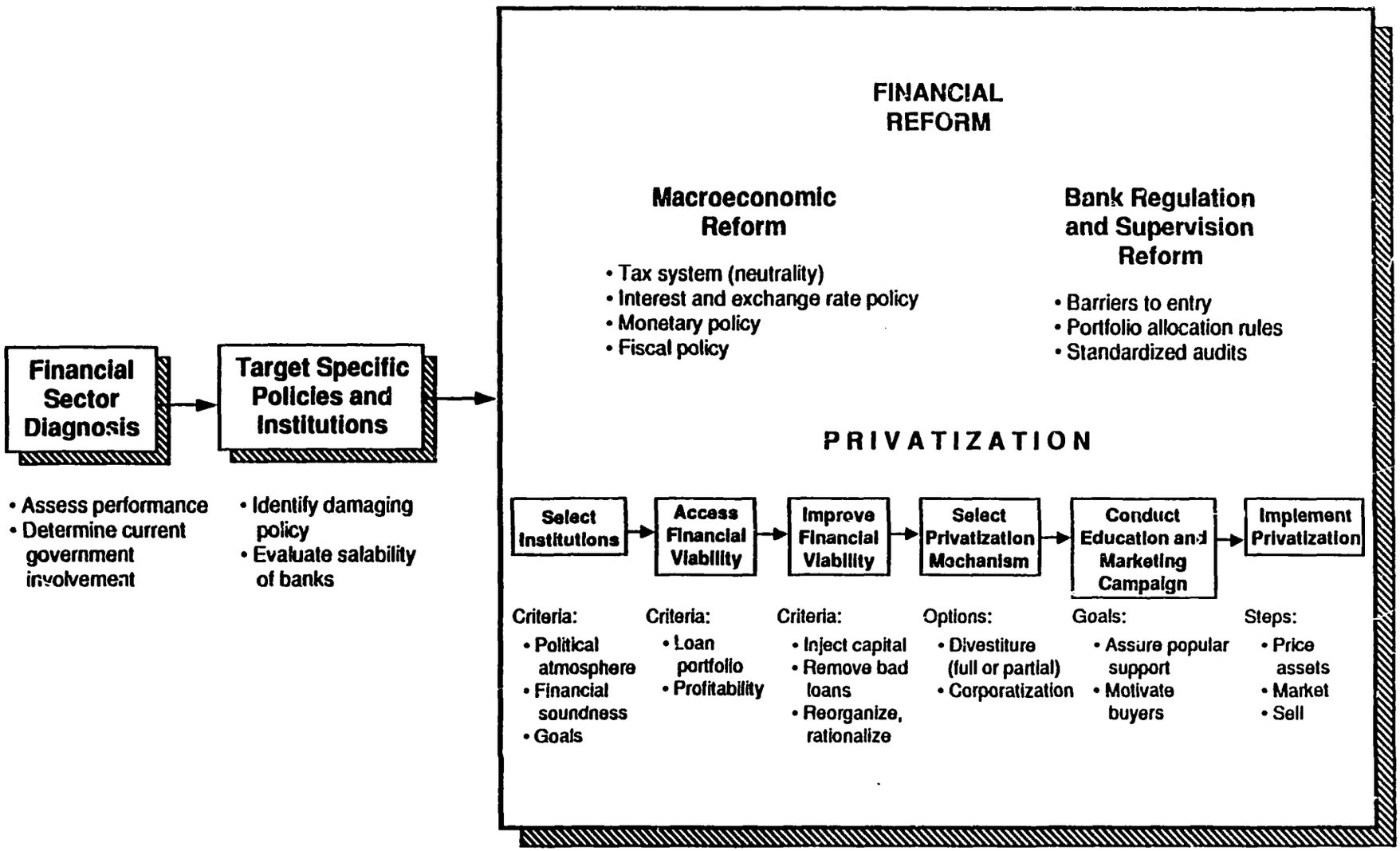

FIGURE 1 METHODS FOR IMPROVING FINANCIAL SECTOR PERFORMANCE: MACROECONOMIC AND FINANCIAL SECTOR REFORM, AND PRIVATIZATION

I. The Need for Financial Sector Reform and Privatization

Financial systems play a critically important central role in the activities of all economies. These systems carry out the important functions of clearing the exchange of goods and services, and administering the aggregation and allocation of financial resources. Without some form of capital and credit markets, societies are limited to little more than barter economies. Financial sectors form the "circulatory systems" of and among agricultural, manufacturing, and other service sectors.

Financial institutions represent the organizational nucleus of capital and money markets and provide several essential services. Banks and other financial firms (savings and loan associations, brokerage houses, insurance companies, leasing firms, etc.) provide the public with a means to save for the future and to borrow to meet current financial needs. These organizations are the only way in which thousands of small investments from one set of "clients" can be transformed into short and long-term loans to fund the productive ventures of another set of "clients."

Unfortunately, financial systems are often overlooked by development practitioners since their structures are viewed as arcane and their problems are seen as too large to tackle by donor agencies. In addition, traditional development assistance has focused on either the "productive" sectors of agriculture and manufacturing or on sectors which provide essential services -- health, education, sanitation, housing, and so forth. Relatively short shrift has been given to the financial system which ultimately serves all of these sectors.

The onslaught of protracted financial crisis throughout the developing world has directed some attention toward capital and credit markets, but has concentrated primarily in efforts aiming to improve nations' external accounts and ability to meet their debt servicing requirements. Relatively limited energies have been expended in designing and implementing systematic reforms oriented toward increasing domestic capital formation and intermediation.

This oversight is particularly disturbing in light of the fact that debt-ridden developing countries enjoy almost no access to international capital markets, have witnessed declines in official financial flows and have attracted only limited amounts of private direct investment. If these nations are to have any chance to achieve pre-oil and pre-debt crisis growth rates, they must generate higher levels of domestic capital, reduce leakages from the system through capital flight, and entice the repatriation of funds already transferred offshore. To meet these requirements, domestic capital and credit markets must evolve in such a way as

to provide necessary incentives and an appropriate policy environment for capital formation and retention.

As with financial systems, financial institutions themselves are often neglected by the "development community," in part because they act as intermediaries between two groups which are typically the recipients of development assistance programs and projects -- the general public and the "productive" sectors of the economy. Development agencies tend to focus either on the poverty and needs of the general public or on the requirements of agriculture, industry, and other productive sectors. Much less attention is focused on the financial institutions that serve as intermediaries between the two groups. The fact is that all sectors benefit from healthy capital and credit markets, and similarly all sectors suffer from unstable or underdeveloped financial markets.

The air of complexity which often permeates discussions of finance is a second reason why the subject of financial institutions is avoided. Many people treat financial intermediation as a "black box," with savings flowing in and loans and investment flowing out.

Financial institutions perform three essential functions: They mobilize savings, intermediate funds, and extend capital and credit in the form of loans and investment instruments. They attract savings by providing individuals and firms with convenient collection points and appropriate and safe instruments at attractive rates. These or other institutions then transform the excess funds into instruments that meet borrowers' needs. Lastly, they lend the funds to individuals, firms, and projects deemed to have the ability to repay the loans and interest incurred. In addition to these banking functions, secondary markets provide financial instruments (equity, marketable securities, etc.) which can be distributed to a broad array of investors. Each of these functions is critical to efforts to assure an adequate supply and appropriate allocation of capital.

The capacity of financial institutions to carry out their responsibilities efficiently and profitably is a function of many factors, including overall economic conditions, government policies and regulations, and forms of ownership and management control. The opposite causal relationship also holds: Financial sector performance can materially affect economic, social, and government policy developments.

Because financial sectors are so little understood by many citizens and policymakers, yet so vital to development, it is highly appropriate to begin to consider financial systems <u>as</u> important economic sectors themselves. Finance is clearly a means to an end. However, it will be impossible to make major strides toward increasing rates of growth and living standards until the "black box" of finance is opened, deciphered, and improved.

Throughout the world, governments are privatizing financial institutions. In countries as diverse as Great Britain, France, Germany, the Philippines, Mexico, and Guinea, governments have made moves to return, or in some cases shift, banking functions to private hands. Annex B lists all bank privatizations known to date. Many additional countries are seeking to learn from these nations.

Bank privatizations represent attempts by governments to invigorate and modernize their banking sectors and, in turn, to stimulate their economies through the acceleration of capital formation and the provision of efficient and expanded financial services. The successful privatizations are often accompanied by financial reforms, because changing the ownership structures alone cannot solve all of the problems associated with ineffective financial sectors. However, it can serve as a positive and important step in the right and direction.

Ownership matters. The incentives extended to individuals and organizations, and the goals and procedures that are adopted by them, are a function of top management and/or ownership discretion and control. If ownership is separated from management, as it often is the case in modern societies, then management takes its cues from the owners.

Owners play a dominant role in business operations. They determine, directly or indirectly, who is hired, what goods and services are produced, how they are distributed, what prices are charged, and what is an acceptable profit level. Applying these to banking, one finds that bank ownership plays a determinant role in personnel staffing levels and qualifications, the mix and distribution of savings and credit instruments, the locations of branch banks, and the interest levels paid and charged.

Privately-owned banks differ significantly from government-owned banks in many regards. Some of the more important variances are described below. Throughout this paper, government-owned banks are defined as banks owned 50 percent or more by one or more government entities, whether local, regional or national.

BANK ADMINISTRATION

Privately-owned banks are generally more efficient than those owned by the government. The higher efficiency is a result of incentives for bank personnel and management to keep costs low, and revenues and profits high. Private owners focus on "the bottom line." In contrast, government owners do not report to profit-seeking stockholders, and often do not publish the equivalent of profit and loss statements or annual reports. Secure in their jobs, government workers do not face the same pressures to work

rapidly and accurately as do private sector employees who do not enjoy a similar degree of job security.

The limited quantitative information that is available supports the conclusion that private sector banks are more efficient. Table 1 illustrates the relative administrative efficiency of seventeen development banks around the world, eight of which are government-owned and nine of which are privately-owned. In most cases, private development banks out-perform state-owned institutions in the same country. In both Ecuador and Korea, privately-owned banks incur lower administrative expenses relative to total assets than do their government-owned counterparts. The private development bank in Ecuador was 26 percent more efficient than the state-owned bank, while the private institution, KDFC-KLB, in Korea was 133 percent more efficient, on average, than the government-owned banks. In the East Asia and the Pacific region, privately-run development banks incurred on average only 80 percent of the administrative costs of government-owned institutions to handle a given asset level. Private banks worldwide averaged lower administrative costs than their public sector counterparts. It is interesting to note that private banks demonstrate lower administrative costs per unit of assets even given the likelihood that private sector employees are paid more than public sector workers.

Governments have not historically been concerned with the internal efficiency of state-owned enterprises (SOEs). That attitude has been changing recently, however, as governments have become aware of the large budget pressures that result from propping up inefficient SOEs. In the particular case of banks, there is an additional reason for government concern. Administrative costs and profits are, in simple terms, a part of the differential between interest rates paid to savers and those charged to borrowers. To the extent that governments can set a framework (i.e., private banking) in which administrative costs are low, rates paid on savings can rise, encouraging additional saving and releasing new resources for growth, and borrowing rates can fall, lowering the cost of doing business and spurring investment and economic development.

TABLE 1:
A QUANTITATIVE COMPARISON OF GOVERNMENT AND PRIVATELY OWNED DEVELOPMENT BANKS

Country and Institution	Admin. Expenses as % of Assets	Gross Income as % of Assets	Financial Expenses as % of Assets
East Africa			
Public DFCs			
BDC/Botswana	4.1	13.0	5.3
TIB/Tanzania	1.0	7.4	2.5
Average, Public DFCs	2.6	10.2	3.9
Private DFCs			
SOFIDE/Zaire	6.3	12.2	3.8
West Africa			
Private DFCs			
SOFISEDIT/Senegal	5.0	9.6	8.1
Latin America & Caribbean			
Public DFCs			
CFN/Ecuador	2.4	9.0	6.4
Private DFCs			
COFIEC/Ecuador	1.9	9.0	3.9
East Asia & Pacific			
Public DFCs			
BAPINDO/Indonesia	3.7	12.5	7.4
DBP/Philippines	1.4	7.3	6.7
CNB/Korea	4.2	14.6	9.5
KDB/Korea	1.9	10.6	7.4
SMIB/Korea	3.5	12.3	8.6
Avg., Korean Public DFCs	2.4	11.7	8.0
Average, Public DFCs	2.5	10.9	7.6
Private DFCs			
DBS/Singapore	1.3	8.9	5.9
KDFC-KLB/Korea	1.0	11.8	8.1
PDCP/Philippines	1.8	12.6	7.4
PISO/Philippines	2.7	9.1	3.4
PDFCI/Indonesia	3.7	12.7	6.8
Average, Private DFCs	2.1	11.0	6.3
South Asia			
Private DFCs			
PICIC/Pakistan	0.7	9.2	6.6
Worldwide			
Average, Public DFCs	2.3	9.6	5.9
Average, Private DFCs	2.2	9.7	5.7

Source: World Bank, "DFCs: State and Privately Owned," Staff Working Paper No. 578, 1983. All figures are averages for 1977 - 1979.

RESOURCE MOBILIZATION

Whether public or private, banks look primarily to four sources for funds to lend: Domestic savers, the government, international capital sources such as private banks and multilateral development banks, and paid-in capital and retained earnings. Case studies indicate that government-owned banks tend to rely heavily on government funds and subsidies and multilateral development banks. Once banks are privatized, there is often a surge of resource mobilization and financial deepening as increased confidence in the banking system and more attractive savings instruments attract new funds from savers. Thus state-owned banks often repress the evolution of viable local sources of capital and contribute to capital flight, while private banks, denied easy access to government subsidies, are generally more effective at mobilizing local resources.

Several case study examples illustrate this point. The barely functioning state-owned banks in Guinea attracted very few deposits, and operated instead as channels for subsidized government credit. Following the implementation of privatization and financial reform in the mid-1980s, resource mobilization improved somewhat. However, negative real interest rates for savers, a result of government interest rate ceilings and high inflation, have kept local savings low.

Results have been better where financial reforms have allowed interest rates to rise to encourage savings. Chile saw a rise in the most widely used financial deepening indicator (the ratio of M2, a broad monetary aggregate, to gross domestic product (GDP)), from 15 percent to 48 percent in the decade following privatization and reform. In Bangladesh, this indicator of financial deepening grew from 20 percent to 25 percent in the seven years following financial sector privatization and liberalization.

The differential between the ability and predisposition of government versus private banks to mobilize local savings points to an important conclusion. By invigorating local sources of capital, private banks tend to reduce the need for local financial markets to depend on foreign borrowing. The protracted debt crisis being experienced throughout the developing world provides an additional impetus for privatization.

PRODUCT DEVELOPMENT

In their quest to attract and retain clients, private banks aggressively use one of the most powerful tools open to them: The innovation and dissemination of new banking products. Examples of new products include instruments for savers and for borrowers, such as certificates of deposit, interest bearing checking accounts, foreign currency accounts, and instruments denominated in real

terms. Because private banks depend more heavily than public sector banks on local depositors for funds, they are much more likely to be creative in developing and gaining approval for new banking products. The predominance of public sector banks in developing countries is thought to be one reason why the financial markets in those nations have not developed the wide range of instruments available in other countries.

In most goods markets, the government is and should be unconcerned with the range of products available. That is not the case, however, in financial markets, because of the economy-wide benefits associated with savings. Side-effects (either positive or negative) of production or consumption which affect people other than direct producers or consumers are called "externalities." Savings generates positive externalities. Savings create capital, which can be productively invested to expand output, jobs, exports, and foreign exchange. Thus, private banks' tendency to create new instruments and increase savings leads ultimately to greater production and more jobs. Conversely, the negative effects of the government-owned banks' failure to create attractive savings instruments and mobilize local savings reverberate throughout the economy.

CREDIT ALLOCATION

Government and private banks also differ in the criteria they use to allocate credit. Private banks tend to use creditworthiness as the deciding criterion, whereas politically driven allocations are rampant in some state-owned institutions. Government institutions are more likely to approve credit according to some predetermined formula, e.g., 30 percent of the portfolio to agriculture, 40 percent to heavy industry, etc. This difference between public and private allocations stems fundamentally from the different incentives under which the banks operate. Government officials are more likely to respond to pressure from other officials and agencies, because in some cases their jobs depend on maintaining good relations. In addition, in the end, neither individual transactions nor the overall bank performance will be monitored carefully for profitability.

In contrast, private bank officials are held accountable for the outcome of the loans they approve. The future of their careers and the bank itself depends on lending funds to projects which generate a profit and repay the loan and interest on time. Because of the ownership structure and the demands that owners place on the entire bank organization, private banks tend to allocate credit based on expected profitability. Thus, credit is more likely to be channelled to those projects with high rates of return in a system in which funds are intermediated by private banks, rather than in a system in which state-owned banks predominate.

LOAN COLLECTION

The same pressures which encourage private institutions to make lending decisions based on financial and cash flow analyses also push them to collect loans vigorously. The emphasis on the "bottom-line," the careful tracking of loans and financial performance, and the strong link between individual careers and loan performance all act as incentives for vigilant loan collection efforts.

These incentives are often absent in state-owned banks. In an environment in which career progression is tied more closely to political connections than to loan decisions and performance, bad loans are less likely to receive close attention and monitoring, and less likely to be the subject of vigorous enforcement.

The lack of effective loan collections has deleterious effects not only on the individual banks which must take the write-offs, but on the entire financial system, as loans come to be regarded more as gifts than contracts which must be fulfilled. The government banks which allow non-payers to escape their commitments, and even receive additional credit, create an atmosphere in which bad debt rates and therefore the costs of contract enforcement rise throughout the financial system.

PERSONNEL RECRUITMENT, SUPERVISION AND COMPENSATION

In banking, as in all service industries, staff quality is a key to success, because personnel is the principal input from which banking services are generated. The right individual with the right skills can make the difference between keeping a client and losing him, and between recognizing a profitable loan from an unprofitable loan.

Public sector banks labor under a number of personnel restrictions and requirements to which private banks are not subject. Government-owned institutions are often pressured to hire individuals based more on connections than competence. Lower salary scales often discourage more experienced individuals from accepting public sector jobs. Since public sector managers are rewarded more for controlling large bureaucracies than for efficiently using staff to perform given functions, overstaffing is rampant. Staff review, evaluation and supervision are often almost perfunctory, since employment and promotions are less a function of individual output and more a function of political pressure.

In contrast, private banks hire, supervise, promote, and release staff based on their perceived ability to add to the bank's fundamental goal of providing quality service to clients in order

to earn a profit. While contacts and connections still matter, they usually matter less. Private enterprises more closely resemble meritocracies than do public firms. Staffing levels in private banks are likely to be much leaner than those in government institutions. Indeed, disposing of the excess personnel is one of the most troublesome issues encountered in privatizations.

II. Developing-Country Financial Markets: An Overview

Any financial system can be described either as a simple set of functions or as an arcane structure of intricate transactions. The simplicity of the system lies in the three basic forces underlying financial activities -- saving (capital formation), intermediation, and borrowing (capital use). Virtually all facets of financial activities relate to one of these three functions. In fact, it is reasonable to conclude that saving and borrowing are the fundamental functions of any financial system, and that intermediation is merely the process for proceeding from one function to the other. Very often even market participants, much less outside observers, fail to appreciate the simplicity of these basic roles.

Financial systems appear complex for several reasons. First, the number of actors involved is large, and each holds different goals and responsibilities. Second, the range of instruments involved in financial transactions is often sufficiently broad to confuse even experienced participants. Third and most importantly, many economic, political and even social variables come into play as both causes and effects underlying the dynamics of financial systems, which add increasing layers of complexity to financial analysis and policy formation (see Figure 2).

As a consequence of the "dual" nature of capital and money markets, shifting from simplicity to complexity, assessments of financial developments and needs have tended to be either deceptively simple, general analyses, or highly detailed descriptions of specific market segments which can only be deciphered by technical experts.

The most appropriate approach for addressing financial market issues is to begin with a description of the basic operating components and forces at work, and then to incorporate additional factors (e.g., institutional, economic, policy, etc.) which come into play in the determination of financial conditions and processes. To follow such an approach, this section will begin with a discussion of the functions of and actors in any financial system. This will be followed by a brief examination of the variables which affect "typical" developing-country financial markets. Finally, the section will present an analysis of the nature and impact of factors which retard growth in money and capital markets and give rise to a condition generally known as "financial repression."

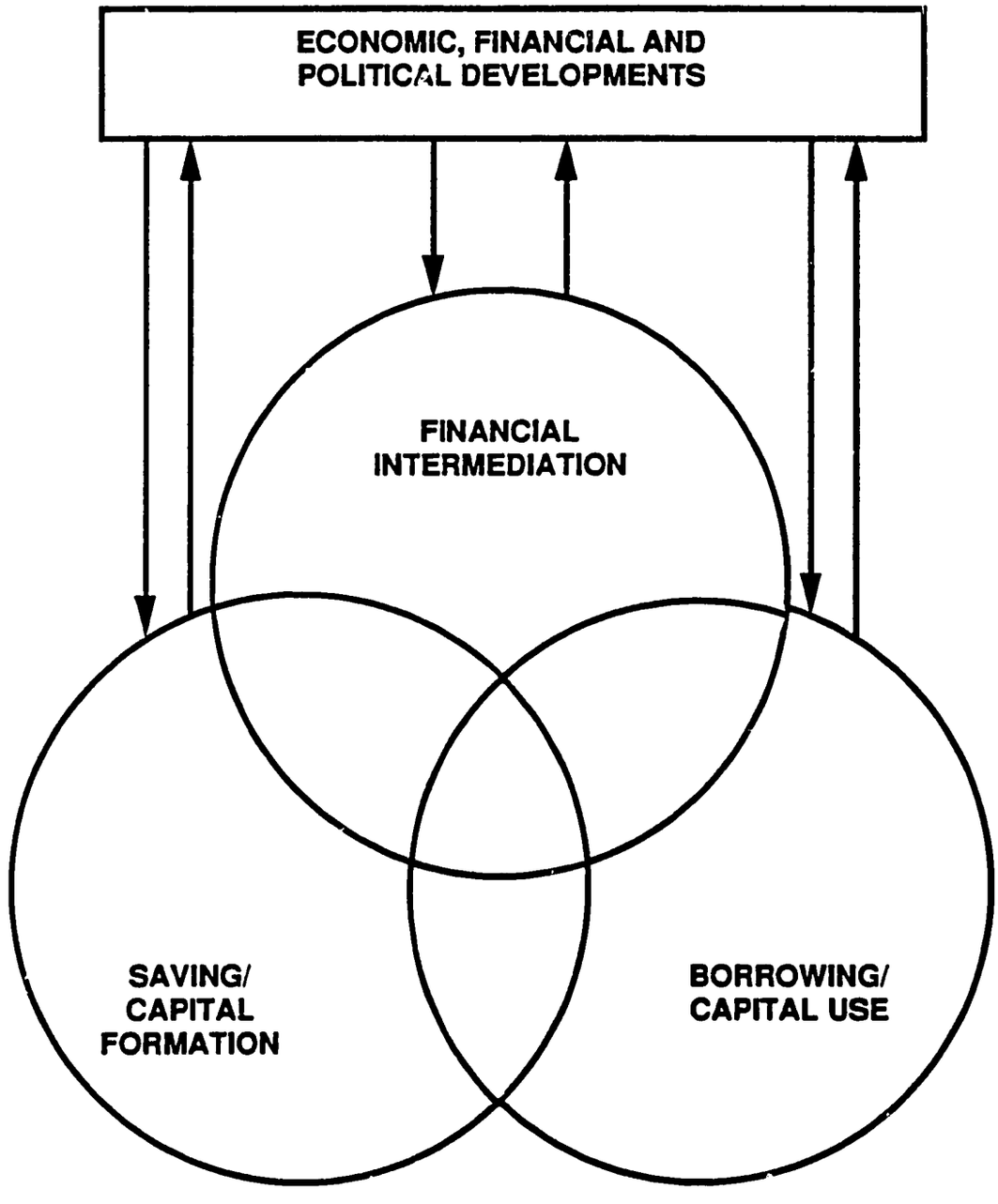

FIGURE 2 CAPITAL MARKETS INTERACTIONS

THE BASIC ROLES OF FINANCIAL MARKETS

Any domestic financial system is composed of three sets of activities: Saving/capital formation, financial intermediation, and borrowing/capital use. Participants in the system can engage in any combination of these functions. For example, at any given time savers are also likely to be borrowers. Individuals maintain both savings accounts and mortgages; corporations place liquid assets in bank accounts and at the same time assume debt to finance new projects; and national governments always carry both asset and liability positions. Similarly, financial institutions are involved in both saving and borrowing as well as in intermediation (see Figure 3).

SAVING

Saving results from an excess of current income over current expenditures. A portion of current income is not consumed but rather is saved to support future consumption. Savings in turn are transformed into financial or nonfinancial assets which are for the most part used, directly or indirectly, to create additional economic activities.

World Bank data indicate that average savings rates vary considerably across countries. In 1986, for example, national savings performances (gross domestic savings as a percentage of GDP) ranged between a low of 78 percent negative saving (dissaving) for Lesotho to a high of 40 percent saving for Singapore and Yugoslavia. National savings rates in 1986 averaged 21 percent for industrial market economies, 26 percent for upper middle-income developing countries, 17 percent for lower middle-income developing countries, and 7 percent for low-income developing countries (excluding China and India). China and India recorded and combined average savings rate of 30 percent.

All economic entities tend to experience periods of both saving and dissaving. In the case of individuals, debt is accumulated early in life to finance education and housing. This is followed by a period of net saving, during which previous debts are amortised and savings are accumulated for retirement, another period of dissaving.

Business entities encounter similar periods of dissaving and saving. It normally takes time for corporations to accumulate capital surpluses. As a result, start-up phases have to be financed by equity or debt, since new business ventures or projects nearly always incur initial negative cash flows before net project receipts turn positive.

Principal Sources of Capital	*Financial Intermediation*	*Principal Uses of Capital*
<u>Institutions</u>	<u>Institutions</u>	<u>Institutions</u>
Households	Commercial Banks	Businesses
Corporations	Development Banks	Governments
Businesses	Savings and Loans	Households
Foundations	Credit Unions	
	Insurance Companies	
	Stock and Bond Markets	
	Mutual Funds	
<u>Instruments</u>		<u>Instruments</u>
Savings Accounts		Corporate Loans
Certificates of Deposit		Consumer Loans
Checking Accounts		Mortgages
Equity Shares		Equity Shares
Government Bonds		Government Bonds
Private Bonds		Private Bonds

FIGURE 3: THE STRUCTURE OF FINANCIAL MARKETS

The typical cycle for sovereign nations tends to be the reverse. In early stages of development, nations often generate surpluses in trade, as earnings from commodity exports exceed effective demand for imports. These trends are usually reversed as the growth process evolves, with countries borrowing funds and attracting investment inflows, partly to pay for needed imports not covered by export earnings and partly to finance development. As economies advance relative to others in terms of capital and technology endowments, they are often transformed into "mature creditor nations." Capital inflows are replaced by outflows in the form of credit to and investments in comparably less developed countries.

BORROWING

Borrowers seek funds for essentially three purposes: To purchase "consumption" items whose costs will be amortised over the productive lives of the borrowers; to finance temporary shortfalls in liquidity; or to finance the purchase of productive capital goods. To obtain funds for the initial two purposes, the borrower must convince the lender that he or she has sufficient general means to service debt repayments. In the case of funds sought to finance a project, the borrower must show that the proposed investment is viable. Over time, borrowers establish reputations regarding their willingness and ability to service financial obligations, and hence are assigned implicit or explicit credit ratings by lenders.

INTERMEDIATION

Financial resources can flow directly between buyers and sellers, or between lenders and borrowers, without involving any intervening processes or institutions. However, for purposes of both convenience and risk reduction, most financial transactions entail some form of intermediation.

Financial institutions provide a wide range of services associated with the two functional roles of financial transactions: Means of payment for the exchange of real resources, or extensions of credit. With regard to the former, intermediaries operate money markets to carry out domestic or foreign exchange transactions, to guarantee payments via letters of credit or their equivalent, and to carry out the physical transfer of funds.

Turning to the allocation of credit, the role of institutions is to "intermediate" between, or match, the asset preferences of savers with the liability preferences of borrowers. Savers generally seek investments that offer high returns, are relatively liquid, have limited maturity, and do not carry high levels of

risk. Borrowers, on the other hand, prefer lower interest rates and often desire longer maturities. The function of intermediaries, therefore, is to reach sufficient tradeoffs among these preferences to accommodate the objectives of both lenders and borrowers. In addition, financial intermediaries provide markets of sufficient size and depth to permit participants to "shop" for alternative instruments and to maintain diversified instruments of assets and liabilities to spread risks.

PARTICIPANTS IN FINANCIAL MARKETS

Although there are numerous actors involved in the saving/capital formation process, the ultimate source of nearly all funds in financial markets is the individual. Individuals hold the claims to most financial assets, either directly from their own deposits, or indirectly through their explicit or implicit ownership of financial and nonfinancial institutions. Business corporations are for practical and sometimes legal reasons considered to be "individuals" regarding their rights and responsibilities, but even these entities are ultimately owned and controlled by individual stockholders.

For analytical purposes, the most effective approach is to divide borrowers from and savers in financial markets into three classifications, households, businesses, and governments, capturing respectively the roles of individuals, business firms and sovereign nations. Each of these "sectors" participates directly in capital and money markets, and in most countries each plays by a somewhat separate set of rules, based on common practices, capabilities, or legal and regulatory environments (see Figure 4).

The household sector consists of individuals and families which for purposes of this analysis earn personal income, spend money to meet current consumption needs, save funds for future consumption, and borrow to acquire goods and services (e.g., housing, education, etc.) which cannot be financed from current income or accumulated savings. The business sector includes the entire array of private enterprises, each of which generates income streams for owners and shareholders, but also requires short-term credit to finance current transactions and long-term capital to invest in plant and equipment. The government sector is composed of different levels of government (local, state or provincial, and national), which collect taxes and other revenues and provide public services such as public safety, education, infrastructure, health, national defense, and so forth. The provision of these and related services requires funds to cover both recurrent costs and capital expenditures.

Financial markets affect nearly all individuals and all sectors in an economy:

For households, financial markets:

- ✔ Facilitate transactions (checking accounts)
- ✔ Offer savings instruments
- ✔ Provide financing for consumption, homes and education

For businesses, financial markets:

- ✔ Provide interest-paying instruments for excess cash
- ✔ Supply short-term credit to finance exports
- ✔ Dispense long-term credit for plant and equipment
- ✔ Provide start-up funds
- ✔ Place equity, notes and bonds

For government, financial markets:

- ✔ Place government bonds with buyers
- ✔ Channel credit to high priority sectors

FIGURE 4:

THE WIDE-RANGING IMPACT OF FINANCIAL MARKETS

The participants in the financial intermediation segment of money and capital markets include a wide range of official and private institutions, each of which plays a role in the processes of capital formation and allocation. The specific mix of institutional actors varies considerably by country, but typically consists of the following types of institutions, whose roles are described in summary form.

- Government participants include central banks, finance ministries, regulatory and supervisory agencies, and sometimes pension funds and other government-operated institutions.

- Commercial banks represent the core of most financial systems, and carry out the important functions of deposit taking, lending, and financial exchange transactions.

- Investment or merchant banks typically specialize in financial services for relatively large businesses, especially the orchestration of direct or syndicated lending and placement of equity, notes and bonds.

- Savings and loan associations transform longer-term deposits into housing or personal loans for households.

- Stock exchanges and brokerage houses operate equity and money markets, providing secondary markets for the broad distribution of investment instruments.

- Mutual fund companies aggregate financial assets and liabilities and provide secondary market access to small investors.

- Insurance companies provide a range of insurance services and inject considerable amounts of funds into capital and money markets.

- Institutional investors include insurance companies and other actors (universities, pension funds, investment companies, trust funds, etc.) which manage collective portfolios seeking higher returns and asset growth than could be achieved by individual investors.

- Venture capital companies specialize in providing start-up funds to new ventures, either on a loan or equity basis.

- Leasing companies finance capital equipment (aircraft, vehicles, construction equipment, etc.) needed by private firms.

- Factoring firms purchase receivables at a discount or manage receivable collections.

In some financial systems, these different participants carry out specialized functions and are prohibited from engaging in others. The recent wave of financial market deregulation in many countries around the world has blurred many of these boundaries, since firms are increasingly eligible to expand the range of services they provide.

FINANCIAL INSTRUMENTS

In many countries, savers have at their disposal a dizzying array of financial instruments in which to place their surplus funds. Each carries a different mixture of risks, returns and conditions. For example, individuals can opt to hold cash, which maximizes liquidity but earns no interest and bears the risk of depreciation through price inflation or currency depreciation. Alternatively, they can hold a variety of instruments which earn greater returns but carry higher risks.

A standard set of instruments for savers includes the following. Call accounts or demand deposits may or may not earn interest. Time deposits are funds placed with banks for specified periods of time; callable savings deposits represent a hybrid of demand and time deposits. Bankers Acceptances are negotiable time drafts drawn to finance corporate operations, primarily trade or working capital funding. Certificates of Deposit are short-term or medium-term investment instruments issued by banks. Money market funds consist of a potpourri of alternative instruments which offer investors shares in portfolios of direct placements of funds. Equities represent shares in the ownership of corporations, and may or may not carry voting rights. Corporate notes and bonds are issued by private companies seeking to finance their operations. Debentures are a form of corporate bond that may be converted into equity. Finally, government securities constitute financial obligations of national, state or local governments (or their equivalents), and include bills, notes and bonds.

On the borrowing side of the equation, individuals tend to rely on mortgages, personal loans and consumer credit to bridge their financing gaps. Corporations issue equities, notes and bonds to raise capital in secondary markets, and acquire direct loans

from financial institutions and from other nonfinancial firms through intercompany loan markets. Governments issue the range of securities described above and in some cases borrow from international financial markets to cover budget deficits and capital expenditures.

Financial intermediaries utilize and manage all of the instruments described above, except direct placements of funds between savers and borrowers. In addition, financial institutions draw funds from the interbank markets and from the rediscount windows offered by central banks.

FINANCIAL PROCESSES

The processes of saving and borrowing are relatively clear and have been described above. However, financial intermediation procedures are more complex and hence require more detailed treatment. The principal processes encompassed in intermediation are the following.

- Capitalization is the accumulation of sufficient capital through equity and retained earnings, and is important to maintain prudent loan/asset ratios.

- Deposit taking is required to assure a steady supply of fresh funds to cover cash outflows in the form of withdrawals and new loans, as well as to accommodate nonperforming loans.

- Asset/liability management is the essence of financial intermediation, and seeks to balance financial exposure in terms of liquidity, interest rates, currencies and maturities in such a way as to maximize returns and minimize risks.

- Maturity transformation is the process of accommodating differences between the maturity preferences of depositors and borrowers in any market segment.

- Underwriting constitutes the function of orchestrating and sometimes guaranteeing the issuance of corporate equities, notes, and bonds, and placing these securities in primary and secondary markets.

- Credit allocation is the act of distributing available funds among a diversified group of borrowers in such a way as to maximize interest

income under established standards for overall portfolio risk.

- Loan portfolio management represents the administration of outstanding loans to assure prompt payment of principal and interest.

- Fiduciary responsibilities are those associated with the legal and ethical handing of funds on the account of clients.

CONDITIONS AFFECTING FINANCIAL MARKETS

The size and strength of any financial system is the cumulative result of a large number of variables. In the area of economic factors, capital and money markets are often a mirror image of a country's absolute level of development, since the supply and demand for capital rise with increasing incomes and production. Very few developing countries have established sophisticated money and capital markets, since financial system evolution is a lengthy process which tends to lag behind the development of other sectors.

Instability is anathema to financial market health and growth. Inflation reduces levels of confidence and spurs savers to place surplus funds in real assets (land, consumer durables, precious metals, etc.) rather than in depreciating financial instruments. Chronic government budget deficits absorb available capital from the system and crowd out private borrowers, and also fuel inflation. Similarly, structural balance of payments deficits lead to leakage from the local markets, in the form of both deficit financing and capital flight, since savers seek to avoid the risk of currency depreciation. The achievement of a reasonable degree of financial stability is an absolute requisite to capital market growth.

Macroeconomic policies and management exert a direct impact on financial markets. Aggregate demand management affects the general demand for funds, and monetary policies set money supply growth patterns and interest rate levels.

National legal and regulatory environments establish the parameters within which financial institutions must operate. The key variables which are derived directly from government rules and regulations include ease of entry of new firms, reserve requirements, deposit insurance structures, prudential lending requirements, credit allocation rules, financial institution supervision systems, and rules for administering insolvencies and bankruptcies.

Finally, social and political factors play a sometimes subtle but often important role in shaping the health and growth of financial systems. Since financial sectors lie at the center of all economic activities, governments frequently seek to maneuver capital and credit activities to meet social or political objectives, such as the extension of preferred credit or subsidized services to particular sectors or groups, or the implicit taxation of other groups. Similarly, political stability clearly plays a key role in the determination of levels of confidence in the economy and in financial markets.

A "TYPICAL" DEVELOPING-COUNTRY FINANCIAL SYSTEM

The brief overview of financial markets provided above gives a basic although perhaps oversimplified introduction to the working parts of any nation's capital and money markets. This section highlights the characteristics which distinguish the economies and financial markets of developing countries from those of industrial countries (see Table 2).

Economic Variables

Any country's monetary sector is, as noted above, a direct reflection of the nation's "real" economy, since most financial transactions involve the exchange of real goods and services. The conditions listed below typify developing country economies and financial markets. Some of the conditions can be altered in the medium term, but others can be changed only over considerable periods of time.

1. Low levels of per capita income result in relatively low rates of capital formation. Although numerous studies confirm the fact that even the poorest groups in any country do in fact save, the absolute base of income from which saving is derived is low.

2. Skewed distributions of income and wealth reinforce an excessive concentration of capital, encourage non-arms-length transactions, and inhibit the development of diversified sources and uses of funds.

3. Concentrations of economic activity in a few sectors constrain lending opportunities and increase the vulnerability of the financial system by limiting the prospects for diversified portfolios.

4. Chronic price instability results in self-fulfilling inflationary expectations and in preferences for real assets, which deter capital formation.

TABLE 2

FACTORS CONSTRAINING FINANCIAL MARKET DEVELOPMENT

FACTOR		RESULTS
Economic and Societal Factors		
Inflation	→	Reduces incentives to save/ invest in financial assets
Low per capita income	→	Low marginal savings rate
Economic concentration in few sectors	→	Limits lending/investment opportunities
Trade deficits/currency instability	→	Capital flight
Management inexperience in banking and other businesses	→	Inhibits performance of banks, reduces borrowers' ability to repay loans
Policy Factors		
Government ownership	→	Reduces efficiency
Budget deficits/mandated bank purchases of government paper	→	Drains capital from system, crowds out private sector
Loose monetary policy	→	Creates inflationary pressures
Overvalued exchange rate	→	Reduces export industry returns and ability to repay loans, encourages capital flight
Lax banking regulation and supervision	→	Condones poor banking practices, leads to solvency crises
Excessive regulation	→	Decreases freedom to seek profit opportunities, diversify risk
Barriers to entry	→	Subsidizes inefficient banks, limits new product development
Weak contract law or enforcement	→	Precludes collections of arrearages, causes banks to require excessive collateral
Interest rate ceilings	→	Lowers ability of banks to attract funds, reduces savings

5. High levels of external indebtedness drain funds from domestic markets, give rise to periodic rescheduling crises, and reduce amounts of new capital available for employment in productive ventures.

6. Limited managerial and administrative capacity within small and medium scale enterprises increases the chances for loan defaults.

7. Lack of real assets to serve as collateral for loans decreases entrepreneurs' access to funds and/or increases the costs of funds.

8. Strong traditions of private/family ownership deter small firms from raising funds through equity markets out of fear of financial disclosure or reductions in management control.

Policy Variables

Unlike economic factors which at least in the near term must be taken as given realities, policy variables can be changed by governments. While policy frameworks are in part based on underlying economic and social conditions, they can also serve as an active catalyst for financial sector growth.

1. Heavy direct and indirect government involvement, intervention and ownership constrain the private sector from participating in formal markets and from establishing financial service firms.

2. Mandated interest rate ceilings on deposits and loans stifle capital formation, since savers often receive negative interest rates on their deposits.

3. Credit allocation directives decrease the flexibility of banks to seek profitable loan opportunities, and often increase the odds for nonperforming loans.

4. Portfolio selection restrictions in secondary markets limit the range of investment alternatives available.

5. Direct or hidden taxation of financial transactions raises the cost of borrowing and reduces returns on capital employed.

6. Required purchases of government securities force financial institutions to fund government indebtedness, often at unprofitable terms, and crowd out private borrowers.

7. Barriers to entry and regulated limits to competition reinforce inefficient institutions and raise transactions costs to participants.

8. Inappropriate exchange rate policies, especially the maintenance of overvalued exchange rates, lead to distorted lending decisions, financial remittance restrictions, and capital flight.

9. Inefficient, cumbersome legal systems make contract enforcement difficult, and seriously impede efforts by financial institutions to collect overdue loan payments.

Resulting Financial Market Conditions

The factors and policies described above are not present in every developing country, nor are they limited to developing countries. However, more often than not they represent a reasonably accurate picture of operational characteristics of money and capital markets in those nations. The end result of these and related variables is what some financial analysts have termed "financial repression," or the externally-imposed restriction of the financial sector to provide services for savings, investment and borrowing.

If any given system is permitted to operate according to market principles and conditions, the only major consequence of economic underdevelopment is the delay of the natural evolution toward a modern financial system. However, when inappropriate policy stances are added to low development levels, the result is an abnormal evolution of the financial sector characterized by seemingly intractable and mutually reinforcing constraints. The most common attributes of such systems are as follows.

- Formal capital markets are "thin and narrow," and possess only limited capital for use by productive enterprises.

- Levels of capital stock remain low, and rates of capital formation are negligible.

- Interest rate ceilings reduce the incentive to save and artificially inflate prices of real assets.

- Borrowers remain heavily dependent on short-term rollover financing to cover both their credit and capital requirements.

- Small-scale and medium-scale firms have limited access to financial credit, leading to the development of informal or curb markets and raising the cost of funds to borrowers.

- Limited options and instruments for savers create excessive demand for existing instruments, driving down their returns.

- Borrowers unable to gain access to local funds seek foreign sources of funds unless they are restricted.

- The transactions costs of financial institutions remain high due to inefficiency and lack of flexibility.

- Formal markets are dominated by concentrated lending portfolios, with many credits extended by government directive to large industrial and/or government-owned firms.

- The profitability of unsubsidized sectors (often agriculture) is reduced due to implicit taxation imposed through financial transactions.

- Domestically-produced savings are lost through capital flight.

- Negative real interest rates, particularly for "preferred" borrowers in the formal sector, give rise to excessively capital intensive production methods and operating inefficiencies.

- Since inefficient legal systems often deter lenders from taking recourse on loan defaults, lenders require abnormally high collateral for borrowings.

The policy strategies which have created the conditions noted above are often attempts to achieve legitimate social and economic goals. For example, interest rate ceilings have long been considered an appropriate means to stem inflationary pressures and prevent usurious lending rates. Nevertheless, the introduction of one form of control almost always necessitates another. Interest rate ceilings, for example, give rise to the need for credit allocation controls, since demand for funds will inevitably outstrip their supply.

The ultimate consequence is the erection of a jerryrigged system of controls and counter-controls, the combination of which introduces a host of distortions and above all a set of serious disincentives to capital formation. While each policy intervention creates a new set of "winners" and "losers," the final cost -- retardation of financial market development -- is borne by all participants in the economy.

Liberalizing financial markets through the dismantling of restrictions and unwarranted controls reintroduces incentives for households and firms to save and invest surplus funds in financial instruments, and for borrowers to seek capital and credit to employ for productive purposes. The efficient use of capital in turn raises overall economic activity, thereby generating needed jobs, exports and foreign exchange. The increase in the overall capital stock generated by reforms permits higher rates of growth and standards of living.

III. Criteria to Use in Determining an Action Plan

The economic performance of developing countries can be materially and in some cases dramatically strengthened as a direct consequence of improvements in the efficiency and stability of their financial systems. The central thesis of this report is that such improvements can be achieved through two sets of initiatives -- privatization and financial policy reform. Privatization allows for financial decisionmaking to be placed into private hands, thereby establishing strong efficiency and profit motives as the driving forces behind financial intermediation. Policy reform serves as a means to increase the role of market forces in the determination of interest rates, the allocation of credit, and the overall scale of financial intermediation. In addition, policy reforms can work to strengthen the financial soundness of the sector, encourage more efficient business practices and provide savers and investors with a wider breadth of financial services and instruments.

Privatization and policy reform should be viewed as complementary and not as substitutes (see Figure 5). The attainment of a policy climate which is conducive to market forces is a requisite to successful privatization, since the introduction of private management and ownership into a hostile, repressed financial environment will almost invariably lead to disappointing results. Similarly, the creation of an appropriate policy framework in a system dominated by government owned and operated institutions achieves less than if privatization were also undertaken.

If one were forced to consider the two strategies separately, in most cases it would be preferable to implement financial policy reform. Overall liberalization creates incentives for all market participants, whereas privatization is targeted at individual institutional actors. Similarly, policy reform can over time achieve some of the goals of privatization through the establishment and gradual expansion of new, private sector institutions. However, the implementation of appropriate financial policies is far more complex and difficult than the discreet sale of SOEs. The design and execution of reform packages often requires strong political will, extensive understanding of interrelationships within the system, and a delicate sense of timing. The absence of any of these attributes can lead to disappointing and even counterproductive results. Nevertheless, the achievement of truly effective financial market reform in many developing countries requires the simultaneous pursuit of both policy change and privatization.

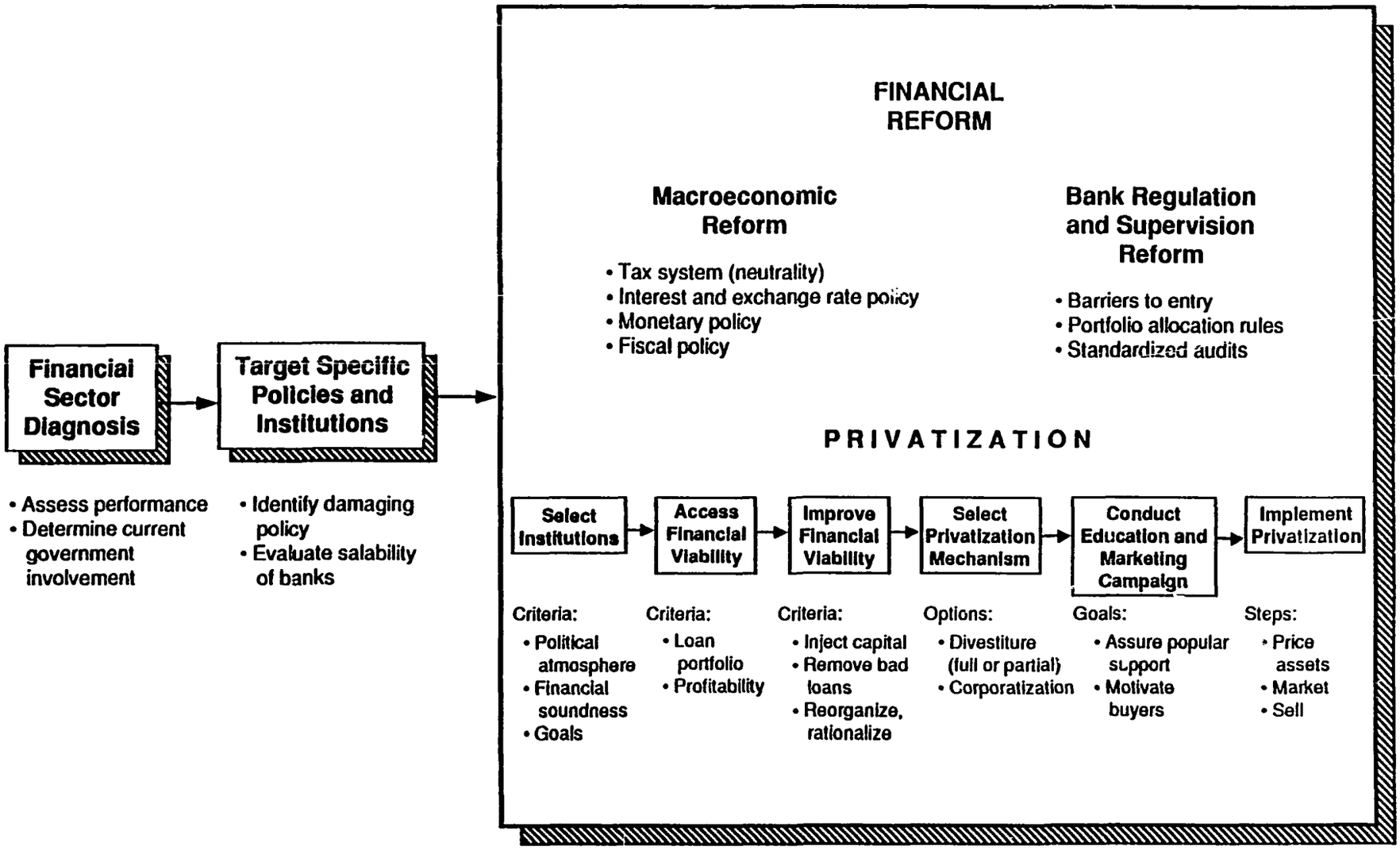

FIGURE 5 METHODS FOR IMPROVING FINANCIAL SECTOR PERFORMANCE: MACROECONOMIC AND FINANCIAL SECTOR REFORM, AND PRIVATIZATION

This section presents guidelines for designing financial reform and privatization measures. As with other initiatives, the appropriate course of action depends on a number of variables, including economic, institutional, political and social factors, many of which are intricately interwoven. There are no easy answers, and this report does not attempt to propose any. However, based on examination of a number of case studies of financial reform and privatization, the criteria exhibited in Table 3 generally identify appropriate policy actions.

CRITERIA TO USE

Macroeconomic Climate for Financial Sector Development

Until the macroeconomic forces on savings, intermediation, and investment behavior are positive and not negative, ownership of individual institutions is less important. In nearly all cases, financial reform should precede or accompany privatization.

As the preceding section demonstrated, high and variable inflation, negative real interest rates, and overvalued exchange rates are anathema to the development of financial markets. Other policies, common in developing countries, also hinder growth in capital markets. These include a weak or unenforced contract law (thereby allowing borrowers who fail to repay their obligation to evade retribution) and weak bank regulation and supervision. Until these obstacles are removed, little else can be done to improve the functioning of financial markets.

Thus, "stand-alone privatization" is unlikely to have the desired effect of improving the efficiency and effectiveness of financial markets. Changing the incentives for bank management and staff by making them more responsive to profit-making opportunities will not improve performance if the entire financial sector remains protected from competitive forces in the form of market-determined interest rates and exchange rates. Privatization can only work within a climate set by suitable economic policies and legal/regulatory structures.

	Criteria	*Policy and Program Response*
1.	Macroeconomic climate for financial sector development	Until interest rates, exchange rate policy, and directed credit programs encourage savings and allocate loans appropriately, focus on improving the policy environment.
2.	Government goals	Certain goals are best accomplished through financial sector reform, including the provision of a business climate conducive to growth, promotion of exports and savings, and economic stabilization. Other goals, such as reducing strain on the government budget and boosting efficiency of financial markets are met through privatization of banks.
3.	Competitiveness of local financial markets	If government banks operate under more restrictive rules than private banks, remove restrictions before privatizing. To the extent that competition encourages government-owned banks to mimic private banks, privatization becomes less important than financial reform.
4.	Political will	In the face of opposition, generate financial sector efficiency through financial sector reform, which usually is not the focus of intense labor union and public opposition.
5.	Financial soundness of banks	The time is right for privatization only if the banks being sold are attractive to private buyers. Governments may need to improve balance sheets by dealing with nonperforming loans.
6.	Market conditions	The lack of a functioning stock market need not stymie privatization. Many options exist, including allowing the emergence of new private banks, and joint ventures with foreign capital and management expertise.
7.	Soundness of economy	If possible, postpone public offerings and private sales until local economy is healthy enough to generate interest in the sale and a fair price.

TABLE 3: CRITERIA FOR SELECTING FINANCIAL REFORM OR PRIVATIZATION

Goals

The appropriateness of financial reform versus privatization is also largely a function of a government's goals. To the extent that the government's interests lie in providing a framework conducive to business, in promoting exports, in rewarding saving behavior, and in stabilizing the national currency, financial reform is the most appropriate path to take. In contrast, if the government's objective is to reduce the drain of unprofitable state-owned enterprises on the national budget, increase competition in financial markets, boost efficiency of financial markets, and spread ownership of government-owned assets among the populace, then privatization is the best alternative. In most cases, nations are pursuing numerous goals, and therefore a combination of financial reform and privatization is recommended.

Competitiveness of Local Financial Markets

If government-owned institutions are operating in local financial markets in direct competition with private banks, and under the same operating rules (especially rules regarding interest rates and directed credit), then privatization becomes less necessary. The combination of an appropriate macroeconomic and regulatory framework for financial markets and competitive pressures will bring about many of the benefits of direct private ownership. As long as the government is somewhat vigilant about requiring adequate financial performance from its banks, pressure from private institutions will encourage the public banks to "keep up," and offer attractive instruments and good service. If private banks coexist with government-owned banks, then governments should probably focus their efforts on improving the economic and regulatory framework for all financial institutions, regardless of ownership, and assign secondary importance to the transfer of the SOEs to the private sector.

Political Will

Privatization is ultimately a political decision, even though it is often based at least partially on economic criteria and goals. Inasmuch as it is the transfer of ownership from the public to a group of private individuals, privatization most directly affects three groups of individuals: The previous owners (the general public), the employees, and the new owners (the private individuals). The general public is usually concerned about the price at which "their" good is sold, and the employees are worried about job security. These two issues are often the major obstacles to privatization, and both should be carefully considered when selecting a privatization method.

When an SOE has a market value below book value because of mismanagement and/or excessive liabilities, the sale price often becomes politicized. The general public often views a low sale price to a group of private investors as a "gift to the rich," and opposition to the sale may result. Similarly, organized labor's concerns about layoffs following a transfer to private ownership can sometimes effectively block a sale.

The strength of potential opposition and the popularity of the government should both be assessed prior to choosing a privatization methodology, and should be continually monitored as the privatization program goes forward. To minimize public opposition to a sale, governments can make use of a variety of techniques. To the extent that macroeconomic and regulatory reform will bring about the needed changes in bank behavior, such reforms can typically be implemented without generating the intense political opposition that privatization tends to generate. Another technique to diffuse public wariness is to undertake privatization in two steps, with the first step being an inflow of new private equity into a government-owned bank, perhaps through a joint venture. The transfer of government shares would follow later. In addition, the "packaging" of the privatization is extremely important. A publicity campaign can point out the benefits of the sale, such as reduced public spending and better service. Such campaigns have proven very successful in Jamaica. When the public is antagonistic to privatization, the word "privatization" should be avoided, and phrases such as "opening up to private capital," "popular capitalism," "restructuring," should be used in its place.

Labor opposition must also be included in the decision to privatize. Partial employee buyouts, at subsidized terms, are one way to grant some of the benefits of the sale to the workers, and thus encourage support for the sale. Labor often requires some guarantee of job security, which can be paid for either by the new owner, or, if that is not feasible, by the government.

Financial Soundness of Institutions

Government-owned banks often need cosmetic (or even structural) surgery on their balance sheets before they are attractive to private capital. Governments cannot expect to sell a highly indebted SOE in a standard public offering. At the same time, extensive restructuring, implementing management information systems, and writing off bad loans can be extremely expensive and time consuming.

Whether the government or the new owner takes the write-offs for bad loans depends on each side's assessment of the bank's worth as well as each side's relative negotiating strength. Governments attempting to place SOEs in thin markets are at a disadvantage compared to those with many potential buyers, in that they may be

forced to accept a lower price or a less attractive transfer arrangement than would have emerged from competitive bidding. As in Chile, governments may need to make arrangements to improve the financial soundness of institutions prior to privatization. If possible, given the financial position of the SOE and degree of competition among potential buyers, the government should strive to craft a mechanism which shares the responsibility and expense for past bad loan decisions between the new owners, who will benefit from future profits, and the past owners (the government), who were at least partially responsible for the decisions made.

Market Conditions

Weak or nonexistent capital markets are often touted as a serious constraint on privatization. However, the analysis of bank privatizations in this report indicates that the constraint is not as severe as is commonly thought. Many countries with only emergent capital markets, such as Jamaica, were able to utilize their stock markets to privatize. The thinner the stock market, the more important an educational and promotional campaign becomes, and the greater the need to subsidize stock purchases by the general public.

Countries that lack stock markets must turn to alternative privatization methods, but such techniques are numerous and therefore the lack of a functioning stock market does not mean that privatization is impossible. Nations such as Guinea and Bangladesh utilized options such as allowing the emergence of new, private banks to compete with government banks, or attracting foreign capital and management to joint venture with government banks. Both techniques proved successful.

IV. Checklist for Financial Reform and Privatization

To assist governments to design financial reform and privatization policies and programs, we have prepared a Checklist (see Figure 6). No such list could be all inclusive, could apply to all situations, or could warn policymakers of every issue that may arise. The Checklist is an attempt to guide program design from an initial diagnosis of the financial markets, through the selection of policy and program options and to final implementation.

DIAGNOSE THE CURRENT FINANCIAL SECTOR

The first stage toward financial reform and privatization is analysis to determine the problems facing the sector and their causes. Initial data gathering should focus on the types of financial institutions and services provided locally, the extent of usage of the formal financial system by both savers and borrowers, and the size of the informal sector. Few services, low usage, and a large informal financial sector all point to a severely constrained or "repressed" banking system.

An "audit" of government policies toward the financial sector is a first step toward determining the constraints on the sector. The review of policies should closely examine the extent of interest rate ceilings and controls, the percentage of total credit that is directed by the government toward specified sectors, the existence of excessive reserve requirements, and the effect of exchange rate policies on local savings and investment.

The "audit" should also highlight the structure of the current financial system, determining the degree of competition in financial markets, and the extent of government ownership. It should estimate the number of institutions in important niches (commercial banks, savings banks, credit unions) and their respective market shares. It should also identify government-owned institutions, a task often complicated by the fact that many different local, regional, and national agencies will own stakes in a single institution. The list in Annex C of government-owned banks could serve as a starting point.

FIGURE 6 CHECKLIST FOR FINANCIAL REFORM AND PRIVATIZATION

CHECKLIST ITEMS

- [ ] **Diagnose Financial Sector**
  - [ ] Assess sector's range and efficiency of financial intermediation services
    - [ ] Types of services provided
    - [ ] Assess usage (by both savers and investors) of formal financial channels, and estimate real growth rates
    - [ ] Assess magnitude of informal sector
  - [ ] Conduct audit of government policies toward the financial sector. Focus analysis on:
    - [ ] Existence of interest rate ceilings and controls
    - [ ] Degree of directed credit and existence of excessive reserve requirements
    - [ ] Effect of exchange rate policies on local savings and investment
  - [ ] Estimate degree of competition in financial markets
    - [ ] Collect data on number of institutions and market shares
    - [ ] Identify government policies that limit types of institutions and range of services
    - [ ] Identify government-owned institutions (often not as straightforward as it may appear). Use Annex C as a starting point.
- [ ] **Target Specific Policies and Institutions**
  - [ ] Determine government goals. Different goals will point toward very different policy and program directions.
  - [ ] Begin policy dialogue on government policies that are most damaging to financial sector performance.
  - [ ] Assess political will for privatization.
  - [ ] Evaluate saleability of banks, market conditions, and soundness of overall economy.

CHECKLIST (Continued)

- [ ] **Undertake Financial Reforms**
  - [ ] Design and implement any macroeconomic reforms needed. In particular, work toward the following policies:
    - [ ] Positive real interest rates, and low inflation
    - [ ] Credit allocation based on risk and return
    - [ ] Competitive exchange rates
    - [ ] Budget deficits which do not crowd out private investment, and do not fuel inflation through the printing of money
  - [ ] Craft and put in place regulatory and supervisory changes. Strive to achieve the following:
    - [ ] Low barriers to entry in banking and other financial services (but adequate capital requirements to ensure stability). Allow private banks to operate. Consider allowing some role for foreign banks.
    - [ ] Audited bank statements, and audited financial records for bank clients
    - [ ] Establish and enforce prudential capital adequacy ratios
    - [ ] Self-regulation to the extent possible. Reward compliance with regulations with additional flexibility in investing assets.
    - [ ] Supervisory personnel in adequate numbers and with enough qualifications to effectively oversee bank operations and detect problems early
- [ ] **Review privatization options, and move toward private sector ownership of financial institutions.**
  - [ ] Select institution to privatize, based on government goals, political will, and readiness of institution for private sale.
  - [ ] Assess financial viability. Expert technical assistance may be needed.

CHECKLIST (Continued)

- [ ] Improve financial viability. Determine the extent to which banks must be improved via removal of nonperforming loans, reorganization, implementation of management information system, etc., prior to sale, and what tasks can be left for the buyer. Evaluate alternatives for removing nonperforming loans from bank portfolio. Inject new capital. Reorganize and rationalize operations.

- [ ] Select privatization mechanism depending on institution to be sold and market characteristics. Public offerings can work even in emerging stock markets. Private offerings may be faster, but more vulnerable to political opposition. Corporatization (implementing management systems and procedures such as those used in private business) can be a useful first step, but move to privatize before political will dissipates.

- [ ] Conduct educational and marketing campaign regardless of privatization option chosen, but especially prior to a public offering. Political opposition is often the primary obstacle to privatization. Campaign will work to minimize opposition, and maximize participation in sale.

- [ ] Implement privatization option. Timing is critical, especially for a public offering.

TARGET SPECIFIC POLICIES AND INSTITUTIONS

Whether a government places primary emphasis on financial reform or privatization depends on its goals. A country seeking to encourage savings and productive investment and stabilize its currency should focus on financial reform. In contrast, a nation concerned about large government subsidies to banks, inefficient bank administration, and a lack of competition among banks should concentrate its efforts on transferring banks to private ownership. However, without first creating a macroeconomic and regulatory environment which is conducive to financial sector development, privatization in an of itself will not achieve the desired effects. The policy audit will indicate whether a government needs to focus on its economic and regulatory policies or whether positive policies are already in place.

If it appears that enough of the policy framework is in place to allow privatization to generate some benefits, the next step is to assess the political will for privatization. Political opposition is the most important obstacle to privatization, and a common reason for a slow-down or abandonment of a privatization plan. For this reason, policy planners should closely monitor prevailing views and the political power of groups such as organized labor, the government bureaucracy in charge of the state-run institutions, and opposition political parties. If opposition is too intense, planners should select a less visible privatization option such as corporatization, an increase in private capital, or a joint venture with the government. Any successful privatization effort must include a well developed campaign strategy to minimize opposition, either through building constituencies of proponents of the program or by co-opting potential opponents. A strong communication component is vital to obtain popular support.

Policymakers should also assess market conditions, including the readiness of various institutions for sale, the availability of local capital, and the general health of the economy. Many institutions must be groomed prior to a sale. Likewise, most developing countries will need an aggressive marketing campaign, and perhaps even subsidized financing terms, in order to be able to absorb a large privatization.

UNDERTAKE FINANCIAL REFORMS

Armed with a list of needed policy adjustments, policymakers should begin to work for change. The priority assigned to each policy change will vary depending on local conditions. However, in general, key policy goals will be positive real interest rates, credit allocation based on risk and return rather than on pre-selected government priorities, and competitive exchange rates. Other critical objectives include low inflation, a tax system that

is neutral toward both debt and equity finance, and budget deficits which do not significantly crowd out private investment and are not financed through excessive, inflationary printing of money.

In addition to macreconomic changes, it is likely that adjustments in bank regulation and supervision will be needed. Required reforms may include a reduction in barriers to entry for local private or foreign banks, a requirement that bank clients (and the banks themselves) furnish audited financial statements, and the establishment and enforcement of prudent capital adequacy ratios. Policymakers should support the creation of banking associations that can police certain aspects of member behavior, removing government interference while still ensuring banking safety. In order to monitor bank performance effectively in the face of increased freedom resulting from banking reforms, it may be necessary to increase staff levels and training for bank overseers.

SELECT AND IMPLEMENT PRIVATIZATION OPTIONS

If the political situation will allow privatization, and if the macroeconomic and regulatory reforms have taken place that will allow privatization to produce benefits, then the government should assess the readiness of both the financial institution and the market for the sale. This determination will be in part technical, based on expert appraisal of the bank's current value and future prospects, and in part political, based on an assessment of who is likely to buy the bank, and an understanding of how the sale will be perceived.

Certain banks will need cosmetic surgery on the balance sheets or even more fundamental rehabilitation prior to being offered for sale. A variety of options exist, including removing non-performing loans from the bank's books, injecting new capital, and reorganizing and rationalizing operations, such as implementing a computerized management information system. The government should assess what measures need to be taken to make the bank attractive to private capital, keeping in mind that there is a trade-off between price and bank rehabilitation. That is, the less the government does to improve the bank balance sheet, such as removing nonperforming loans, the lower the selling price is likely to be. A government anxious to implement a rapid sale can choose not to improve the bank's balance sheet, but will receive a lower selling price. In some cases it may be necessary for the government to pay an institution to take over the public bank, as is the case for many U.S. savings and loans institutions currently under supervisory control. In some situations, the most practical option may be to close the public bank.

The government should then select an appropriate privatization methodology, choosing from a variety of options including public

share offerings, private sales, disbanding government banks and authorizing new private institutions, reorganizations, and/or employee buyouts. Governments facing great political opposition may want to consider maintaining public ownership, but creating more independent institutions that are self-financing and act more like private banks. This process is sometimes referred as corporatization. It is one way to improve bank performance without a lot of publicity or fanfare. Commercialization can include reducing controls, portfolio requirements and subsidies for government banks, entering into private management contracts, encouraging competition with private institutions, and increasing the autonomy granted to government bank managements. Commercialization is a useful first step toward readying an institution for eventual sale.

Lack of a functioning stock market is no reason to avoid privatization. While undeveloped capital markets necessarily limit the options available to the government, and make a public offering difficult or perhaps impossible, there nonetheless exist a number of options that do not require a stock market, such as a private sale or corporatization.

Regardless of the privatization mechanism chosen, an aggressive educational and marketing campaign is almost always needed. A promotional effort is a powerful means to advertise the benefits of privatization (or steps leading to eventual privatization) and defuse potential opposition. Such a campaign is essential to a large public offering in a country unaccustomed to offerings. Supported by strong media activity, large public offerings have been successful even in countries without well developed stock markets, such as Jamaica.

The last step is the implementation of the privatization. Timing is critical at this point. A public offering that coincides with a sudden drop in stock prices will greatly reduce government revenues from the sale, and may diminish public confidence in the long-run profitability of the shares. To the extent possible, governments should schedule both private and public share offerings to take advantage of rising market prices and a healthy economic forecast.

The recommendations made above will not apply to all situations. However, they are based on a careful scrutiny of many cases of financial reform and privatization worldwide, and should serve useful in assisting governments to design policies and programs to promote the healthy development of financial markets.

V. Financial Sector Liberalization

Financial sector liberalization, or the movement from current repressed conditions to a hypothetically ideal system, should proceed along two vectors -- the achievement of financial stability through the adoption of appropriate monetary and fiscal policies, and the deregulation of the financial system itself. Instability and excessive regulation feed upon themselves and result in a closed cycle of financial repression. The first critical task is to secure some semblance of financial stability.

FINANCIAL STABILITY

The principal characteristics of financial instability are high levels of inflation, structural government budget and balance of payments deficits, currency volatility and debasement, and chronic capital flight. Each of these conditions is anathema to domestic capital formation. The ultimate elimination of instability can only be achieved through the bitter medicine of "structural adjustment" measures -- various belt-tightening policies to reduce excessive government and private consumption.

In most countries the key problem is government excess. Governments simply spend more than they earn in revenues. To meet their financing needs, governments force the purchase of their securities, raise reserve requirements and mandatory deposits with government agencies, exploit seigniorage rights by printing new currency and expanding the money supply, and borrow from international capital and credit markets. Other sources of instability include the maintenance of inappropriate trade and foreign exchange policies, the imposition of price controls, and the extension of subsidies and other programs which distort prices and output. Unfortunately, each of these practices becomes ingrained over time in the overall policy structure, develops its own set of beneficiaries, and is extremely difficult to eliminate.

As any national leadership can attest, these are no simple solutions to the problem of financial instability. Each curative measure incurs costs which governments or their constituents are reluctant to bear. A standard set of policies which has proved successful in achieving stability includes the following courses of action.

Reduce and Improve Effectiveness of Government Expenditures

Over time, governments must seek to "balance their books" by reducing spending. This implies the need to reduce both capital and recurrent expenditures through the reduction or elimination of existing programs and projects. In addition, expenditures should

be shifted to areas of highest social return and away from inefficient "pork-barrel" projects.

Increase Government Revenues

In addition to cutting expenditures, government authorities need to seek new sources of tax revenue. In many cases tax collection systems can be improved to capture higher percentages of direct taxes incurred but not paid, but rate increases are usually also necessary.

Modernize the Tax System

Stability is best achieved by broadening the tax base, preferably shifting toward direct taxation, and removing tax-driven subsidies and disincentives. Tax reforms should also eliminate biases in favor of debt financing and against equity financing and the use of other secondary market instruments.

Maintain Positive Real Interest Rates

The conventional wisdom of the past was that interest rate ceilings were needed to contain inflationary pressures. The actual experience of success cases such as Taiwan, Chile, Turkey and others proves the converse, that rates which reflect the true cost and value of money (i.e., relatively high rates) lead to the suppression of inflation and equally important to a more efficient allocation of financial resources. Unless interest rates exceed the inflation rate, conditions encourage investors to speculate in real estate and tradeable commodities, rather than to invest in productive investments. Moreover, without a positive return on local financial assets, investors will try to hold their assets overseas, where returns are higher, leading to capital flight. In general, developing countries should have higher real interest rates than developed countries to attract needed capital and to compensate for generally higher political, financial and legal risks.

Control Money Supply Growth

Financial instability is combatted by restricting the expansion of monetary aggregates. Seigniorage should be used as only a limited source for government revenues.

Maintain Competitive Exchange Rates

Exchange rates must be at competitive levels to discourage capital flight and to efficiently encourage exports and import substitution. Since the typical condition is currency overvaluation, the standard prescription is devaluation coupled with tightened monetary policy to stem the inflationary impact of depreciation and to send a signal that further large-scale devaluations are not expected. In addition, an exchange rate policy that maintains a competitive exchange rate by adjusting the rate with inflation levels should be implemented. For many developing countries, the shallowness of capital markets makes a completely free-market rate policy an undesirable policy.

Remove Price Controls

Price controls are seen as an expedient method to contain inflation in the short run, but inevitably are ineffective and in many cases actually stimulate price rises, since they act to reduce the availability of supply and ultimately reduce production. Therefore, the gradual elimination of controls is often an important component of stabilization strategies.

Most economic stabilization programs include some combination of the policies described above. Other policy reforms aim at stimulating economic activity and efficiency. These include shifting from quantitative import restrictions to tariffs, and reducing duties on needed inputs and raw materials; eliminating export taxes and other disincentives to exporters; establishing tax or other incentives for new investment; and reducing bureaucratic "red tape."

Sequence Reforms Appropriately

The sequencing of macroeconomic reforms is a critical issue. A large body of literature focuses on whether capital controls should be eased before or after trade controls. Exact sequencing depends on many factors, and the academic and policy community admit that proper sequencing is not yet fully understood. The general concensus among policymakers and economists is that controls on the flow of goods should be lifted first, and then restrictions on the flow of money across borders should be removed. Specifically, basic macroeconomic reforms should be adopted first. Vitally important variables include the maintenance of competitive exchange rates and positive real interest rates. Then, trade policies should be liberalized, and finally, controls on moving capital across the border should be eased.

One reason for first liberalizing trade policies is that any inappropriate changes can be reversed or modified before large

amounts of real resources are affected. Because of the speed at which money can be moved, the response to adjustments in capital controls is likely to be sudden and large. Millions of dollars in foreign or local currency can cross borders overnight. Due to the rapid transfer of large volumes of funds, the cost of inappropriate adjustments can be very large. In contrast, investor response to changes in tariffs and exchange rates are much slower, because of the time lag required to make a real investment (as opposed to a portfolio investment). Similarly, changes in goods flows (trade) are inherently much slower also because of transportation delays and limited consumption demand.

In addition, the adjustment process is much smoother if trade controls are lifted first. Once trade barriers are lifted, real investment based on a non-distorted assessment of the profitability of alternative projects will commence. Assuming capital controls have not been lifted, portfolio investment will continue based on distorted incentives. When restrictions on the capital accounts of the balance of payments are subsequently lifted, portfolio investment, but not real investment, will have to adjust. Because of its nature, the adjustment will be fairly rapid. Thus, governments should move toward liberalization beginning with trade controls.

Finally, by liberalizing trade regimes first, a country can begin to generate new exports and develop an improved current account position to finance a liberalized capital account. By instituting sound trade and macroeconomic policies, investors will have increased confidence in the local economy, and will have less incentives to export capital. Moreover, with improved real economic conditions and policies, investors, both local and foreign, will be encouraged to invest domestically, not abroad.

BANKING SYSTEM DEREGULATION

Financial regulation and supervision consists of an array of policies and rules established for the purpose of governing the operations of participating institutions and directing the course of money and capital markets development. Certain policies such as reserve requirements and interest rate controls are both instruments of economic policy and means to regulate the behavior of financial institutions.

Debates regarding what constitutes an "appropriate" degree of financial system regulation, as opposed to excessive or insufficient regulation, have been carried on for decades if not centuries without resolution. However, historical experience has indicated conclusively that inadequate regulation and supervision lead to financial instability and crisis, and that excessive regulation impedes capital formation and constrains the ability of the financial markets to contribute to economic development. The

only available option is therefore to put into place a system which represents a working compromise between the two extremes.

The financial systems of most developing countries are subject to greater regulation than are their counterparts in industrial countries for several reasons. Developing country governments generally seek to exert greater control over the economy as a whole, and the financial sector plays a key role in the exercise of control. In addition, government leaders feel their capital and money markets are not well developed, and hence are more vulnerable to external shocks. In certain cases, private market actors in developing countries are deemed as more likely to engage in fraudulent practices.

Over the past decade, development policy practitioners have reached the conclusion that over-regulation can actually prove counterproductive to the attainment of stability and accelerated growth. This view has been reinforced by the general deregulation movement experienced in industrial countries in recent years. As a result, financial market deregulation has been set in motion in many nations. Policymakers and regulators are normally presented with the following "portfolio" of reform possibilities.

Remove Interest Rate Ceilings on Certain Classes of Deposits or Loans

Interest rates represent the cost of funds to holders and users, and therefore are the most powerful determinant of saving and borrowing. Ceilings often result in negative real rates of interest, which deter saving and encourage borrowing. The removal of such ceilings reduces or eliminates these biases against capital market deepening.

Decrease or Abolish Barriers to Entry by Private Domestic and/or Foreign Banks

Many financial systems are essentially closed to new entrants, which in effect protects existing firms and allows them to operate inefficiently. Through the provision of market access to new banks, competitive forces are introduced and market participants can turn to new sources of funds and financial services.

Reduce Excessive Reserve Requirements

Reserve requirements are employed for the important reasons of controlling money supply growth and assuring the capital adequacy of banks. Excessive reserve requirements or mandatory deposits with government agencies, however, are often imposed for the thinly veiled purpose of financing government deficits. High

reserve requirements reduce the flow of funds to productive enterprises as well as decrease bank profitability.

Eliminate Unreasonable Portfolio Allocation Rules

Financial institutions are required to meet certain guidelines concerning their investments (in loans or financial instruments) in order to protect the security of their depositors' assets. However, regulations may require that loan portfolio shares be maintained for "priority" sectors, without regard to profitability and risk, or that extremely high proportions of financial portfolios be held in the form of government instruments. The prudent relaxation of these rules will release capital for use by private business.

Shift Emphasis From Regulation to Supervision

Many developing countries and certain industrial countries are "long" on regulation and "short" on supervision. One reason is that it is easier to tell institutions how to behave rather than to examine their actual behavior. A general movement to improve the quality and capabilities of bank examiners would reduce the need for what often are considered "nuisance" regulations.

Standardize Reporting Guidelines and Require Adequate Financial Audits of Banks and Nonfinancial Companies

Very often excessive regulation is seen as an antidote to the lack of proper financial reporting by banking and nonbanking firms. Much of this problem could be addressed by a movement toward transparency and public access to financial records.

Allow Unprofitable Banks to Fail, but Protect at Least Small Depositors

A major dilemma facing all bank regulators is the decision to permit financial institutions to fail. While absolute receiverships can normally be avoided through mergers and acquisitions, the prospects of possible bankruptcies send strong messages to depositors and lethargic bank managements.

Encourage Self Regulation to the Extent Possible

Self regulation is a novel concept in many societies, but over time can preclude the need for strong governmental controls, with all of their negative side-effects. Bankers associations, for example, can develop oversight capabilities to police their

members' behavior. In addition, the presence of private credit or paper rating agencies provide useful information to investors and depositors.

Authorize Banks to Engage in Broader Ranges of Financial Services

In many countries, banks are constrained in their liberty to offer new financial instruments or services. This limits their growth potential and their ability to seek new profit opportunities. Reducing the lines often drawn between different financial subsectors can act as a powerful motive to increase efficiency through the introduction of competitive forces.

OPERATIONAL GUIDELINES AND PRINCIPLES

The basic premise underlying this analysis is that appropriate financial market reforms as well as privatization of financial institutions can remove important constraints and act as powerful stimulants to private sector-led growth. It is important to recognize, however, that reform initiatives require careful planning and execution to preclude undesired consequences and instabilities. No segment of any economy is more potentially volatile than the financial system, since funds can in most cases be shifted with great speed and ease. Therefore, the adoption and use of certain procedural guidelines can enhance the prospects for successful policy development and implementation.

1. Approach financial policy reform as a means to an end rather than an end in itself: Capital and money markets exist for the purpose of assisting individuals and firms engaged in the process of saving, investing and borrowing. Those who examine financial system problems and design alternative remedies should always keep in mind the ultimate needs of market participants.

2. Always accompany deregulation with adequate supervision: Too often those in charge of deregulation have given short shrift to new requirements for supervision. The ultimate result is a wave of instability brought on by the excesses of freedom of action. Ironically, deregulation should often be accompanied by an increase in the staff level of the supervisory agency, and almost certainly by increased training.

3. To the extent possible, precede liberalization with improvements in banking management capabilities: Bank officers who have pursued careers administering mandated policies are not prepared to cope with market forces such

as price competitiveness, lending risk, portfolio management, etc.

4. Employ phased-in policy reforms where possible to allow adjustment in market behavior and avoid excessive swings: Dramatic shifts in such areas as portfolio requirements or interest rate ceilings can produce adverse consequences and often require policy reversals. A phased liberalization strategy can often permit gradual rather than radical shifts in behavior and financial flows.

5. Adopt incentives for prudent financial management: Very often eligibility for liberalized rules can be tied directly or indirectly to institutional performance. For example, banks which consistently meet prudential performance standards can become eligible for a relaxation in their portfolio holdings requirements. This type of incentive rewards sound banking practices and establishes models for behavior.

6. Identify and address secondary effects of and constraints to reform measures: The elimination of interest rate ceilings does little for borrowers in the short run other than increase their cost of funds. Similarly, the abolition of credit allocation formulas may result in the complete withdrawal of lending to specific sectors. These and other side effects need to be addressed directly in the formulation of policy changes, and in some cases compensatory measures will be required.

CONSTRAINTS TO LIBERALIZATION

Numerous problems confront any effort to implement financial liberalization. In many countries, market participants have put into place structures and procedures to cope with the symptoms of financial system repression, and are loathe to adapt their behavior to meet the requirements created by market forces and competition. More importantly, certain participants have often been granted some form of "privileged" status (e.g., subsidized credit, preferential access to funds, etc.), and for reasons of self interest coalesce into groups which vocally oppose reform programs. The longevity of tenure of finance ministers who have implemented fundamental financial reforms tends to be limited. Since the impact of financial policy change is felt throughout the society, reformers need to take concerted steps to develop constituencies to counter often powerful opposition blocs.

In addition, the introduction of market-oriented policies almost inevitably leads to a transitional process of "survival of the fittest" in which disadvantaged groups might suffer in the near

term from higher interest charges or a reduction in available credit. Accordingly, liberalization programs ideally should include initiatives to take into explicit consideration the needs of the poor or financially vulnerable groups that are adversely affected by reforms.

In the short run, liberalization also faces several important but less obvious constraints. If a government takes away or reduces the financial institution barriers to entry, it is assumed that new banks will form and begin to operate. The newly-formed private banks may draw away the depositors and borrowers who do not require subsidies and will repay their loans. This means that the viability of government banks may be further impaired, and they may require larger fiscal support from the government if their continued operations are perceived as desirable.

Other constraints may make liberalization and the formation of new banks difficult. One may be the limitation of specialized banking skills in the country. Another may be the lack of capital resources of existing or potential entrepreneurs with which to form a bank. A third constraint may be the lack of a sufficient market, as was the case for newly formed banks in New Zealand. The new banks lent to marginal customers, incurring losses as the riskier businesses failed to repay.

VI. Improving Financial Sector Performance: Guidelines for Privatization

CONSTRAINTS ON PRIVATIZATION

Overview of Common Constraints on Privatization

It is notable that despite the large number of government-owned banks operating in developing countries, few banks have been privatized or targeted for privatization. Conversely, nationalization of financial institutions has often been undertaken in the Third World because of the critical importance of banks to the economy. Examples of major nationalizations include the 1987 bank takeover in Peru by the Garcia government, the nationalization of the banks in Chile under Allende, and the nationalization of the entire banking sector in El Salvador in 1979 to support agrarian reform under the Duarte administration. Nationalizations are often politically popular and are much easier accomplished than privatizations.

Bank nationalizations have been undertaken because a nationalized banking sector can be ordered by the government to allocate credit among selected, priority economic activities, and to provide long-term loans to preferred sectors. This was the case in El Salvador, where each nationalized bank was directed to provide working capital to land reform cooperatives. In short, the nationalized banking sector often becomes an instrument for carrying out the national political agenda of the government.

Furthermore, governments can gain popular support by portraying nationalization as a means to direct funds away from business elites who may control a country's economic machinery. Other governments have nationalized foreign banking operations in order to capture the perceived excess rents of those operations. Whatever the political motivation, bank nationalizations tend to stay in place, at least until economic conditions deteriorate to the point where privatization or de-nationalization becomes inevitable. Therefore, a major constraint to privatization is often the government's desire to use the banking system as a tool to implement its economic and social policy.

Similarly, if a government bank has served as a conduit for subsidies to certain economic activities, there will be resistance on the part of beneficiaries to eliminate the preferential programs. This occurs primarily because the recipients of the subsidies form effective constituencies to further their interests. The disruptions caused in the rural economy of New Zealand, when the Rural Bank was compelled to charge market interest rates, and the subsequent pressure from agricultural sector businesses, provide a good example of why governments hesitate to tamper with

existing subsidies or with the channels through which they are directed.

Another constraint to privatization arises in cases where government officials are using the financial sector for personal financial gain. This was the case in the Philippines, where President Marcos used two government-owned lending institutions, the Philippine National Bank and the Development Bank of the Philippines, to channel massive amounts of credit to corporations set up by his associates. Many of these corporations had limited commercial viability, but the lending mechanism served to enrich both Marcos and his associates. Until the Marcos government fell in early 1986, little if any thought was given to the possibility of privatizing these banks. When the Aquino government took office, these two major state-owned banks were overburdened with non-performing assets that contributed to the country's financial crisis. This led to the divestiture of the non-performing assets as a major component in that privatization program.

In general, however, the major constraints to privatization tend to lie more in the implementation of the actual divestiture. These constraints crop up even after the political decision is made by the government to privatize certain government-owned companies.

First, sales of publicly-owned banks are often resisted by the banks' managements. Accordingly, governments need to appoint independent bodies to carry out privatizations. The management of a government-owned bank typically would not find it in its best interests to develop its own divestiture plan and, if approved, implement it. This was the case with the Philippine National Bank (PNB). The Asset Privatization Trust asked PNB to develop its own divestiture plan, but the management resisted. To carry out privatization requires not only political decision-making on the part of the government, but the will to follow-through on its decisions. Independent, interventionist actions are usually required.

If the bank is well-run and not subservient to private economic interests in the country, the government may want to retain the bank's management and employees. This was the case in the divestiture of the Jamaican Commercial National Bank. However, if the management and employees are not to be retained, then careful planning involving fair treatment of employees to be dismissed, retired or absorbed elsewhere must be undertaken. The representation of the employees by a labor union is a serious consideration and potential constraint. If the management and employees are to be replaced completely, the shortage of the specialized skills required in a banking institution in some countries may also act as a serious constraint.

An additional constraint may arise if the government is attempting to sell the bank to a group that owns a conglomerate of

family or other concentrated economic interests. This may be seen as a step toward concentration of wealth, and may be resisted by the general public or by specific interest groups. To avoid this problem, the Jamaican government limited the shareholding of any individual to 7.5 percent of the shares issued.

Another potential constraint may arise out of how the assets of the financial institution are valued. The valuation must satisfy both the government and its constituents that in the privatization transaction, the government is not "giving away" or undervaluing the country's assets. Because the primary asset of any bank is its loan portfolio, there must be agreement as to the worth of the loan portfolio.

The disposition of non-performing loans may also pose a constraint to privatization. Sometimes it will be impossible to divest the financial institution without ridding its balance sheet of uncollectible loans.

The lack of availability of financial data on the bank's operations may also serve as a constraint. Even in some cases where audited financial data exists, the unreliability of financial statements and local accounting practices for valuing assets may serve a constraint. Often the government feels it should receive book value for SOEs privatized, and that position raises a severe constraint.

Certainly one of the bottlenecks to selling financial institutions through the issuance and flotation of shares has been thought to be the lack of well developed capital markets, especially in smaller economies. The sale of the Commercial National Bank in Jamaica shows that need not be the case, even though that country's capital markets are very thin. The availability of informal sector funds for such investment, as demonstrated in the Bangladesh case, may be one of the positive effects registered as the privatization movement progresses.

Lack of knowledge about shareholding, even among middle-income individuals, may constitute another limitation to divestiture using flotation and share sales. A related constraint is that governments may not wish to relinquish ownership of profitable companies, despite the fact that profitability is fundamental to such share sales.

Certainly one of the major considerations for private buyers in a privatization is whether they can profit from their investment. Because many government-owned banks have been used as an instrument of government socioeconomic policies, there may have been little concern about the financial performance of the bank. A prudent lending program may not have been the practice and lending may have been directed to infeasible or uneconomic activities. As a result, collections may have been low, yielding

poor financial results. Furthermore, the expectations of borrowers regarding loan repayment may be such that collections may be difficult during the first years after privatization.

As discussed, because the government's financial and monetary policies directly affect a bank's profitability, those policies may create a major constraint to privatization. For example, if the central bank requires reserves be held in below-market yielding government securities or the interest rate regime does not allow an adequate spread given the level of risk, it may be difficult to sell the bank until those policies are changed. For this reason, it has been stressed elsewhere in this report that financial reform and deregulation (not jeopardizing prudent supervision and oversight) is recommended as a desirable complementary activity.

The ability to make a profit also depends upon whether there is sufficient market potential for an aggressive but prudent lender. If the bank to be privatized has primarily focused its lending on borrowings by the government or government-related activities, prospective buyers will want to carefully study the bank's market potential.

If the financial performance of the bank has been poor, the government may not want to divest it outright because the sale could yield considerably more if the bank were rehabilitated. This is the case of three banks under consideration for privatization in New Zealand. Expenditures running into the millions of dollars were made by the New Zealand government to upgrade and computerize information systems, and to generally modernize the bank's operations. Such expenditures may be appropriate if a broad stock flotation is envisioned; however, extensive rehabilitation may be inappropriate if the bank is to be sold to another financial institution. In the latter instance, the buyer could best undertake the required rehabilitative steps according to its own strategy and requirements.

In some countries where divestitures to local buyers may be acceptable, sales to foreign investors or financial institutions may create a wave of resistance. Certainly the prospect of foreign ownership can create a political constraint. In the Philippines, where prospects of foreign investment dominating sectors worries the local business community, several banks have been privatized using debt-equity swaps. In such cases, international banks owed money by individual parties or the Philippine government have been able to convert these uncollectible loans into equity in government-owned banks. The government has had to balance its need to reduce its external debt with its preoccupation concerning foreign investment. Debt-equity swap programs may actually aggravate antagonism towards foreign investors in some developing countries.

In some countries, though, it may be necessary to encourage some foreign investment to overcome the constraints of a lack of capital or limited bank management experience and capability. These arrangements are often made more palatable when administered in the form of a joint venture with the government or local investors. The case of the Guinea government entering into joint ventures with three French banks offers an excellent example of how one country overcame such constraints in order to strengthen and expand nearly defunct domestic banking services in a short period of time.

In summary, a series of constraints affect the prospects for both privatization and liberalization many developing countries. Privatization and liberalization must be viewed as primarily political processes, and each privatization program needs to be tailored to overcome constraints.

How Privatization of Financial Institutions Differs from other Privatizations

As financial institutions are the providers of capital, one of the basic factors of production, they broadly affect economic growth. A commercial banking institution serves a unique function in the economy, intermediating the excess funds and savings of its depositors into the sound extension of credit to borrowers. A private bank must earn an adequate return for its stockholders and provide safety for its depositors. The loan-making activities of a banking institution are the economic lifeblood of a country's private enterprise sector. By comparison to a typical industry or service business, therefore, the privatization of a banking institution could have a far greater impact upon the economy as a whole.

Because of the intermediation carried out by financial institutions, they are also subject to government policies, especially monetary and banking policy. Depending upon the sophistication of capital and credit markets in the country, financial institutions may be subject to the effects of open market operations, reserve requirements and discount borrowing from the central bank. Thus, financial institutions are more directly affected by government policies than non-financial SOEs.

Confidence in the financial institution by depositors is an important factor in its privatization. Confidence in a product or service of an industry or non-financial service organization will certainly affect its sales and profits. However, in the case of a bank privatization, lack of confidence can erode the bank's deposit base and seriously impair the success of the privatization transaction. To be successful, privatization of a financial institution must offer equal or greater security to existing depositors.

GUIDELINES FOR FINANCIAL INSTITUTION PRIVATIZATION

Privatizations can be structured in many different ways, but the key to successful privatization is a custom-made approach that will meet the needs of the government, potential investors, and the public. Privatization approaches most appropriate to banking institutions include the following:

- Sale of shares to the public, management and employees;
- Complete or partial divestiture to private buyers;
- Commercialization or corporatization;
- Management contracts, sometimes in conjunction with stock flotation; and
- Closure and liquidation.

1. Sale of Shares to the Public, Management and Employees: The sale of shares constitutes a transfer of ownership to an individual or a corporate entity. Along with the share goes the right to vote for the directors of the board of the bank and on matters put before all the shareholders. The Jamaica case offers an excellent example of the divestiture of a bank through the sale of shares to the public and employees.

There are two compelling reasons to employ the stock sale approach. First, the sale of shares to the general public helps overcome the objection that government assets may be transferred to the wealthier individuals in the country. In reality, a poor individual may not be able to afford even a single share of bank stock. This probably would be so even if the par value of the shares were very low. However, any attempt to sell shares to persons beyond the economic elite will most likely be broadly supported. Chile enabled many lower income persons to become shareholders through its Popular Capitalism program. Share purchasers were able to make a five percent down payment and amortize the remainder over 15 years on a no-interest basis. As of late 1988, more than 100,000 individuals in this program invested more than $400 million in privatized businesses.

However, if the par value is set low in an attempt to attract many lower income buyers, it may mean that each shareholder's stake is so small that the subsequent earnings per share paid by the bank may mean little. Furthermore, because of the dilution of control these shareholders will exert little control over management to ensure that prudent lending practices and administration are followed. Therefore, some institutional investment should be encouraged. Institutional investors will typically exert active control over bank boards to ensure that their investment is protected. The balance between institutional investor participation and that of the public will be a key consideration in a stock flotation.

One of the key factors determining whether a stock flotation is possible is the past financial performance of the bank. Even if a bank has not been consistently profitable, perhaps due to its role in government economic programs, the bank may still be inherently viable. This means that if it were not operating as a government bank pursing government-mandated goals, or if it had prudent management, the bank could be profitable. To achieve profitability it may be necessary for the bank to be transformed into an autonomous corporation as an interim step. Corporatization is discussed further below.

The balance sheet of an institution may reflect the poor lending practices of past management, i.e., there may be many uncollected or uncollectible loans. The best approach may include the transfer of these loans to the appropriate ministry (usually Finance or Treasury) or the central bank for collection and write-offs.

Once the decision has been reached to divest all or part of the ownership of the bank through a stock flotation, the following set of steps need to be taken to carry out the issue:

- Auditing;
- Transfer of non-performing loans;
- Design of protections for minority shareholders;
- Stock issuance, valuation and pricing;
- Prospectus preparation;
- Stock transfer to executing agency;
- Share sale promotion and marketing; and
- Stock flotation.

AUDITING: In order to determine the exact financial position of the financial institution, it is necessary either to procure new financial reports or certify existing reports. These actions should be taken by independent auditors. Such reports should identify any financial contingencies that may affect the financial status of the institution in the future. Particular attention must also be paid to the value of the bank's loan portfolio. For example, all loans should be aged according to standard procedures.

If the audit reveals that the bank is not actually profitable, a financial specialist should prepare financial projections to identify steps to achieve viability. It may be decided that the bank should be divested through a negotiated sale, or perhaps corporatized. It may be better to negotiate the sale of the bank to another financial institution that can take appropriate steps to improve services and achieve profits. If the audited statements of the bank indicate profitability, a stock flotation is possible.

TRANSFER OF NON-PERFORMING LOANS: A government bank's portfolio is likely to have a certain number of uncollectible loans. These loans should be transferred to the appropriate government ministry or the central bank for collection or write-offs. These transfers will enhance the bank's balance sheet and improve its salability.

PROSPECTUS PREPARATION: A prospectus is a document providing full disclosure of all pertinent information about the financial institution. A prospectus should include:

- A description of all assets and liabilities;
- Profit and loss records for several years, based on an audit prepared by an independent auditing firm;
- A description of all outstanding issues of securities and terms;
- A list of all officers and directors, together with the salaries of the top officers; and
- Identification of anyone presently holding 5 percent or more of the ownership.

Before the price is set on the stock issue, a preliminary draft of the prospectus should be prepared. In the United States, the preparation of a prospectus implies a level of fiduciary trust with legal liability in case false information is included in the document. Therefore, it is recommended that specialized assistance through an internationally-recognized investment banking or accounting firm be employed for the preparation of the prospectus.

STOCK ISSUANCE, VALUATION, AND PRICING: It is generally necessary to issue new shares unless there has been a previous issue. This will involve the actual creation of stock certificates that specify its par value. Setting the par value is a function of the value of the bank, the buying power of the public and the interest there may be in purchase of the issue.

The valuation of a financial institutions varies substantially from that of, say, an industry. However, the basic premise is the same: The value is based on how much the business can earn after taxes. The valuation of a bank may require two types of calculations to determine its worth:

- Valuation of its components; and
- Valuation as a going concern.

The components valuation approach involves:

- Loan portfolio valuation;

- Core deposit valuation; and
- Valuation of proprietary items, the name of the bank, etc.

For financial institutions, the audited balance sheet is a fairly good indicator of value. This is so because the loan portfolio is composed of financial instruments which state the terms and conditions of the loan. The loans must be aged to reflect collectibility. However, the balance sheet does not reflect potential future earnings. Therefore, a going concern valuation must be performed to avoid understating the bank's true value. Again, specialized valuation assistance should be accessed through an internationally-recognized valuation firm.

Once the value of the bank is established, then an appropriate share price can be set. Price setting requires a balance between the need to set prices low enough to ensure a strong demand for the shares and the need to avoid criticism that the government should have received more for the sale of the shares. Setting the price too high will cool demand. Once the par value is established it can be incorporated into the prospectus and the stock certificates can be printed.

SHARE SALE PROMOTION AND MARKETING: Once the prospectus is completed, it can be distributed to all persons interested in purchasing the shares. A problem in developing countries is that not many persons will be able to read and understand the contents of a prospectus. Furthermore, most persons will not understand what it means to be a shareholder, what are the rights of shareholders, and when and why dividends are paid. A successful stock flotation in a developing nation requires a massive public education campaign. Even in the United States, a great deal of emphasis is placed on promoting the sale of shares to the public. This campaign should begin well in advance of the completion of the prospectus and the proposed issue date. It is advisable to utilize the services of a professional public relations firm. Radio, television, the press, and targeted presentations should be used to arouse interest and educate the public.

STOCK TRANSFER TO AN EXECUTING AGENCY: Some unit of government, an investment bank, or a consortium comprising investment banks, brokerages, etc., should be made responsible for the sale of the shares. In case of a flotation of shares of a particularly strong bank, an investment bank might even underwrite the issue. However, in most cases these institutions will only act as an agent for the government, collecting a fixed fee or a commission on sales.

STOCK FLOTATION: This step involves the actual sale of the stock to the public. A mechanism should be established beforehand to allocate the shares in case the issue is oversubscribed. In the Jamaican case, a share allocation arrangement formula was

established to ensure that smaller investors were given priority in the process.

DESIGN OF PROTECTIONS FOR SHAREHOLDERS AND SECONDARY MARKET FACILITIES: Prior to the issue of a stock in a thin capital market, it is indispensable that all shareholders have certain protections:

- A mechanism should be established for maintaining contact with all stockholders. An exact record of all shareholders, their names, addresses and number of shares owned must be maintained by the bank.

- A mechanism for voting must be established and safeguarded for all holders of voting common stock.

- Shareholders should receive audited financial reports prepared by independent accountants, on at least an annual basis.

- Payment of dividends, if declared, should be paid to the shareholder.

If a regulatory unit to guarantee that these protections are maintained is not in existence prior to the privatization, it should be established before the sale of shares proceeds.

Another important consideration for investors is the ability to re-sell their shares in case they need liquidity or feel that they no longer want to hold the shares. In cases where a stock exchange exists, the registration of shares with the agency in charge of the stock exchange must be undertaken prior to their issuance. However, some countries have no exchange at all, and in such cases a relatively informal exchange or "trading post" needs to be established to handle these transactions. Another possibility might be a buy-back arrangement whereby the company repurchases its own stock at a small discount from shareholders desiring liquidity.

It can be seen that the public sales of shares as a means to privatize a financial institution is a complicated process. It involves a series of specialized services to ensure that each step is correctly executed and that the interests of both investors and the bank are protected. Privatization of banks in this manner has distinct advantages in spreading, not concentrating, wealth. This could pay excellent political dividends to the government, which could encourage the authorities to continue and expand privatization activities. Bank privatization through a sale of shares can also act to deepen domestic capital markets. However, the transaction will require time and considerable expense.

Complete or Partial Divestiture to Private for-Profit Institutions

Divestiture of a government-owned banking institution to a private sector group or financial institution tends to be an easier undertaking than the share sale process described above. The buyers interested in such a process might typically be a local business conglomerate controlled by family interests, a similar business conglomerate that includes a financial institution desiring to expand its markets, or an international banking institution. One key to the success of such privatizations is that the buyer should bring bank management experience to the institution. Prospective buyers will be interested in the financial performance record of the bank, its financial potential, and the percentage of the operation that the government is willing to sell.

One disadvantage to this technique is that it can concentrate wealth further in the country, especially if sold to local already wealthy business interests. Privatization could be seen as benefitting the rich at the expense of the poor. Furthermore, without proper supervision the banks may skew their lending to meet the needs of their owners, which may include bailing out companies in which their owners have a stake.

An international banking institution offering to buy a local bank could be viewed with concern in some countries where foreign investment is not viewed favorably. Nevertheless, international banks may be owed money by the government or individual institution, and may have the right under a debt-equity swap program to convert their debt to equity in a local business. A good example of this is found in the Philippines, where government-acquired banks have been sold to international banks through debt-equity conversions.

Buyers will be especially interested if they are allowed to buy the majority share, or at least exert effective control of the bank through the subordination of the government's voting rights. Such a bank should be able to install new management which can quickly take steps to improve its operations. This could produce immediate economic benefits.

Another advantage in using this technique is that the bank to be privatized may be sold without demonstrating a record of profits. The buyer must be convinced, based on financial analysis, that the turned-around bank could be profitable, and that the bank will not be subjected to undue government interference that could jeopardize profits. A foreign buyer will also want guarantees that it can repatriate future profits. In order for the government to

negotiate the sale of banks using this technique, it must take several steps:

- Perform an independent audit certified by an independent, professional auditing firm;
- Perform a valuation of the bank;
- Assess what must done concerning the bank's management and employees;
- Address any legal obstacles identified;
- Prepare a "best available" information brochure for potential buyers; and
- Provide ample time for potential buyers to make their own analyses to support their investment.

Using such an approach avoids the requirement of rehabilitating the bank prior to the sale. The government may be persuaded to transfer uncollectible and government agency loans to an appropriate ministry. However, computerizing the bank's record-keeping functions and taking other steps to modernize the operation should be left to the new buyers who can tailor changes to meet their needs.

One of the most important steps for the government to take is to determine the obligations it has with regard to the employees of the financial institution and set forth the best means to meet those obligations. As government employees, most bank workers will have accrued pension and other benefits. These should be calculated and paid by the government upon sale of the operation. Furthermore, the new buyer may want to install its own management team, but may want to retain the employees whose training and experience may be difficult to replace. One option is to include in the sales agreement a provision for retaining specified employees for a trial period of six to twelve months. If at the end of the period the employee is deemed suitable, he or she can be retained.

Preparation of "best available" information will provide prospective buyers all data on the banking operation for their consideration. Buyers will want to carefully examine the loan portfolio and will negotiate the purchase, in part, based upon the aging of the bank's loans. Buyers will also want to examine legal agreements with creditors, such as loans provided by multilateral lending agencies, to determine the potential effects of the sale.

Commercialization/Corporatization

Commercialization or corporatization is viewed as an interim step to divestiture. Corporatization is recommended when the financial institution is currently unprofitable, but is viewed as having remediable deficiencies and strong potential profitability. The steps to be taken in establishing an autonomous corporation are as follows:

- A financial viability analysis that envisions the payment of amortizations, taxes and dividends to the government is prepared.
- The government establishes a statutory corporation to which it will transfer the assets and the liabilities of the present government bank.
- Rehabilitation requirements are identified.
- A valuation of the assets of the bank is completed and a loan is made providing for repayment by the new statutory corporation.
- Arrangements are made for the transfer of personnel from the government payroll to the new corporation. Salary structures are examined to ensure compatibility with levels in similar private sector operations. A management contract with an international bank wherein a professional management team or advisors are placed in the bank to upgrade the banking procedures and systems and achieve profitability may be useful.
- The development of a new accounting system or adjustment of the present system is usually required.
- Arrangements for ongoing supervision and regulation of the corporation must be made.

These steps to restructure the bank may result in an improvement in its financial performance. However, even if the bank is attracting deposits and lending at market interest rates, paying taxes and dividends to the government, and amortizing the transfer price of the bank, the bank continues to be a government-owned bank. Accordingly, there remains a possibility for the government to attempt to influence the lending practices of the bank.

In addition, the performance of the bank may be so dramatically improved that the government and the public no longer perceive the need to create a privately owned institution. In the case of New Zealand, the Labour government lost credibility because it initially announced that it would limit its efforts to

corporatizing banks, and subsequently determined that it should push for privatization. The lesson is that corporatization should only be viewed as a step toward ultimate privatization. Corporatization probably does not go far enough, and leaves open the opportunity for the government to return to previous non-economic practices. The ultimate step in an effective corporatization procedure is the issuance and sale of shares either on the local stock exchange or the techniques described above.

Management Contracts

Contracting out the management of government-owned banks is another form of limited privatization. Management contracts may be especially useful in those instances when the government has no intention, at present, of divesting the state-owned bank. In these cases, a management contract may lead to a demonstration of the financial performance of the institution under private sector incentives. In the case of corporatization, a management contract may be a necessary ingredient for achieving success with the newly structured financial institution. The selection of contractors and the structuring of the management contract will have a strong influence over whether this arrangement achieves the desired results.

Potential contractors able to assemble sufficient bank management expertise may not exist domestically. Furthermore, contracts involving the management of competitor banks may have collusive results. Therefore, it may be necessary to establish a tendering process that includes expatriate bidders. Under all circumstances, a tendering process should be used. The elements of a management contract should include:

- Management staffing, procedures and costs for replacement of personnel;
- Duration of contract with conditions for renewal;
- Definition of duties, obligations and rights;
- Training of local staff;
- Profit-sharing arrangements;
- Clauses providing effective control of bank operations;
- Reporting requirements, specifically to the board of the bank;
- Clauses for resolving differences of opinions; and
- Conditions for termination.

One of the most important clauses in a management contract is that which entitles the contractor to have a share of the profits. Sometimes these clauses are structured progressively; the more profits earned, the greater the remuneration received by the contractor. Such clauses may stimulate better financial performance.

Another important clause involves the effective control, without governmental interference, over operations. It is likely that the government may still want to impose its regime of credit allocation, the provision of subsidies, and similar uneconomic practices upon the bank's operators. These will not be changed unless the broader financial sector reforms discussed elsewhere in this report are instituted. Nevertheless, once the "rules of the games" are set for the bank's operations, it should be insulated from all but normal monetary and financial policies.

One advantage in utilizing a management contract is that it provides an opportunity for another banking group to become familiar with the banking markets in the country in the event of eventual divestiture of government-owned banks.

Closure and Liquidation

To date, one of the most prevalent means to privatize state-owned-enterprises has been informal privatization or closure. In these cases, the government has decided that continued operations mean further losses and requirements for continued, often increased, budgetary support. However, the government may not want to be perceived as "taking a step backward" by closing down an operation. Moreover, it usually does not want to be seen as creating further unemployment.

The government in such cases may make the decision to provide no additional financial support. This usually is sufficient to bring the SOE to insolvency within a short time period. The socialistically-oriented Guinean banks were allowed to decline to that point -- in fact, it appears that those banks had become useless in acting as deposit takers, and the only loans extended were to government agencies.

There is in such cases a good opportunity for the liberalization of entry requirements. New banks might be formed by local entrepreneurs or as a result of policies to encourage joint ventures between international banking operations and local entrepreneurs.

One advantage associated with liberalizing market entry policies is that the qualified personnel of the moribund government

bank may be absorbed by the new banks. This would make the tough political decisions required much more palatable.

This chapter has discussed constraints on privatizing banking institutions and the differences between the divestiture of such institutions and other government-owned nonfinancial entities. Those differences stem primarily from the importance of banking institutions to the economic well-being of the country. The chapter has also discussed various techniques to privatize these institutions, touching on important issues such as profitability, concentration of wealth, and protection of minority investors and depositors, as well as various technical and financial requirements.

VII. Impacts of Financial Reform and Privatization

Countries which embark on a course of financial reform and privatization are likely to experience a number of important benefits, and may experience several negative side effects as well. This section outlines the positive and negative effects of taking the measures suggested in this report (see Table 4).

The benefits of financial liberalization and privatization are significant. Perhaps most importantly, nations that undertake these measures set the foundation for healthy financial market development by encouraging all market participants, both on the saving and on the borrowing side of the equation, to take part in bank intermediation rather than avoid it.

When a country has successfully reduced inflation, implemented appropriate interest and exchange rate policies, and encouraged the establishment of a competitive, private banking sector, savers will no longer be encouraged to speculate in real estate or other real assets, or hold assets in foreign currencies or overseas. Instead, savings will be directed toward productive domestic investment. With more attractive returns and a greater breadth of available services, the rate of savings should also increase. Capital that previously was invested in government securities as required by law will be available to fund private businesses.

Both reform and privatization will pave the way for further innovation and introduction of new savings instruments with attractive returns, and are likely to encourage additional saving. Macroeconomic reform will have this effect by means of stabilizing inflation and the value of the currency, and thereby allowing savers to return to paper instruments denominated in local money. Privatization will encourage this result because the strengthened profit motive will push banks to innovate in order to attract new resources. Higher domestic savings rates will reduce dependence on expensive foreign capital and provide additional funds for growth.

Adopting the measures recommended in this report will also result in an improved allocation of scarce capital. Currently, large quantities of capital in development countries -- over half of all capital available in some nations -- are invested by law in low-yielding government securities, or are channeled to unproductive, government-selected projects, often with little hope for repayment in the short term. Once the government scales back its expenditures and reduces the scope of directed credit, and once banks are allowed to pursue profitable lending opportunities, larger amounts of capital will flow toward private investments that are productive and generate a sufficient cash flow to ensure loan repayment.

TABLE 4

BENEFITS OF BANK PRIVATIZATION, MACROECONOMIC REFORM, AND REGULATORY REFORM

Bank Function	Privatization Will Improve Bank Performance	Macroeconomic Reform Will Improve Bank Performance	Regulatory Reform Will Improve Bank Performance	Economic and Societal Benefits of Improved Performance
Operate Efficiently	✓			Lower intermediation costs, increase savings and investment
Mobilize Resources	✓	✓	✓	Increase capital formation
Develop Financial Products	✓		✓	Reduce capital flight
Allocate Credit Among Alternate Investments	✓	✓	✓	Increase efficiency of investments, speed economic development
Collect Loans	✓		✓	Allocate costs fairly, reduce strain on government budgets
Recruit and Supervise Personnel	✓			Lower intermediation costs, create higher quality work force
Maintain Fiduciary Relationships	✓		✓	Increase savings, reduce capital flight
Minimize Corruption in Banking Sector			✓	Increase bank confidence, increase pool of investment funds

Reform and privatization will not only encourage more intermediation, but also engender greater efficiency in intermediation. Lower administrative costs, reduced reserves for bad loans, and diminished mandatory purchases of low-yielding government securities will all work to diminish the wedge between interest paid to savers and interest charged on loans. As the spread becomes smaller, interest rates can rise for savers and fall for borrowers, thus further encouraging saving and investing.

One reform in particular, lifting interest rate ceilings, will benefit many different groups, among them small businesses that currently face well documented credit needs but are shut out from formal capital markets. When forced to operate under low interest rate limits, banks logically lend only to the least risky projects, which necessarily eliminates most small businesses which are vulnerable to sudden setbacks because of their undiversified nature, limited access to technology, and generally poor quality of management. Raising or eliminating credit controls will allow banks to tradeoff risk against return and funnel desperately needed funds to small businesses which typically are the primary generator of jobs in developing as well as developed economies.

As with all policies and programs, reform and privatization are likely to bring about some undesirable effects. In particular, interest rates are likely to rise for both savers and borrowers, raising banks' costs for acquiring funds, and raising the cost to those businesses, usually large, that previously had access to subsidized funds. In addition, granting more freedom regarding lending decisions and removing banks from direct government ownership may result in increased opportunities for fraud and non-prudential lending. For example, knowledgeable observers in Mexico point to diminished bank corruption under government ownership. A third common difficulty is that bank managements may not be prepared to operate in the freer environment created by reform, which could lead to some bank instability, and possibly to bank failure. Inexperienced management has been blamed for contributing to the bank failures in Chile in the later half of the 1970s. Lastly, privatization can lead to excessive concentration of wealth among the rich, and to unwise lending between banks and the corporations that own them.

Increases in interest rates will pose a hardship for two groups: Banks which must pay higher rates to attract resources, and borrowers accustomed to a low cost of funds. Financial reforms which raise rates for savers may diminish bank profitability. Of course, banks will attempt to pass along the higher cost of funds to their borrowing clients. Those clients used to borrowing at subsidized rates, such as managers of "politically connected" projects or firms in industries which the government encouraged, will be hard-pressed to pay the new higher rates, especially if their projects do not generate a sufficient return. These clients

are likely to be vociferous opponents to financial reform and privatization, and their political connections should be considered prior to embarking on a strategy to improve financial markets.

Higher interest rates could dampen investment in the short run. However, since higher interest rates are the result of an improved capital allocation process, the efficiency gains from better investment will likely overwhelm the potential reduction in investment.

Another negative repercussion of privatization and financial reform can be increased fraud. With some exceptions, direct government ownership and regulation (as opposed to supervision) seem more effective at controlling corruption. Strong measures should be taken to guard against increased fraud, including collusion, in the wake of reform and privatization, not only because the fraud itself is undesired, but also because publicity regarding such occurrences would seriously jeopardize any further reform and privatization attempts.

A third common difficulty that arises in conjunction with financial reform and privatization is that generally weak bank managements, accustomed to operating within severely restricted parameters, find themselves free to make a wide variety of decisions they have never before faced. As occurred in Chile, a new-found freedom of action can result in poor decisions as bank managements climb the learning curve toward balancing portfolios, selecting high quality loan candidates, and operating effectively in a competitive environment. Because of this tendency, it is important to strengthen bank management skills when new policies are put in place.

Bank supervision should also be strengthened at or prior to financial market liberalization. Ironically, the size and quality of bank supervision staffs should grow at the same time that many bank decisions are handed back to the banks. By decreasing direct control but increasing supervision, governments will move toward building a foundation for financial sector growth, monitoring the sector and identifying problem areas, but giving private banks the opportunity to innovate, expand, and develop.

Excessive concentration of bank ownership and troublesome business/bank linkages are a last negative effect which results more from privatization than from financial reform. As was painfully illustrated in the Chilean privatization of the early 1970s, extensive bank ownership by large corporate groups can lead to unsound lending decisions and bank failure. The private sale of banks to large businesses can also engender public resentment if it is perceived as the sale of public assets to the wealthy, and especially if the price is viewed as too low. These concerns should be carefully considered as privatization is planned, and attempts should be made to ensure widespread public ownership.

Concerns have been raised that the widespread ownership resulting from an aggressively marketed public offering is perhaps too thinly diffused, leaving control in the hands of the same bank management that operated the institution prior to the sale. For this reason, it is useful to approach a local or foreign institutional investor, such an insurance company, pension fund, or another financial institution, to buy a significant but not controlling share in the bank to be privatized. This "lead owner" will have a strong enough stake in the bank's performance, and importantly, the technical knowledge to assess bank decisions, to oversee bank operations effectively, and challenge the existing management if needed.

In spite of these possible negative repercussions, financial reform and privatization remain as key steps toward broad-based economic development. Care should be taken to minimize downside risks and to prepare the populace to accept minor short-term adjustments. However, without financial liberalization and privatization to provide businesses with access to credit, prospects for medium- and long-term economic growth are slim.

Annex A

Case Studies on Financial Sector Liberalization and Privatization

CASE STUDIES ON

FINANCIAL SECTOR

LIBERALIZATION AND PRIVATIZATION

Bangladesh:	Divestiture and Reduced Barriers to Entry, A Dual Track Privatization Policy
Chile:	Innovative Bank Divestiture
Guinea:	Creation of a Private Banking Sector
Jamaica:	A Successful Share Offering
Mexico:	Breaking Down the Barriers to Entry
New Zealand:	The Positive Results of Policy Reform
Philippines:	Dismantling Government Domination

'78'

BANGLADESH:

Divestiture and Reduced Barriers to Entry:

A Dual Track Privatization Policy

Bangladesh
Divestiture and Reduced Barriers to Entry:
A Dual Track Privatization Policy

I. SUMMARY

Since 1982 when Bangladesh announced a general economic liberalization to encourage a greater role for the private sector, the private sector has been able to gain control of a significant portion of the country's banking assets. In 1981, no local private banks existed, and six state-owned commercial banks controlled about 93 percent of banking assets. In 1988, nine local private banks are in operation and about 45 percent of bank lending is now conducted by private or autonomous institutions. However, like many of Bangladesh's reform efforts, the accomplishments have not met original goals. While the structure of ownership of banking assets has changed dramatically, the financial sector is still dominated by state-owned or controlled banks that continue to base decisions as much on political criteria as economic ones. Moreover, fundamental financial sector policy reform had not yet been implemented. Interest rates still remain controlled and banks continue to keep non-performing loans on their books at full value. A recent World Bank final sector loan includes conditionality to change these matters, but only time will tell if the measures will be implemented as designed.

Increasing the role of the private sector was accomplished with a dual track privatization policy, including both full and partial divestiture of state-owned institutions, and more importantly, a reduction in the barriers to entry for private institutions. The two smallest state-owned banks were fully divested through public offerings in 1984-85, and 20 percent of a third state-owned bank was sold in 1988. Lowered barriers to entry led to the establishment of six new private local banks in 1982-83. A seventh bank, an Islamic bank, was established in 1987.

These private banks are the most dynamic and thriving part of the banking sector, and have contributed significantly to a large increase and deepening of Bangladesh's financial sector. However, much of the private sector's success is due to continued mismanagement and forced unprofitable lending within the remaining state-owned banks, which continue to dominate banking. If these state-owned institutions were more efficient and were not forced to operate under different rules than the private banks, it is doubtful that the private institutions would have been so successful.

While the increased competition engendered by privatization has led to better financial services for the economy at large, certain elements, primarily rural, have experienced reduced banking

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services. Privatized banks have closed down most of their rural banking networks because they are considered not to be profitable. This development has left a significant proportion of rural society with reduced access to banking services and forced them to rely more on informal financial institutions for their credit needs. Since rural lending was conducted under regulated below market rates previously, some rural creditors must now pay significantly higher interest rates.

II. FINANCIAL POLICY CONTEXT

In early 1982, the Bangladesh government established a program of privatization and general economic liberalization. The financial sector was partially included in this new policy direction. In 1981, before the new policies were implemented, the financial sector was almost totally controlled by the state. The six state-owned National Commercial Banks (NCBs) owned 93 percent of all bank assets, with the remainder owned by a small group of foreign banks. Outside of banking, the financial sector was and remains very limited. Apart from insurance companies, non-bank sources of finance are minimal, although a nascent, but growing, equity market does exist, and non-bank financial institutions are growing.

Since 1981, the market share of private banks has increased sharply. By 1986, after the divestiture of two NCBs and reductions in the barriers to entry, the remaining four NCBs owned only 70 percent of bank assets. By 1988 their share is expected to fall to 50 percent. Newly established, private institutions have gained most of market share lost by the NCBs, as the share of foreign banks has remained constant, and the two divested NCBs were small institutions.

Although greater private sector participation is being encouraged, the state has continued to exercise substantial control of the financial sector. In addition to ownership of the predominant banking institutions, the state greatly influences interest policies and bank lending through administered interest rates and directed credit programs to "primary sectors". The major thrust of these policies was to keep general interest costs low and to ensure that priority sectors, which include agriculture and a wide range of "politically well-connected" projects, receive credit at less-than-market rates.

For most of the directed credit programs, the Bangladesh Bank, the Bangladesh central bank, refinances the loan at less-than-market interest rates. Even with this refinancing, however, after making provisions for bad loans, it is estimated that there is an average negative interest rate spread of four percentage points on these directed credits. With two-thirds of the lending of the National Commercial Banks (NCBs) going to directed credit programs,

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it is not hard to understand why these institutions are financially troubled.

The NCBs are also required by the state to maintain an extensive rural branch network to facilitate lending to the rural sector. According to several sources, these networks are not cost effective, and therefore these banks are essentially being forced to provide a public utility type function for which they are not compensated.

Another characteristic of the business environment of the Bangladesh banking sector is a very slow, weak legal process to enforce loan repayments. Even if courts do take action, it is rare for them to do so before three to four years after a bank initiates a legal process. Moreover, the regulatory structure discourages banks from taking legal action, since a bank must put a loan on a non-accrual basis once legal procedures have begun. Since this weakens a bank's reported income, upon which bonuses are based, bank officers are averse to force loan repayment through the courts.

Finally, Bangladesh has very weak regulatory and supervisory institutions and procedures. The government overseers lack qualified personnel, especially to conduct audits and other procedures to assess the financial soundness of institutions. In addition, the banking sector lacks a universal system to classify loans. Problem loans are often disguised in balance sheets because banks are loathe to take provisions against them. As a result, most of the state-owned banks report strong incomes even though they are technically bankrupt, i.e., the true value of their liabilities greatly exceeds that of their assets.

III. FINANCIAL POLICY REFORMS

Apart from measures to encourage greater private sector participation in the banking sector through divestiture of the smaller state owned-banks and reduced barriers to entry, few significant financial sector policy reforms have been implemented since 1981. Recently, however, authorities are beginning to recognize the fundamental weaknesses of the banking sector and are taking tentative steps to address some of the problems.

Recent reform measures include the following:

- Relaxation of credit ceilings. Instead of using credit ceilings on individual banks as a primary monetary instrument, the central bank is attempting to implement monetary controls through interest rates, reserve requirements and other more flexible and less discretionary mechanisms.

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- The remaining state-owned banks have been encouraged to be more aggressive in collecting loan repayments. The banks have improved their performance in this regard, but not nearly enough to improve their financial position fundamentally. Politically well-connected borrowers, both private and public institutions, still do not feel compelled to repay. NCBs are only recently willing to cut off access to credit. This poor loan recovery rate is the most important cause of the state-owned banks' poor performance.

  It should be noted that some observers believe that the poor results of the NCBs' enhanced loan recovery program is due to counterproductive actions by the private banks. According to these sources, many private banks are willing to lend to firms and individuals that are in default to the NCBs. Since many of these creditors are connected to the industrial groups and families that control most of the private banks, the perceived risk of this lending by the private banks is low. In most cases, these firms and individuals have the funds to make their payments, but simply do not consider it necessary to make their payments to NCBs.

- Perhaps most importantly, a National Commission on Money, Banking and Credit has been established to review and make recommendations for the reform of the financial sector. Working with the IMF and the World Bank, the Commission has already made considerable progress in developing a new loan classification system that will require banks to assess their loans more realistically and take prudent banking measures to deal with problem loans. Over time, if this classification system can be enforced, it will encourage greater loan recovery efforts and better loan risk analysis. Other, even more far-reaching reform measures, such as the establishment of market-based interest rates and the gradual elimination of directed credit programs, are being discussed.

IV. IMPLEMENTATION OF PRIVATIZATION

The privatization of financial institutions in Bangladesh has followed two policy paths: Full and partial divestiture, and reduced barriers to entry.

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Divestiture

From 1984 to 1985, the two smallest NCBs, the Pubali and the Uttara Bank, were privatized through public offerings. In 1988, government partially divested the next smallest NCB, Rupali Bank, also through a public offering. All three of these banks were general commercial banks providing a full range of commercial bank services. In addition, all three had extensive and costly rural branch networks.

Total Divestiture: Pubali and Uttara Banks

The two smaller banks, Pubali and Uttara, were divested near the end of a large program of privatizing an array of institutions that had been nationalized in the 1970s. Most of these enterprises were jute and textile mills. The government initially planned to privatize all enterprises formerly owned by Bangladeshis and all unprofitable state-owned enterprises. After privatizing 37 textile and jute mills in two years, opposition to the program and to the government in general began to strengthen. Populist parties and Labor unions, afraid that privatization would decrease employment and salaries, dominated this opposition. As the political strength of the Ershad government weakened, its privatization program stalled. The two small NCBs were some of the few enterprises outside of the jute and textile sectors which were completely divested. The privatization process for the banks, including the public offering, was conducted when opposition to privatization was mounting.

For both banks, the public offering was oversubscribed, as was the case for other public offerings of state-owned enterprises. Under the rules of the Bangladeshi stock market, where the public offerings have been placed, newly issued stock must be sold at par. Since both of these banks had many non-performing loans that were not priced to market, the antiquated accounting practices used in Bangladesh resulted in an overvaluation of the shares. The popularity of these shares is more a function of peculiarities of the Bangladeshi economy than the attractiveness of the investment. Purchasing stock shares is one of the most convenient means with which to launder money. By purchasing stock in cash, monies earned through black market activities can be converted into legal instruments. As a result of this process, stock prices are only partially determined by the financial performance of the enterprise itself. The public offering was oversubscribed because of demand generated by laundering activities.

As a result of the public offering and significant secondary market transactions, the ownership of Pubali Bank is widespread and dispersed, and therefore is unable to

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effectively influence or control bank management. Uttara Bank, however, is controlled by a large Bangladeshi industrial group which is able to oversee and supervise bank management.

Since the privatization, Uttara Bank has performed well. New management has changed the bank's operating methods. It is much more commercially oriented than the NCB's, and generally conducts business like other private banks. On the other hand,
Pubali Bank continues to face many of the problems of the NCB's, including poor loan recovery, strong unions that inhibit the adoption of new work practices and a continuation of non-profitable preferred credit programs. Although Pubali Bank has not changed as rapidly as Uttara Bank, it is generally considered to be more efficient than the remaining NCBs. Nevertheless it is still in weak financial shape. Its poor condition demonstrates that although privatization can change management incentives and a bank's operating methods, without concomitant financial sector policy reforms which remove excessive government controls, both direct and indirect, and which provide sound macroeconomic conditions, privatization alone will not be sufficient to reform individual banks or the banking sector.

Both Pubali Bank and Uttara Bank are attempting to reduce their rural branch network and also their rural lending. The government is resisting these efforts, but has no direct means to stop them. However, indirectly the government can hamper bank activities through central bank operations and regulatory procedures. As a result, these privatized banks must reorganize more slowly than they would like in areas that contradict government policies.

Perhaps the reason that Uttara Bank has been able to become more commercially oriented more quickly is that its management is less dependent on government goodwill because its owners are a strong, independent industrial group. With this powerful group in control, the bank can better resist government pressures. Rupali Bank management has no interest group to protect it, and thus has been much more cautious in changing its practices.

Partial Divestiture: Rupali Bank

After three years of discussions, the partial divestiture of Rupali Bank, the smallest of the remaining NCBs, was implemented in the Spring of 1988 through a public offering. The Rupali Bank partial divestiture was undertaken as part of the Ershad government's revised privatization program. This new program was the result of a political compromise between donors that wanted a continuation of the previous stalled

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program and opposition interests that wanted an end to privatization efforts. The revised program calls for only partial divestiture, up to 49 percent of an enterprise's capital, of which 15 to 20 percent is reserved for employees. By maintaining majority control of firms, far fewer changes in management behavior are likely than if the private sector gained control of them. Although the government is officially committed to bringing new private sector directors from the new shareholders, the ratio of private sector to official sector representation on the board is determined by the government on a case-by-case basis.

Due to an accelerating rate of loan defaults in the mid-1980s, Rupali Bank was weaker financially than the previously divested banks. Accordingly, it was restructured cosmetically through a revaluation of its fixed assets before the equity offering was issued. Since no new capital was injected by the government before the subscription, nor did the government assume any of the defaulted loans of public agencies, the financial situation of the institution did not change.

As a result of Rupali Bank's poor financial situation and the generally less attractive terms of the new privatization program, demand for these shares was less than expected. Initial plans called for the offering of 49 percent of the bank's capital, with 15 percent of total capital reserved for employees. However, as it became clear that demand for these shares was weak, the initial offering to the public was reduced from 34 percent to 20 percent. This twenty percent issue was oversubscribed, and therefore hailed as a success. However, this oversubscription was possible only because a much smaller amount was offered. Employees have shown little demand for the 15 percent reserved for them. Unions want these shares to be given to employees at no cost, while the government expects employees to pay. Given the strong position of unions in Bangladesh's politics, it is likely that the government will have to accede to the unions' demand. It should be noted that since the bank is technically close to bankruptcy, selling even 20 percent of its non-existent capital is quite an accomplishment. However, the demand for shares is not due to belief that the bank's performance will be turned around, but rather to aforementioned peculiarities of the Bangladeshi equity market. In addition, other NCBs have bought shares.

As was the case for the totally divested banks, none of the capital raised by the public offering went to the bank itself. Rather, all went to the general government coffers. This failure to use the privatization process to restructure banks is one reason why multilateral institutions are opposed to further divestitures until the public institutions are strengthened. Under the current program of partial divestiture, the government sells essentially worthless paper

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that has value only as long as people need a vehicle to launder their black-market funds.

Reduced Barriers to Entry

The rapid growth of newly established private banks over the past seven years demonstrates the potential of reducing barriers to entry as a mode of increasing the role of the private sector. Since 1981, when the first private local banks were established, these institutions have grown to control about 25 percent of total bank assets. By 1988 there were nine private local banks.

Although little documentation is available on how the actual process of reducing entry barriers was conducted, the results illustrate very clearly the intentions of the government. As part of the government's policy to encourage greater private sector participation in the economy, including the financial sector, it began approving a series of applications for new banks. Approval requires a full cabinet decision. In FY 1982-1983, six new private banks were established. One of these was joint-venture with Arab interests, while the rest were locally controlled. Even though the object of the policy was to establish private banking institutions, the Government of Bangladesh has required that it hold a 5 percent share in all private banks. In one of the private banks, IFIL, the government holds a 40 percent share.

Since the first six banks were established in 1982-1983, one other bank, an Islamic bank, followed in 1987. With the two privatized state-owned banks, the local private banking sector includes nine institutions. The fact that none of them have failed indicates that as a group they are doing relatively well. According to several observers, most are quite profitable and are growing. However, due to the industry's poor reporting and accounting practices, an accurate picture of an individual bank's financial condition is not available.

Private banks have prospered in Bangladesh primarily because of the poor banking practices and the required unprofitable lending of the state-owned banks which dominate the market. The private banks, unlike the NCBs, cannot be forced to lend under the preferred credit programs. Moreover, the private banks conduct more vigorous loan repayment programs. According to several sources, these include sending out "thugs" to recover payments. More importantly, creditors who do not repay are cut off from any further lending. Political connections do not play as important a role in lending decisions. Private banks lend to relatively low-risk, well-established private firms and individuals. The higher risk lending is left to the NCBs.

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In addition, unlike the NCBs, the private banks match their deposits with their lending needs. The NCBs, following official policy, attempt to mobilize deposits as an objective in and of itself, regardless of their need for funds. As might be expected, the NCBs have excess liquidity. With only a small interbank market and a small government security market due to the absence of a sizeable fiscal deficit, there are few instruments or markets in which to place these funds. The NCBs have invested some of their excess liquidity in the privatized banks. Because of the excess deposits, the NCB's have no cash flow problem, even though they are technically bankrupt. When deposit growth ebbs, however, the cash flow situation will also deteriorate, bringing on a financial crisis. Hopefully, reform efforts will proceed quickly enough to avoid this crisis.

Most of the private banks are either controlled or associated closely with a large family-run industrial group. For some groups, the primary purpose of the bank is to serve as a financing instrument for other enterprises in the group or connected to the family. Because of these connections, the risk of non-payment is low, as long as the group is committed to the viability of the bank. However, it is possible for the bank to serve as a source of funds to bail out failing enterprises. In this scenario, the interests of depositors could be threatened.

V. RESULTS

Over the seven year period since the Ershad government began its financial sector privatization policies, the financial sector has grown and deepened by most measures. Credit to the private sector expanded from 6.2 percent of GDP in 1981 to 16.7 percent in 1987. Similarly, the ratio of M2 (a broad monetary aggregate) to GDP, the most widely used indicator of financial deepening, grew from 20 percent to 25 percent. Finally, the ability of the financial sector to mobilize resources also expanded sharply. The ratio of time deposits to GDP rose from 11 percent of GDP in 1981 to 15 percent in 1987.

Although much of the growth of the financial sector is due to the generally sound macroeconomic policies implemented over this period, policies to encourage a greater role for the private sector in financial activities played an important role. Private enterprises have taken advantage of profit opportunities, which have fueled their expansion. While part of the financial sector's growth is due to the public sector's program of expanding financial services in the rural sector, most of the growth, especially on the lending side, has come from private financial institutions. Observers expect that by

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end-1988, private financial institutions will have captured almost 50 percent of bank lending.

While the expansion of the financial sector is helpful for economic development, it must be remembered that in Bangladesh this expansion happened concurrently with the development of serious structural problems in the financial sector. If these problems are not addressed soon, the expansion could be reversed very rapidly. Privatization has helped the financial sector expand and provide services to the most buoyant areas of the economy, but it does not directly address the fundamental problems of the sector. These must be attacked through financial policy reforms and institutional changes at the NCBs.

By providing effective competition to the NCBs, however, the private financial sector is contributing to the momentum for needed, fundamental structural reforms. Through superior management and greater freedom from government interference, private banks have taken away most of the profitable business from the NCBs, leaving them with only unprofitable government-mandated lending. Previously, NCBs could operate inefficiently and conduct unprofitable lending and still stay solvent because they had the cushion of some profitable lending to the private sector. In short, the government allowed the taxation through the financial sector of some elements of society to provide subsidies to others. With the advent of private bank competition, this flawed policy became inoperable because the "taxes" became much harder to collect. In addition, the costs of the subsidies, i.e., non-payment of loans, losses due to mandated lending at less-than-market rates, etc., have increased to the point that the government has decided to try to curtail them. In the political process to reform the system, the rise of the private sector provides a powerful interest group in support of market-based financial sector reform.

Although private banks provide effective competition to the NCBs, there is considerable evidence that they collude to limit competition between them. For example, in the few cases where some interest rate levels have been liberalized, the rates have gone almost immediately to the mandated ceiling at every bank, even when lending at the previous lower administered rate was clearly profitable. Whether collusion would continue if there were greater liberalization that allowed for competition in many more areas is unclear. However, the fact that collusion seems to be taking place gives substantial ammunition to the opponents of greater financial sector liberalization.

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VI. LESSONS AND APPLICATIONS

The primary lesson of the Bangladeshi financial sector privatization efforts is that reducing barriers to entry is an effective means of developing the role of the private sector. These new institutions can develop new management styles and corporate cultures without the wrenching changes that are required in reforming an existing institution. Moreover, their success can serve as a model for managers in existing troubled institutions. Finally, the political obstacles to this mode of privatization are much less than the transfer of existing institutions from the public to the private sector. Obviously, for this strategy to work, there must be areas where these new institutions can operate profitably. If all financial services are controlled such that it is impossible to earn profits, no new banks will be established. Accordingly, some semblance of financial liberalization must be completed before this strategy can be implemented.

The Bangladeshi experience also illustrates that the successful selling of shares does not mean that the privatization is successful. The object of privatization is not to market shares, but rather to improve the efficiency of an enterprise by changing ownership and thereby changing management incentives. Partial divestitures which leave control of the institution with the government will not accomplish this unless there are ways that minority shareholders can influence management. Moreover, the Bangladeshi experience also demonstrates that share prices even in a competitive market do not necessarily reflect their true value. Small and thin equity markets in developing countries can be strongly influenced by non-financial factors. The nature of equity markets should be analyzed closely before public offerings are issued.

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CHILE:

Innovative Bank Divestiture

Chile: Innovative Bank Divestiture

I. SUMMARY

Financial institutions in Chile have experienced two waves of privatization. The first wave was implemented in the mid-1970s when the Pinochet regime came to power and returned twenty commercial banks, nationalized under the previous Allende government, to the private sector. In the early 1980s, when the private banks became burdened with bad loans and escalating interest payments on external funds, the government stepped in and regained ownership and control. These banks were then "reprivatized" in the mid-1980s.

The first group of privatizations is instructive in "what not to do." The extensive interlocking ownership between large business groups and the banks that resulted from the hasty privatizations led to unsound lending decisions which the weak regulatory framework and supervisory system was incapable of detecting and preventing. While it is too soon to pass definitive judgement, initial signs indicate that the second series of privatizations, which utilized several innovative, successful privatization techniques, can serve to guide, in a positive way, other nations seeking to reform and invigorate their financial markets. In particular, the "popular capitalism" method of facilitating widespread share ownership by offering no-interest financing holds promise for use in other countries.

II. THE FIRST PRIVATIZATION WAVE

The Financial Policy Context

Chilean financial institutions have gone through five stages in the last twenty years: Nationalization, liberalization, development of close ties with industrial groups, direct state control, and reprivatization and deregulation.

Prior to the first privatization wave in 1974-75, the Chilean financial system was characterized by complete government ownership of all financial intermediaries. Interest rate controls resulted in negative real rates for lending and saving. A plethora of targeted credit programs channeled investment funds to state-owned companies and high-priority government projects. Banking deposits were not insured, but there was a widespread belief that the government would intervene if needed to safeguard deposits.

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Financial Policy Reform

During the mid-1970s, the Pinochet government, following the advice of the "Chicago school of economics," undertook a sweeping set of initiatives to liberalize the economy. The government relaxed tariff barriers, tightened monetary policy to rein in inflation, liberalized the financial system by eliminating interest rate controls, and embarked on a massive wave of privatizations. During that decade, the government also experimented with regulatory reform, granting banks and other financial institutions greater operating freedom.

As one of their first financial liberalization measures, the government abolished interest rate ceilings on both lending and deposits for thrifts, giving rise to a new class of financial institutions. In one year, 1976, 26 new thrifts were established. One year later, interest rate ceilings on commercial bank deposits and loans were abolished. Interest rates paid on peso deposits and other peso-denominated assets increased dramatically. From 1979 to 1982, interest rates on peso deposits earned an average of 20 percentage points more than the London Interbank Offer Rate (LIBOR). The high interest rates triggered a massive inflow of capital, as banks borrowed at the relatively low rates abroad and relent funds at higher rates.

The government's decision to abandon the "crawling peg" exchange rate regime in June 1979, and set the exchange rate at 39 Chilean pesos to the U.S. dollar, fueled the foreign borrowing. Banks moved quickly to increase their foreign indebtedness in order to take advantage of the artificially low peso. Foreign borrowing increased further in 1980, when limits on bank borrowing from overseas markets were abolished.

The government also liberalized laws regulating bank ownership. A 1974 law limited bank ownership by individuals to 1.5 percent, and by firms and organization to 3 percent. In the prevailing lax supervisory environment, the law was not enforced and in fact was rescinded in 1978. Barriers to entry by foreign banks were removed, and they flocked to the country. In 1979 alone, 8 foreign banks opened in Chile, tripling the number of foreign banks from 4 to 12.

In an additional liberalization move, the government ended targeted credit programs. This extremely important measure allowed the banks to change from passive funnels of rediscounted Central Bank funds to preferred sectors, to active intermediaries attracting private funds by offering attractive deposit rates and lending those funds at market rates to enterprises deemed to have the potential to make a profit and repay the loan.

Beginning in May 1976, the Central Bank began to pay market rates on bank reserves. The government then reduced reserve

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requirements, which reduced bank costs by increasing their pool of loanable funds. The reserve requirement for banks was reduced to 10 percent for sight deposits and 4 percent for time deposits.

Implementation of Privatization

Financial market liberalization in the 1970s was accompanied by a rash of privatizations as the staunchly anti-socialist military government moved to sell the firms nationalized by the previous government. In 1973-1974, 92 firms, including 11 banks, were sold to private interests. An additional 350 firms were returned to their previous owners.

Because of political concerns over foreign ownership, foreign firms were prohibited from buying the Chilean companies. The only source of sufficient local capital to buy the banks were the "grupos," large Chilean-owned business conglomerates. The conglomerates were interested in buying the banks in order to access bank capital to purchase other state-owned businesses being offered for sale. In a financing scheme that became known as "the bicycle," the banks lent funds to the conglomerates to purchase SOEs, with the shares of the businesses being purchased serving as collateral. The result of the flurry of buying activity in 1973-1974 was that each major conglomerate purchased a bank which then lent the conglomerate funds to purchase additional businesses.

Results

Initially, the liberalization and privatization brought about several economic benefits. Financial market liberalization resulted in rapid growth and proliferation in the number and type of institutions operating in Chile (see Table 1). The lifting of the interest rate controls in 1976 resulted in the creation of a new class of savings and loan institutions, the finance companies (financieras). As one knowledgeable observer reports [1],

> The volume and diversification of government and Central Bank papers in the market increased noticeably; the range and number of mutual funds increased manifold; businesses began to issue significant amounts of commercial paper which were intermediated by depository institutions, stock exchanges and mutual funds; the insurance business expanded its list of products; consumer credit offered by financial institutions expanded noticeably.

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[1] Ludens, as reported in Velasco, p. 8

Table 1

CHILE: GROWTH IN FINANCIAL SYSTEMS AS A RESULT OF LIBERALIZATION

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Total number of banks & finance companies	21	20	20	39	47	54	56	54	49	45	45
Domestic banks	20	20	18	18	22	24	25	23	21	19	19
Foreign banks	1	1	2	3	4	12	13	18	19	19	19
Finance companies	--	--	26	18	21	18	18	13	9	7	7

Source: Andres Velasco, "Liberalization, Crisis, Intervention: The Chilean Financial System, 1975-1985," Central Banking Department, International Monetary Fund, July 21, 1988, unpublished manuscript.

The wave of liberalization and privatization did not appear to have increased the savings rate. The average savings rate for the liberalization decade, 1974 - 1983, was 10.7 percent, which was actually slightly lower than the 12.6 rate experienced from 1966 - 1973. In short, the strategy produced only shifts in asset holding rather than true incentives for capital formation.

The decline in government regulation and the return of firms to private ownership did spur private investment, at least until 1981 when the recession cooled the incentives to invest (see Table 2). From 1975 to 1981, gross private domestic capital formation as a percentage of GDP increased from 4.6 to 15.6 percent. At the same time, government capital formation decreased as the government attempted to reduce the fiscal deficit. Thus one result of the liberalization was that domestic investment as a percentage of GDP increased slightly, and the composition of investment shifted dramatically to the private sector.

While the measures resulted in unprecedented financial institution widening and deepening, in hindsight it appears that many of the institutions were unprepared to operate in the unrestricted environment, and widespread bank failures resulted when the economy entered a recessionary period in the late 1970s. The bank failures were brought on by excessive concentration of bank loan portfolios, the newness of operating in a free market environment, the dearth of skills necessary to operate successfully in that environment, and the lack of supervision. Another important cause was the sudden increase in nonperforming loans due to excessive foreign borrowing, the devaluation of the peso, and falling commodities prices.

Interlocking ownership between groups of large industrial companies and the banks led to excessive risk taking as the banks channeled large quantities of funds to their own enterprises. In 1981, loans to companies that were partial owners of the banks reached an average of 21 percent of the loan portfolio in the five largest banks, and 46 percent of the portfolio of Banco de Santiago, the nation's largest private bank.

Other destabilizing influences also contributed to the financial crash. In 1982-1983, the prices of Chile's main exports, especially copper, collapsed. The financial condition of the banks' clients was weakened by high domestic real interest rates, which averaged 77 percent from 1975 to 1982, and by rising interest rates abroad. The number of corporate bankruptcies rose from 2 in 1978 to 15 in 1980 and 75 in 1982. The sudden, large devaluations of the peso beginning in 1982 multiplied the value in pesos of the dollar-denominated debt obligations of both banks and firms.

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Table 2

CHILE: GROSS DOMESTIC CAPITAL FORMATION
(as a percent of GDF)

	Gross Domestic Capital Formation		
	Private	Public	Total
1960-65	3.8	10.5	14.3
1966-70	4.7	11.3	16.0
1971-73	-0.9	12.4	11.5
1974	8.4	12.8	21.2
1975	4.6	8.5	13.1
1976	7.4	5.4	12.8
1977	7.7	7.7	14.4
1978	11.6	6.2	17.8
1979	12.6	5.2	17.8
1980	15.6	5.4	21.0
1981	15.6	5.1	20.7
1982	...	...	11.3
1983	...	...	9.8
1984	...	...	13.6
1985	...	...	13.7

Source: Cuentas Nacionales de Chile, 1960-1983, Direccion de Politica Financiera, Central Bank of Chile, as quoted in Andes Velasco, "Liberalization, Crisis, Intervention: The Chilean Financial System, 1975, 1965," Central Banking Department, International Monetary Fund, unpublished manuscript, July 21, 1988.

III. THE SECOND PRIVATIZATION WAVE

The Financial Policy Context

For the reasons just cited, Chile entered a severe recession in the early 1980s. It is important to note that Chile's macroeconomic difficulties did not affect all the banks equally: Management capabilities at the individual bank level were crucial in determining the banks' ability to withstand the external pressures. The government-owned, conservatively managed Banco del Estado was affected only marginally, as were the foreign banks operating in Chile.

However, with few exceptions, the locally-owned Chilean banks entered a period of extreme financial weakness and instability. From 1981 to 1983, the Chilean government intervened in or liquidated sixteen financial institutions: Ten commercial banks, including the nation's two largest commercial banks, and five finance companies which were on the brink of collapse. The Chilean government liquidated three banks, nationalized five, and appointed overseers to two more.

Financial Policy Reforms

Many of the current capital markets laws and regulations were motivated by the Chilean financial crisis of 1982. The overriding goal of new regulations and stronger supervision is to assure to the extent possible that the difficulties of the early 1980s do not recur. For the most part, the regulations appear to have struck an appropriate balance between the under-regulation and over-regulation of the past.

The most important legislation affecting financial markets is the Capital Markets Law (Law 18,045 of 1981) and the General Banking Law (Law 18.576 of 1986). The three basic tenets of Chilean capital markets laws are nondiscrimination, transparency, and tax neutrality. The principal of nondiscrimination means that local and foreign firms must be treated alike. Transparency means that transactions are to be visible and closely scrutinized for compliance with laws and regulations. The Superintendency of Banks is required to publish information on the nature and quality of financial institutions' assets three times each year. Lastly, the tax structure is designed to minimize bias either for or against debt as opposed to equity finance, thus allowing financing options to evaluated on their own merits and not on their tax consequences.

In 1981, the government adopted measures to limit bank exposure to individual companies and subsidiaries, and prohibited banks from accepting stock as loan collateral, thus addressing a key cause of financial instability.

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The government implemented a formal deposit insurance program in 1983. The insurance coverage was gradually decreased. In June 1986, deposit insurance was granted only to banks which met minimum capital requirements, upon application. By 1989, only small depositors will be insured and only 90 percent coverage of small savings accounts will be guaranteed by the government.

The government also tightened bank supervision by reorganizing and rationalizing the supervisory functions. The Central Bank and three Superintendencies regulate the many institutions that make up the Chilean financial markets. The Superintendency of Banks and Financial Institutions is the governmental organization charged with regulating and supervising commercial, development and investment banks, thrifts, and credit cooperatives. The Superintendency is organized into four departments -- Accounting, Supervision, Research, and Legal Counsel -- and employs 150 professionals. The supervisory body requests and reviews quarterly statistical information on the institutions it supervises, verifies compliance with regulations and assesses the quality of the loan portfolios. A second regulatory body, the Superintendency of Securities and Insurance Companies, oversees the stock exchange, securities dealers, brokers, mutual funds and insurance companies. The third agency, the Superintendency of Pension Fund Administrators (AFPs) oversees only AFPs.

Since the 1981 - 1983 recession, Chile has worked to improve the record-keeping of financial institutions and the results are impressive. Disclosure and reporting requirements in Chile are the most comprehensive in Latin America and have made an important contribution to high quality supervision and confidence in the system. Accurate statistics are available on a timely basis for overseers as well as policymakers and researchers.

Implementation of Privatization

Objectives: In keeping with its philosophy of a "social market economy" (Doctrina de una Economia Social del Mercado), the government made plans to sell the banks to the private sector. According to official government publications, the rationale for the privatizations was as follows. First, the government must respect private property, and cement property rights as firmly as possible in laws. It must allow free exercise of private productive activities, and let the market assign resources through supply, demand and price. In sum, the Pinochet regime firmly believed that the state must seek a subsidiary role to private enterprise in directing the economy.

The privatization had several secondary objectives as well. Through privatization, the Chilean government was seeking a wide distribution of state-owned wealth. The widespread distribution

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would not only result in a more just ownership of wealth, but would serve as a barrier to future excesses of political and economic power by the State.

Privatization Step 1: Set time limit for return of nationalized enterprises. Soon after intervening in the troubled institutions, the government announced that the banks would be returned to the private sector by December 31, 1986. The last bank was returned very nearly on schedule, in April 1987.

Privatization Step 2: Improve Asset Quality. In order to return the government banks to private hands, the government first needed to make them attractive investments. Bad loan portfolios were the key obstacle to the banks' financial health. The Central Bank agreed to save the banks by purchasing the nonperforming loans from the troubled institutions with the agreement that the banks would divert future dividend payments to repurchase their loan portfolios. The Central Bank bought, at book value, nonperforming loans in amounts up to 3.5 times each bank's capital base, in return for Central Bank notes. The banks were required to divert future dividends on common stock to the Central Bank up to the point where they had repurchased the entire loan portfolio. Banks are allowed to issue preferred shares, which can pay 50 percent of normal dividends. Through this mechanism, the Central Bank acquired $3 billion in nonperforming loans.

Privatization Step 3: Use creative financing mechanisms if necessary. Once the balance sheets were improved, the Central Bank utilized another innovative tool, which they named "popular capitalism," to encourage the public to buy shares in the banks. The Central Bank offered 15-year loans for up to UF2,000 at zero percent real interest to small investors who bought shares. Only citizens who were current on their taxes were eligible for the preferential financing. A total of 400,000 people took advantage of the no-interest funds, and purchased $400 million of shares in the two leading banks, Banco de Chile and Banco de Santiago. The Central Bank estimates that it managed to recapitalized the banks at a cost of only 8 - 10 percent of what it would have cost to liquidate them.

Privatization Step 4: The Sale. Lacking securities underwriters, the government announced that Corfo, the Chilean Development Corporation, would buy any unpurchased increase in the capital stock. The government would in essence trade the emergency credits granted in the previous years to equity. However, the government ownership would not last indefinitely. Corfo was required to sell at least 20 percent of its shares each year. Thus, within five years the government would divest all of its shares in the banks. Since the sales were fully subscribed, it was not necessary for Corfo to acquire any shares.

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Results

Too few years have passed since the privatizations and financial reforms were implemented to pass definitive judgement on their efficacy. However, it appears that competition among privately owned financial institutions in Chile has resulted in a wide variety of instruments for savers. Individuals and firms with excess funds can choose from instruments with fixed and variable interest rates, and with varying maturities and degrees of safety. Banks in Chile are still recovering from the crash, and have yet to attain full financial soundness. One can tentatively conclude, however, that Chile is approaching an appropriate balance between government control and regulation, which stymies capital market innovation and development, and hands-off policies that allow banks and related corporations to pursue high-risk strategies that destabilize the entire financial sector.

As Table 3 indicates, the Chilean financial markets consist of a large number of private institutions competing with one another. Of the five types of institutions -- official institutions, commercial banks, investment banks, development banks, and other financial intermediaries -- commercial banks are by far the most important financial market player. Sixteen locally owned banks and 20 foreign banks serve the Chilean market.

The Chilean government has limited its participation in the financial sector to a few key functions in which government is the logical, appropriate player. Only one bank, the large Banco del Estado, is still owned by the government. As the largest bank in Chile, it serves the financial needs of government entities and holds Treasury deposits.

In contrast to its earlier, wide-ranging responsibilities, the Chilean Central Bank is now charged with issuing currency, implementing monetary policy along guidelines set out by the Monetary Council, and serving as lender of last resort and implementing debt-to-equity conversions. The Bank makes use of the same three tools used by the U.S. Federal Reserve to control the money supply: Reserve requirements, open market operations, and a rediscount facility. Since 1982, the Bank has been called upon numerous times to provide emergency credits to rescue banks and financieras and their depositors.

While the government has divested nearly all its financial holdings, it still owns a number of companies in other sectors. The National Development Corporation (CORFO) is the publicly- owned holding company for the state-owned enterprises. CORFO provides low-cost loans to its holdings, utilizing profits from its surplus-generating enterprises and multilateral development bank funds. Government enterprises generate approximately one-quarter of Chile's GDP. In contrast to those in many countries, most of the government-owned businesses in Chile are profitable. Together,

Table 3

CHILE: CAPITAL MARKETS PROFILE
November 1988

Capital Markets Institutions	Number of Firms	Number of Government-Owned Firms	Regulated By
OFFICIAL INSTITUTIONS			
Central Bank	1	1	na
Banco del Estado	1	1	B
COMMERCIAL BANKS	36	0	B
Locally-owned	16	0	B
Foreign-owned	20	0	B
INVESTMENT BANKS			
Soc. Financieras	4	0	B
Agentes de Valores	25	0	S
DEVELOPMENT BANKS			
CORFO	1	1	E
OTHER			
Stock Exchanges	1	0	S
Mutual Funds	5	0	S
Leasing Companies	13	0	S
Pension Funds	12	0	A
Insurance Companies	17	0	S
Savings and Loans	4	0	B
Credit Cooperatives	2	0	B

na Not applicable.
A Superintendency of AFPs.
B Superintendency of Banks and Financial Institutions.
E Ministry of Economy.
S Superintendency of Securities and Insurance.
* Total capitalization of equity at market prices.

SOURCES: Chilean Central Bank and Superintendency Monthly Bulletins; SRI Calculations

they contributed 9.1 percent of government budget revenues in the mid-1980s.

Even with the extensive private ownership and competition in the Chilean banking system, investment banking in Chile is fairly undeveloped. Four "financieras" and 25 securities brokers underwrite share issues and trade in public and private bonds and notes. They also offer cash management, financial advice, and merger and acquisition services.

Chile is one of the few countries in the world with a private pension system. Since 1981, employees and self-employed individuals have had to channel 10 percent of total wages to private pension funds (Administradoras de Fondos de Pensiones -- AFPs), which create personal retirement accounts and investment the funds in government securities and low risk bonds and shares. The top three pension funds all have substantial foreign ownership. In 1986, Bankers Trust purchased a 40 percent share in Provida, S.A., the largest pension fund, using pesos obtained through a debt-to-equity conversion. Aetna owns 50 percent of the second largest pension fund, Santa Maria, and the American Insurance Group (AID) has a substantial participation in La Interamericana, the third largest fund.

As a result of financial liberalization, Chilean banks offer savers positive real interest rates. Real short-term (90 -365 day) deposit rates averaged 4.1 percent in 1986; lending rates on the same maturity averaged 7.7 percent. The annual real rate of return on the fixed-income instruments traded on the stock exchange averaged 5.1 percent.

IV. LESSONS AND APPLICATIONS

The two Chilean experiences in privatization offer several lessons for other countries seeking to reduce the role of government direction in the economy and specifically in the financial sector. The first lesson, drawn from Chile's first wave of privatization in the 1970s, is that hasty private sales of banks to large local corporations should be avoided. This is especially true if the regulatory framework is weak. Although initially such concentrations of capital may seem to be the only available local capital, the negative effects of tightly interlocking bank/corporate directorates can include skewed, concentrated loan portfolios with the potential to undermine financial stability. The Chilean experience served as a poignant illustration that while rapid privatization to large local interests meets the pressing short-term political need to move forward on privatization, it may undermine the entire privatization strategy in the long-term.

Another lesson offered by the Chilean experience is the importance of a strong regulatory framework. Government oversight

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was extremely deficient following the first wave of privatizations, and did not detect and prevent the ensuing financial crash. The critical components of effective government supervision of financial institutions are:

- Standardized accounting practices and adequate audit capabilities to insure accurate estimates of company performance and loan quality;
- Sufficient quantity and quality of regulatory personnel;
- Development of a series of prudential regulations and ratios, and strict monitoring of compliance with prudential ratios and effective penalties for noncompliance

The Chilean experience also points up the need for controlling growth in the financial sector. The rapid emergence of dozens of new financial institutions strained the Chilean management capacity beyond what it was capable of handling, and inexperienced managers' decisions contributed to the financial crash. Competition and freedom of entry are critical components of a functioning financial system, but adequate capital requirements and strict experience requirements for top management should accompany the liberalization of the financial system.

Several positive lessons can also be drawn from the Chilean privatizations. First, Chile's popular capitalism is an impressive example of a way to increase share ownership in the national economy, and rapidly recapitalize a financial institution. The mechanism proved to be very cost-effective, compared to other recapitalization methods, and also very popular from a political standpoint. Widespread ownership is one of the strongest deterrents to future nationalization attempts, and facilitating share purchase by lower and middle class individuals is perhaps the only way to interest these groups in participating in privatization.

Some observers of the Chilean financial system are concerned that the nation has now gone too far in the direction of disaggregated ownership. They argue that the tens of thousands of small shareholders in Chile's commercial banks do not have the interest or knowledge in bank operations needed to provide effective oversight of the Board of Directors.

To reduce this concern, large local corporations could be approached to serve as lead, but still minority, owners of newly-privatized banks. A locally owned "grupo" could be approached with an offer of from five to twenty percent of bank shares, enough to assure that the corporation has a strong interest in the bank's

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profitability, but not enough to create corruptive links or force biased lending decisions. Unfortunately, most large businesses in developing countries prefer to hold a controlling interest, or not be involved. However, if a sufficiently attractive offer is made, perhaps some businesses would accept minority participation. The presence of a substantial owner would improve shareholder oversight. In the case of a bank with a doubtful asset base and uncertain future profitability, a share purchase by a well-known local business would increase the level of confidence in the quality of the investment, and improve the prospects for a successful share offering.

Second, Chile demonstrated that even banks with large portfolios of nonperforming assets can be privatized successfully if the government first takes appropriate measures to improve the balance sheets. By temporarily assuming the nonperforming assets, the Central Bank increased the attractiveness of the banks to private investors without accepting the full burden and cost of the bad loans. In essence, the Chilean government created a mechanism to share the responsibility for past poor lending conditions and unforseen external economic forces between the banks' owners and the government.

GUINEA:

Creation of a Private Banking Sector

Guinea: Creation of a Private Banking Sector

I. SUMMARY

In the mid-1980s, several years after the death of Sekou Toure, the founding father of the Guinean state, the nation's new leaders began a radical program to transform the socialist economy developed during Toure's twenty-year reign. The new leaders have attempted to transform the moribund socialist economic structure into a dynamic, market-based system, albeit with the state continuing to play a major role. This transformation program has included the closing of many state-owned enterprises, allowing private markets to allocate and distribute most goods, and a general opening of the economy to foreign markets.

A key element of this radical restructuring was the establishment and development of a new banking system, in which all the leading banks were joint ventures between French multinational banks and the Guinean state. The previous banking system performed banking services in name only. Rather than serving as institutions to intermediate financial claims and liabilities and to clear payments, the banks under the old regime served as credit dispensing agencies for public enterprises and as vehicles for monetary creation. This previous system, which was notoriously corrupt, was closed on December 26, 1985, and replaced on January 6, 1986 with the establishment of three joint-venture banks. The establishment of the new banks was combined with other financial sector reforms to give the new system a more solid economic framework upon which to build. The reforms included the creation of a new currency and a massive devaluation to bring the new currency closer to a realistic level. Since the establishment of the first three joint-venture banks, a fourth bank has been established.

Compared to the dismal state of the previous banking system the new private system is a vast improvement. Credit, albeit only short-term, is available to the private sector, and a relatively efficient payments mechanism is operating. However, due primarily to a series of structural problems, the new system has failed to mobilize domestic savings effectively and is not profitable, according to most sources. Problems include: (1) the lack of a legal system or even clear property rights through which one can enforce contracts and force repayment; (2) inappropriate monetary and financial policies that overvalue the currency and keep all but the shortest-term interest rates negative in real terms; and (3) the lack of experienced Guinean bankers, forcing the new banks to employ highly-paid expatriates at almost all top and even mid-level management positions, leading to very high operating costs.

Even with the current difficulties, the Guinean experience demonstrates that a new private banking system can be developed

very quickly. Foreign involvement is the key factor in the quick establishment of these institutions. However, the Guinean experience also shows that to develop an efficient system, appropriate financial and legal policies must be established and enforced. Without them no financial system can operate effectively.

II. FINANCIAL POLICY CONTEXT

The banking sector of the pre-reform economy was moribund and performed few, if any, banking services. As would be expected in a socialist state, all banking institutions, except for one small Islamic bank, were state-owned and operated. Although these institutions were called banks, they were banks in name only. Rather than intermediating financial claims and liabilities, these institutions served primarily as credit dispensing agents to public agencies and as conduits for monetary creation to finance the large government deficit. Theoretically, these "banks" accepted deposits, but almost none were placed voluntarily. The majority of deposits were composed of required deposits from public employees and the deposits of public agencies. (Once the "banks" were closed down, a large amount of voluntary deposits were "found." However, according to most sources, these voluntary deposits were created by corrupt banking officials to obtain money from government as part of the closure process.)

In addition to providing few banking services, these banks were also notoriously inefficient and corrupt. Not only did this tradition make their closure costly, but it also left the country with no experienced bankers who could be trusted to manage any banking operation efficiently or honestly. Moreover, this tradition left most private Guineans very hesitant to use banks or any other formal financial institution to meet their financial service needs. Similarly, those who did use these institutions had little experience about the need to repay loans on time or at all.

III. FINANCIAL POLICY REFORMS

The establishment of joint-venture banking institutions was part of a coordinated program to quickly establish a new, more efficient banking and financial system. Guinean financial planners and their advisors understood that without changes in the underlying macro-economic and monetary structure of the economy, a new banking system would not be able to operate effectively. Accordingly, the same day the new banks were formally established, a new currency, the Guinean franc, was issued. Its foreign exchange value was several times less than the overvalued previous currency. In addition, weekly foreign exchange auctions were

established to set the price and to allocate foreign exchange freely.

More liberal financial policies, consistent with the establishment of a system of independent and competitive banking institutions, were also established. Rather than a system of administered interest rates, interest rate ceilings were established. Although this system gave banks flexibility in setting their credit policies, ceilings have been set below the inflation rate which has discouraged deposits, except those of a very short-term nature.

While these policy reforms represent a vast improvement over the previous regime, it should be noted that they have not gone far enough to establish the conditions needed for a dynamic financial sector. In addition to maintaining negative real interest rates, the Central Bank has intervened in the auctions to keep the rate of currency devaluation below the rate of inflation, and inflation continues to be high, running at an annual rate of approximately 20 percent. Perhaps most importantly, little has been done to establish an effective legal system or to clearly demarcate property rights. Guinea's socialist and village communal tradition inhibit the formulation of individual property rights necessary for functioning private markets.

IV. IMPLEMENTATION OF PRIVATIZATION

On December 23, 1985, the old "banking" system was closed, and after a two-week bank holiday, on January 6, 1986 three new joint-venture banking institutions were formally established. All three of the new banks were formed as joint-ventures between French multinational banks and the Guinean state. The government owns a slight majority of the capital of two of the banks. As part of a World Bank loan which provided most of the funds for the government's participation in these banks, the state is committed to selling its share to private Guinean interests by 1991. However, it is unlikely that state will be able to meet this commitment due to the current unprofitability of the banks and the absence of local private interests with significant amounts of investment capital.

Guinean leaders understood early that the creation of a viable and dynamic financial sector capable of efficiently allocating financial resources was a prerequisite for the successful liberalization of their economy. After rejecting the possibility of reforming the existing state-owned banking institutions because of their poor financial condition, corrupt and inefficient corporate cultures and absence of competent managers, a decision was made to close down the existing banks and invite foreign banks to participate in establishing new institutions.

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Since the establishment of a viable financial system was considered a prerequisite for other necessary structural reforms, there was great urgency to establish the new system quickly. Banks from several countries, including the United States, were invited to negotiate with the government to establish joint-ventures. However, only three French banks, all of which have extensive African banking networks and which were formally involved in Guinea before independence, successfully completed negotiations. Each bank negotiated separate "convention speciales," or operating agreements, that specified tax advantages, repatriation allowances and special expatriate employment privileges. Negotiations were conducted quickly to ensure that the banks could open by January 6, 1986, when the new financial system was established.

Although the government owns a majority of the capital of the banks, the banks are effectively controlled by the expatriate managers who fill all top and most mid-level positions. Through these managers, the foreign banks are able to set policies at the institutions. Moreover, their "convention speciales" give them significant flexibility with financial flows, which allows them to run these banks essentially as branch offices. Government influence in the banking sector operates through the setting of financial and monetary policy, not through ownership rights. With effective control and their extensive experience operating similar operations in West Africa, the French banks had little difficulty in establishing these Guinean joint-venture operations. Their difficulties have come from attempting to operate profitably in a problem-ridden financial and legal environment.

The most troublesome phase of the implementation of a "private" banking system came from the closing of the old banking system. The problems did not arise from any loss of services, since the old banks provided none, but rather from the cost of the closure. In closing the banks it appears that bank officials created fictitious deposits which the government is now attempting to cover.

Most of the old banks' assets were loans to public agencies. Most of these were poorly documented and are uncollectible in any case due to the poor financial condition of these agencies. After marking down these loans to their true value, the old banks were left with liabilities that were more than double their assets. The absence of competent and honest banking officials to oversee the closure of the banks contributed significantly to the cost of the operation. In addition, the decision to close the old system quickly also contributed to the cost, since there was no time to hire a sufficient number of qualified, objective experts for a long enough period to ensure that the accounting was done correctly and with adequate safeguards.

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V. RESULTS

On several levels, the Guinean program to develop a private banking system has been quite successful. Three joint-venture institutions were established at the beginning of the program in early 1986, and a fourth joint-venture was established in 1988. These four privately operated institutions, along with a smaller Islamic bank which dates to the Toure regime, provide banking services far superior to those of the old system. Short-term credit is now available for commerce, especially external trade, and a relatively efficient payments mechanism now exists. Credit is allocated primarily on the basis of ability to pay, not on political connections, even though one's ability to pay itself is often a function of the latter.

Although the new system is able to provide adequate financial services for the Guinean economy, it has not been able to mobilize financial resources significantly, nor, apparently, have the banks yet been able to operate profitably. The lack of profitability did not seem to inhibit a fourth French bank from establishing a bank in Guinea, indicating that some close observers believe that the market has considerable potential, or that the banks are hiding their local gains and taking their profits elsewhere through the manipulation of financial accounts.

Both of these shortfalls are due primarily to continued serious structural and policy weaknesses. Under current macro-economic and financial policies through which interest rates are negative and the exchange rate is overvalued, there is little incentive for savers to invest in local financial instruments, primarily bank deposits and local currency. Rather, the incentive is to invest in real assets (goods and real estate) or in foreign exchange, preferably overseas wherever interest rates are highest. Under these conditions it is difficult for financial deepening (an increase in the value of financial assets as a percentage of total output) to occur, and banks can do little by themselves to encourage financial resource mobilization. Opening more branches would reduce transactions costs, but not enough to overcome the disincentives to use the financial system for anything but as a payments vehicle.

The unprofitability of the banks is due primarily to the high default rate on their credits and very high operating costs. It is reported that 30-40 percent of the bank loans made since the creation of the banks in 1986 are in default. The poor payment record is due to the country's lack of experience with banking practices, i.e., the need to repay loans (if possible on time). Even more importantly, the bad debt rate is due to the lack of a legal system to enforce contracts and property rights. Indeed, property rights themselves are not clearly demarcated. With no means to enforce payments, banks can do little to collect loans except to cut off a customer's access to credit.

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The banks' high operating costs are due to the need to employ highly paid expatriates at all top management and most mid-level management positions. Some observers have criticized the banks for this practice, but they have little choice if they are to operate moderately efficient and honest operations, since the old system generated almost no competent bank management. Since banks could reduce operating costs by employing Guineans, one would expect over time that the percentage of local managers will increase sharply.

VI. LESSONS

The Guinean experience provides several lessons about privatization. The first is that a viable private banking system can be developed from the ground up very quickly, if experienced foreign banks are allowed to play the management role. When time is of the essence, this foreign-bank based strategy is a very appropriate approach to privatization. However, it is an expensive strategy. Not only will these institutions tend to hire highly paid expatriates, but also a share of their profits will be transferred abroad. For countries that lack qualified bankers, however, these costs may be a worthwhile investment to build a local banking infrastructure.

Other lessons of the Guinean experience are negative. The first is that the closing of weak public banks can be very costly, if the government attempts to pay depositors. Not only will the past poor financial performance make the closing expensive, but more importantly corrupt officials can dramatically increase the cost by creating fictitious deposits. This type of behavior can also happen within private institutions. The Guinean experience illustrates the need for very close supervision of failing institutions, and the vital importance of documentation to verify claims.

The final lesson is that there is no substitute for sound financial policies and an effective legal structure. Efficient banking and financial deepening cannot take place without them. While private institutions will probably be able to provide better services than public ones because of the different incentive structures for management, the government policies under which banks operate are perhaps an even more important guide to their actions than ownership structure. Accordingly, if desired financial services are not profitable because of the legal and economic environment, neither private nor public institutions will be able to provide them. If appropriate financial development is to occur, appropriate financial and macro-economic policies must be maintained, and an effective legal structure must be implemented.

JAMAICA:

A Successful Share Offering

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Jamaica: A Successful Share Offering

I. SUMMARY

The Jamaican government sold a majority share (51 percent) of the National Commercial Bank (NCB) in December, 1986. The public offering of J$90.6 million (U.S.$16.5 million) was the largest public enterprise divestiture in Jamaica's history. By all objective measures, the sale was a clear success, since the offering was oversubscribed by 170 percent, attracted more than 30,000 stock purchase applications from Jamaican citizens and institutional investors, and raised the bank's stock price by as much as 67 percent on the first day on which it was traded on the Jamaican Stock Exchange.

II. THE FINANCIAL POLICY CONTEXT

The financial system of Jamaica is moderately developed. Capital and money markets by no means offer the breadth, depth, and level of sophistication present in industrial country markets, but the basic institutional and functional structure is in place. It revolves around a diversified set of financial institutions, consisting of the Bank of Jamaica, commercial banks, merchant banks, development banks, building societies, and credit cooperatives, most of which operate according to competitive conditions and market forces. The economy is highly monetized. In recent years, interest rates have been determined largely by supply/demand conditions.

The Jamaican Stock exchange was established in 1969, but languished throughout the 1970s as a result of generally declining economic conditions, corporate failures, and nationalizations. The stock market rose significantly in value and volume during the 1980s, but declined in late 1987 and early 1988, following trends witnessed worldwide. As of mid-1988, the stock exchange listed common shares for 38 companies, preferred shares for 7 firms, and debentures for 6 companies. Government securities are not listed on the exchange.

As in most developing countries, Jamaica's capital markets evolved at a slower pace than did other segments of the financial system. Corporate financing for medium and large scale firms has typically been managed through direct borrowing from domestic or international banks, retained earnings, or intercompany loans from parent firms. Securities markets have not played a major role in corporate financing. Smaller enterprises typically rely on internally generated funds or family savings.

Throughout the 1970s and early 1980s, the financial sector of Jamaica acted largely as a captive to inappropriate macroeconomic

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and external policies. The domestic capital and money markets were forced into financing parastatal enterprises and increasing government budget deficits, and enjoyed limited attractive lending opportunities due to the downward economic spiral caused by declining demand for the nation's traditional exports and by import substitution-based industrial policies. As a result, while the institutional structure of the financial system was essentially sound, it played a subordinate role to fiscal policies and government ownership decisions, and was therefore unable to carry out its necessary functions in the area of capital formation.

The sale of NCB was designed and implemented not as a component of any financial sector policy or reform, but rather as part of a general government strategy to reduce the role of government in the economy through the privatization of state owned and operated enterprise (SOEs). This explicitly stated strategy of the government of Prime Minister Edward Seaga aimed at reversing the trend of a rapidly growing public sector witnessed in the 1970s. A 1982 government study catalogued the existence of over 200 public enterprises and about 230 statutory boards and various other agencies. These SOEs carried out a wide range of economic activities typically left to the private sector, from agribusiness to manufacturing to the provision of financial services. A World Bank study calculated that these enterprises accounted for over 20 percent of Jamaica's gross domestic product (GDP), and much of the government's rising fiscal deficit (about 18 percent of GDP in the late 1970s) could be attributed to operating losses generated by these enterprises.

The Seaga campaign platform included a pledge to reduce the government's role in the economy, to be accomplished in part by the divestiture of SOEs. Shortly after Prime Minister Seaga was elected, he created an informal Divestment Committee to review all candidates for privatization. In 1983 this Committee was succeeded by a more formal Divestment Secretariat, which was funded by the Agency for International Development (A.I.D.) and benefited from increased authority and a full-time staff.

By the mid-1980s, the government had taken several steps to divest SOEs through means other than direct stock sales to the public. Progress was relatively slow and was marked by several failed initiatives, but proceeded with growing momentum. Approximately 80,000 acres of government-owned land was sold to private holders. Operating control of several large hotels was transferred to the private companies through management contracts. Most of the country's agricultural marketing boards (59 out of 69) were leased to the private sector, and several forms of public services in Kingston were contracted out to private firms.

Jamaica's privatization strategy reached a watershed in 1986. Reflecting on the strong results of privatization achieved in the United Kingdom and Canada, and increasingly frustrated with the

outcome of Jamaica's piecemeal approach based on a complex, long-term plan, the Prime Minister and his advisors became convinced that a more active strategy was required. This approach revolved around the identification of SOEs with a reasonable chance of attracting private investors, and the public sale of these enterprises through stock offerings. The NCB was selected at the first candidate to test the new policy strategy.

III. FINANCIAL POLICY REFORMS

In the early 1980s, the Jamaican government was faced with a convergence of adverse economic trends which were caused by both domestic policies and external forces. These trends included rapidly rising levels of government expenditures and employment, high rates of inflation and unemployment, capital flight, and burgeoning levels of government and external indebtedness. To reverse these conditions, the government initiated a sweeping series of "structural adjustment reforms," supported by the World Bank, the International Monetary Fund, and bilateral donors. Actions taken which affected Jamaica's financial system included the following:

Exchange Rate Reform

Until the early 1980s, the value of the Jamaican dollar was pegged at U.S.$1.78. After a period in which several different regimes were tried, the government initiated a biweekly auction for foreign exchange in December 1984. This system was replaced by a "flexible managed" regime. Combining devaluations of the Jamaican dollar (against the U.S. dollar) with depreciation of the U.S. dollar relative to other major currencies, the Jamaican currency depreciated on a real effective basis by 36 percent over the 1980 to 1987 period, thereby enhancing the competitiveness of Jamaican exports.

Separation of Monetary and Fiscal Policy

In the 1970s and early 1980s, excessive monetary expansion was used to finance the large and growing public sector deficits, primarily through the vehicle of a government overdraft facility with the Bank of Jamaica. The natural results were rises in price inflation, capital flight, increased foreign indebtedness, and a "crowding out" of the private sector from local capital markets. The Seaga government actively sought to break the monetary/fiscal policy interdependence through a variety of structural adjustment measures, including tax reform and reductions in budget expenditures.

Operational Requirements for Banks

Due in large part to structural fiscal deficits, the government had imposed liquidity ratio and cash reserve requirements on banks, which had the effect of subsidizing public sector borrowing. Commercial banks, for example, could only meet required liquidity ratios by purchasing low yielding government treasury bills, thereby forcing them to charge higher rates for commercial loans to the private sector. These "government financing schemes" were eased over time as the government's overall deficit has been reduced from a high of 16 percent of GDP at the end of the 1980s to about 5 percent of GDP in recent years.

Industry Deregulation

While by no means targeted toward the financial sector, the government's efforts to deregulate commercial transactions have exerted direct positive impacts on financial operations. For example, the number of commodities subject to price controls has been reduced from 60 to 13.

Tax Reform

In early 1986, the government implemented the first phase of a comprehensive tax reform program. This included reductions in the highest marginal tax rates on personal income, elimination of certain tax credits, and streamlined tax administration. Biases in favor of debt financing (versus equity financing) were reduced through the imposition of taxes on interest earnings. Corporate tax reforms, including a reduction of the maximum tax rate from 45.0 percent to 33.3 percent, were enacted in 1987.

External Debt Reduction

Jamaica had by the early 1980s generated a significant level of accumulated external indebtedness because of structural trade deficits and profligate government spending. A series of reforms were undertaken to correct the serious balance of payments and debt problems. The exchange rate system was reformed, and several import substitution policy biases against exports were removed. In early 1982 the government lifted some 60 quantitative restrictions against imports, the first step in a five-year program to eliminate as many trade restrictions as possible. The number of items subject to quantitative restrictions has been reduced from over 360 to under 90 since that time. Export promotion efforts, particularly for nontraditional exports such as light manufactures, have yielded initial positive results. In addition, progress has been made in liberalizing exchange controls on capital account transactions. A debt rescheduling strategy has been followed, and

a debt-equity swap program was initiated in late 1987. Notwithstanding these achievements, the problem of outstanding external indebtedness remains the most serious constraint to Jamaica's long-term growth.

IV. IMPLEMENTATION OF PRIVATIZATION

The Banking Institution Involved

The National Commercial Bank has a long-standing history of operation in Jamaica. It was initially established in Kingston as the Colonial Bank of London in 1837. The bank was acquired by Barclay's Bank of London in 1925, and Barclays owned and operated the bank for over fifty years. In 1977 the bank was nationalized, along with many other enterprises, by the government of then-Prime Minister Michael Manley, and its name was changed. At the time of nationalization, NCB was the second largest commercial bank in Jamaica, with total assets amounting to some J$236 million.

Over the ten-year period of government control, NCB achieved a modest record of profitability and growth, largely because the bank was not subjected to strong government interference. The bank's top management team, many of whom had worked for the bank during its period of private ownership, struggled and successfully retained operational independence. The NCB was run as if it were a private corporation, receiving neither special treatment nor onerous requirements by the government. As a result, the bank continued to pay corporate taxes and play a normal role as financial intermediary and provider of financial services. The bank's deposit and loan base continued to rise through the early 1980s, and pre-tax profits increased to a peak of J$38 million in 1985.

The market-oriented management and financial performance of the NCB clearly strengthened the prospects for successful privatization. The earnings record suggested the promise of positive returns for prospective investors, and the absence of debt or a poor loan portfolio removed the need to deal with the standard problem of accumulated deficits. In addition, the quality of the bank's balance sheet implied that other than the one-time receipt of proceeds from the sale, the divestiture would not have a major impact on the government's fiscal position.

Rationale for the Privatization

As noted above, the stock sale of NCB was carried out as part of a general divestiture strategy developed by the Jamaican government. The goals of this strategy were established under "A Suggested Programme for the Privatization of Government

Enterprises" submitted to the Cabinet by the Prime Minister in the Spring of 1986. These objectives included the following:

1. Improve the efficiency of the economy by placing more productive capacity under private control

2. Develop the local capital market and stimulate the involvement of a large number of citizens in the free market system

3. Encourage more private investment and reduce the "crowding out" effects of state ownership

4. Reduce the fiscal deficit

5. Raise foreign exchange in those cases where foreign investors would be permitted to participate in the privatization

The choice of NCB as the test case was made not only to meet the general government objectives described above, but also to serve as a model and a standard for future privatizations. The NCB was the first privatization to be implemented through a public share offering, and represented the largest privatization undertaken to date, since it would involve transactions estimated at between J$90 million to J$100 million. Therefore, the selection of NCB as a candidate was intended to meet several targeted goals.

The sale of NCB shares would provide a concrete example of a privatization which would distribute the ownership of a major Jamaican enterprise widely throughout the public. The transaction would also expand the size of the Jamaican stock exchange by approximately 10 percent, hopefully attracting a new class of investors and stimulating a new form of domestic savings and investment instrument. A successful transaction would expand public awareness and support for privatization as a desirable national objective, thereby providing a useful "demonstration effect." In addition, placing NCB under private control would yield efficiency gains for the bank itself, as well as directly reduce the role of the government in commercial activities. Finally, the effective spread of ownership among thousands of small shareholders would blunt potential criticism from the political opposition that privatization implied the sale of government assets to the economic elite in Jamaica.

Privatization Method Employed

From the outset, the strategy for "privatizing" NCB was a public sale of 51 percent of the bank's shares. The method revolved around a standard public issue, involving market

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valuation, dissemination of prospectuses, a marketing plan and a time-bound period for the offering to take place. Aside from these typical components of any public offering, a number of special features were included, as described below, to take into account the objectives of the government and the fact that such a sale was relatively novel to Jamaica.

Implementation

The precise execution of the NCB privatization was strongly influenced by the meeting between a close advisor of Prime Minister Seaga and a British privatization specialist. The advisor had been invited to attend an A.I.D.-sponsored conference on privatization, held in Washington in early 1986. The specialist, a former member of Prime Minister Margaret Thatcher's privatization team and currently on the staff of the London-based merchant bank N.M. Rothchilds, was a speaker at the conference. These two individuals developed a close working rapport and became core members of the implementation team. All of the leading actors on the team came from the private sector and had previous concrete experience in relevant transactions. The institutions involved included Rothchilds, the Kingston Office of Price Waterhouse and Company, attorneys from two of Jamaica's most respected corporate law firms, NCB management, and a team from the Jamaica Information Service, which was charged with carrying out the marketing campaign.

The specific steps taken to prepare and execute the transaction were as follows:

STOCK TRANSFER AND CAPITAL INJECTION: In June 1986 the shares of NCB were transferred from the office of the government's trustee, the Account General, to the National Investment Bank of Jamaica, the organization chosen to carry out the transaction. At that time, NIBJ also contributed J$20 million of fresh capital to NCB to improve the bank's balance sheet, which reflected a low capital/assets ratio in comparison to commercial banks in the private sector.

PROSPECTUS PREPARATION: From August through October, the privatization team focused their full energies on preparing the NCB for sale. This task included the preparation of a comprehensive prospectus, 170,000 copies of which were distributed throughout the country.

FUTURE OWNERSHIP STRUCTURE: The proposed strategy was for the outright sale of 51 percent of NCB's outstanding common shares, leaving 49 percent of the bank's stock in government hands. However, to complete the "privatization," the 49 percent government holding was transformed into non-voting shares, as specified in the prospectus, with the government legally committed to the gradual sale of its shares as circumstances and conditions permitted. This

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condition effectively eliminated the government's financial and operational control over the bank, and assured future stockholders that NCB would be managed by and for the private owners.

SHARE SALE MARKETING: The team faced an enormous obstacle in the guise of an almost complete lack of public understanding of the rights and responsibilities of corporate shareholding. Since the government sought to distribute the shares of NCB widely, this required a massive public education campaign. The marketing strategy included the use of radio, television, press conferences, audiovisual productions, and targeted briefings to such groups as the Jamaican Agricultural Society, the Jamaican Employers Federation, the All-Island Jamaican Cane Farmers Association and the Private Sector Organization of Jamaica. The entire prospectus was reprinted by The Daily Gleaner, the national newspaper, one week prior to the offering. In addition, a special, four-page brochure, "Questions and Answers About the Share Offering," was prepared and distributed widely, including a reprint by The Daily Gleaner sent to some 200,000 individuals. The marketing campaign was assisted by a strong degree of public awareness of NCB, due to its nationwide branch network and record of profitability and professional competence.

SHARE PRICING: The task of setting an appropriate share price required a balancing of the need to set prices low enough to ensure a strong response against the objectives of maximizing revenue from the sale and avoiding charges that the sale was a "giveaway" of public assets. The team employed a traditional approach for valuing the share price. They first evaluated the past and prospective financial performance of NCB, using the private Bank of Nova Scotia as a comparative benchmark. They then decided to set the share price at a discount from that of the Bank of Nova Scotia according to the standard practice used when issuing stock heretofore untraded in the market. This decision was bolstered by the desire to assure wide shareholding, and was also supported by the fact that NCB had been performing less profitably than other major commercial banks.

The share price was eventually valued at J$2.95, representing a price/earnings (P/E) ratio of 7.6. The comparable ratio for other leading commercial banks operating in the private sector was 9.3. The lower price set for NCB shares established their competitiveness and provided clear incentives for potential shareholders.

SHARE ALLOCATION: Well in advance of the share offering, the government determined and announced that the sale would give priority to small shareholders. This goal sought to diffuse politically-based criticism that control would be shifted to the nation's wealthier class. In addition, widespread ownership would minimize the prospects for another round of nationalization in the future.

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To achieve this objective, a limitation of 7.5 percent of the issued capital of the NCB Group per individual or firm was established, even at the risk of an undersubscribed offering and proscribed future growth. In addition, the sale included an allocation scheme which gave preference to individuals seeking small lots of shares. If shares would have been distributed on a proportional basis, each applicant would have received 35.5 percent of shares requested, since the offering was oversubscribed by 170 percent. According to the formula used and described below, however, applicants for 1,000 shares received their full request, whereas those applying for the largest block of shares received less than 9.0 percent of the shares requested.

SHARE ALLOCATION FORMULA

No. Shares Requested	No. Shares Received	Plus (%)	Of Additional Shares Requested Up to:
1,000	1,000	85.0%	500 shares
1,500	1,425	70.0%	500 shares
2,000	1,775	45.0%	1,000 shares
3,000	2,225	35.0%	1,000 shares
4,000	2,575	25.0%	1,000 shares
5,000	2,875	20.0%	2,500 shares
7,500	3,325	12.5%	2,500 shares
10,000	3,638	9.0%	40,000 shares
50,000	7,238	9.0%	50,000 shares
100,000	11,738	8.5%	Of Remainder Applied for

EMPLOYEE STOCK OWNERSHIP: The overall stock sale strategy included an attractive feature for bank employees to acquire shares. This plan included a small number of free shares (20), a matching share program (25 free shares for 25 shares purchased at the offer price), and share discounts and priority access. In addition, employees were eligible to obtain their allocations by borrowing directly from the bank via a J$10 million Special Loan Fund. This financial package used the shares themselves for collateral, and employees could repay the Fund over a two year period through payroll deductions. As a result of these facilities, 98 percent of the NCB's management and staff participated, and these employees became the largest group of shareholders in the bank, controlling about 12.8 percent of the voting shares after the public offering.

DISTRIBUTION: Successful execution of the offering required an effective and far-reaching distribution system. The network

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utilized consisted of the local branches of the Jamaican post office plus the branches of eligible banks serving as the points of distribution and collection. This network resulted in a total of some 400 retail outlets for the stock sale.

V. RESULTS OF THE PRIVATIZATION

The public offering of NCB shares took place over a ten working day period in November/December 1986. The offering was 170 percent oversubscribed and all expectations regarding investor interest were exceeded. Over 30,000 citizens and institutions in Jamaica applied for shares.

NCB shares were first traded on the Jamaican Stock exchange on December 23. Some 170,000 shares were traded. The price of shares closed at J$4.94, a two-thirds increase from the offer price of J$2.95, leading to observations that the initial value set was underpriced.

A higher price would have increased the government's revenue from the sale. However, the primary goal was not revenue generation, but rather gaining public support. Therefore a low offer price was a wise strategy. Notwithstanding the comments regarding the offer price, the sale was judged by all participants as a major success. A large government-owned and operated bank was placed back into private hands. The transaction indicated a successful experiment, the first public offering of its kind in Jamaica, which could be used as a model for future privatizations. The stock market benefited from the entry of thousands of new shareholders and participants, and enjoyed a major increase in capitalization of the market. Finally, public suspicions concerning political interference in the transaction and misgivings over the feasibility of the transaction were overcome by the careful manner in which the offering was implemented.

VI. LESSONS AND APPLICATIONS

The NCB privatization example furnishes a number of useful lessons regarding strategies and tactics for the divestiture of public enterprises.

1. The privatization of a major financial institution through a "standard" public offering of shares can succeed. However, careful planning and execution are of critical importance in the areas of balance sheet enhancement, prospectus preparation, information dissemination and marketing, and retail distribution.

2. A principal ingredient underlying the success of the NCB transaction was the fact that the bank was well managed

and enjoyed a proven history of profitable performance. It was not plagued by a poor loan portfolio, and was operated efficiently even during its period of government ownership. The profitable performance was due at least in part to the wise government decision not to set interest rate ceilings, but rather to allow banks to set rates at the levels needed to attract deposits and cover costs.

3. Public offerings of SOE shares can mobilize new domestic savings from even relatively poor societies, introduce new investors and investment instruments to the capital markets, and increase overall market capitalization. However, this requires concerted educational and marketing efforts.

4. Equity market privatizations are not completely dependent on a highly developed, sophisticated capital market. Capital markets and privatization are closely interrelated, since investor confidence, the tax structure, monetary policies and economic performance play important roles. However, the NCB divestiture was accomplished in a relatively thin equity market, witnessed by the fact that the transaction increased the stock market's capitalization by 15 percent.

5. Appropriate share pricing is a critically important factor. Most objective observers would conclude that NCB's offer price was undervalued by traditional market standards, but this was deemed necessary in view of the fact that the sale was innovative in the Jamaican context and success was crucial from a political standpoint.

6. Privatizations can represent an integral component of comprehensive structural adjustment activities. The sale of NCB generated U.S.$16.5 million for the government, which could be used to reduce budget deficits. In addition, NCB has since grown and increased its profitability, thereby offering increased tax revenues to the government.

7. The chances of successful public offering divestitures are enhanced if the privatizations are preceded or accompanied by certain policy reform initiatives. Most analysts would agree that the sale of NCB probably could not have taken place in the early 1980s, when Jamaica was mired in declining economic conditions and a host of policy constraints. Improvements in the tax system, deregulation, trade and exchange policy reforms and other measures taken in Jamaica prior to the offering created an atmosphere conducive for the successful private sector purchase of NCB. While no single policy change can be

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isolated as exerting a critical influence, the combination of reforms undertaken played a highly positive role in setting the stage for the privatization.

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MEXICO:

Breaking Down the Barriers to Entry

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Mexico: Breaking Down the Barriers to Entry

I. SUMMARY

The Mexican government has traditionally played a large role in the national economy, owning and operating a number of monopolies such as petroleum refining and distribution, certain mining activities, railroads, forestry, and radio and television, and competing with private enterprises in areas such as retail food stores and cinemas. In 1982, in the midst of a foreign exchange crisis, the government added banks to its list of state-owned enterprises.

Because the economic and foreign exchange difficulties remain unresolved, and because the government and the nation are accustomed to extensive government ownership of the economy, the banking sector remains basically in government hands. As Figure 1 shows, more than 92 percent of all financial assets are owned by government-controlled financial institutions. The government monopoly on commercial banking functions as "the ultimate barrier to entry," as no private commercial banks may operate. Even before the nationalization, Mexico had erected stiff barriers to foreign banks. Citicorp is the only foreign bank allowed to operate. Since the nationalization, private financial institutions, especially private brokerage houses, have successfully managed to slip around the barrier and provide some banking services.

Two types of partial bank privatization have occurred in Mexico. A first type of partial privatization, the emergence of privately owned brokerage houses to rival the nationalized banks in providing money and portfolio management services to large depositors, has been credited with increasing the competitiveness of banking and inducing the government-owned banks to introduce several attractive new instruments. The second type of partial privatization ocurred in 1987, when the government sold 34 percent of the capital in the banks to the private sector. Because the sale left operational control and decision-making in the hands of the government, few direct results were expected. The banks do have a larger pool of loanable funds as a result of the capital infusion. In addition, employees, many of whom chose to purchase stock, have a greater incentive to perform now that they benefit directly from profits.

II. FINANCIAL POLICY CONTEXT

On September 1, 1982, in the face of a foreign exchange crisis, President Lopez Portillo of Mexico issued a decree nationalizing the banking system. The Mexican peso had depreciated by nearly 400 percent during the year, rising from 26 pesos to the U.S. dollar in January 1982 to nearly 100 pesos by December.

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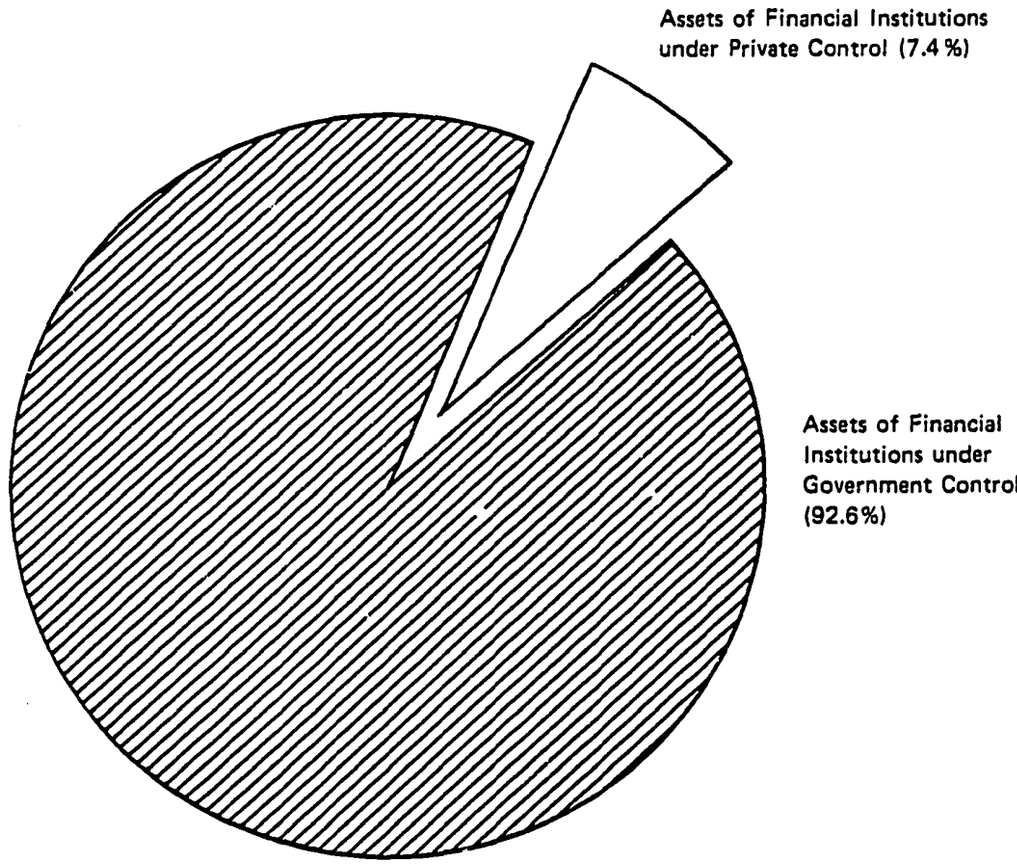

Institution	Assets ($ Billions)	Percent of Total Assets
GOVERNMENT - CONTROLLED	52.3	92.6
Multibanks	35.6	63.0
Nacional Financiera (Nafinsa)	16.0	28.3
Insurance Companies *	0.7	1.2
PRIVATE SECTOR CONTROLLED	4.2	7.4
Mutual Funds *	2.3	4.1
Brokerage Houses	1.9	3.3
TOTAL	56.5	100.0

* Shared government and private sector control.

Source: SRI Estimates. All figures as of December 1986.

FIGURE 1 GOVERNMENT CONTROL OVER PRINCIPAL FINANCIAL SECTOR ASSETS

Foreign exchange reserves plummeted from more than $4 billion in 1981 to less than $900 million in 1982. The trade and the current account balances had deteriorated steadily over the previous five years, ending 1981 with deficits of $4 billion and $14 billion, respectively. Inflation was edging toward a rate of 100 percent annually, and real gross domestic product (GDP) was stagnated.

In this deeply troubled economic context, the Federal Government moved to nationalize the banks in order to preclude widespread bank failure and stem the flood of foreign exchange overseas. The only banks not nationalized were Mexican branches of representative offices of foreign banks and Citibank N.A. (the only full-service foreign bank allowed by the government to operate in Mexico). The decree was formalized on December 30, 1982, in the "Public Service Banking and Credit State" (Ley Reglamentaria del Servicio Publico de Banca y Credito).

The decree compensated the private owners of nationalized banks with long-term bonds which were issued in August 1983 and which mature in 1992. The Bank Indemnification Bonds (Bonos de Indemnizacion Bancaria, or BIBs) are secured by the Federal Government and are tradable on the stock exchange to allow owners to obtain liquidity.

Prior to the nationalization, Mexico had developed an impressive array of specialized financial institutions. The financial system consisted of 60 commercial banks, several dozen savings and loans, and approximately 20 development banks and trust funds which funneled subsidized credit to high-priority sectors. Savers could choose between a wide variety of fixed and floating rate instruments, including government bonds and commercial paper, with maturities ranging from 3 months to 12 years.

When the banks were nationalized, the government announced it would "preserve the administrative autonomy of each bank in order to foster competition, creativity and efficiency in their operations." Beginning in 1983, however, the government began consolidating the institutions. Within three years, the government had reduced the number of banks from 60 to 19. The financial structure currently consists of six nationwide banks and thirteen regional and multi-regional banks, with a total of 4,500 branches and approximately 185,000 employees. The banks are complemented by general and specialized development banks and trust funds, all owned and operated by the government.

III. FINANCIAL POLICY REFORMS

Since the nationalization, the Mexican government has moved to improve bank supervision. In December 1984, the Mexican Congress passed a new package of financial legislation which increased the powers of the Central Bank to regulate the banks.

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The law and its regulations established strict prudential operating rules, including capital/asset ratios, portfolio diversification standards, and limits on investments in individual firms. The law also established ceilings for domestic credit and government debt.

The government has not shown any interest in reducing its control over credit allocation. The 1984 law reduced the reserve requirement (the percentage of selected liabilities that banks must hold with the Central Bank), an important improvement, but also increased the percentage of total credit that must be channeled toward "priority sectors." The new legislation decreased the reserve requirement from 50 percent to 10 percent of eligible liabilities, allowing banks to increase their lending. Unfortunately, the law also increased government control over bank lending portfolios, by raising the percentage of total lending that must go to sectors chosen by the government.

IV. IMPLEMENTATION OF PRIVATIZATION

All banks are still majority government owned, and the government has shown no interest in returning them to private hands. However, two kinds of partial privatization have occurred in Mexico in the last several years. In 1987, the government laid the framework for partial privatization by authorizing the sale of 34 percent of the capital in each nationalized bank to private hands.

Private individuals and businesses could choose between two instruments offering them ownership in the banks: Equity shares (certificados de aportacion patrimonial) and subordinated convertible debentures with a 5-year maturity. The shares, which gave their owners full voting rights, and limit their liability to the value of the share, are traded on the Mexican Stock Exchange. The debentures are convertible to voting shares on the occasion of each interest payment (4 times each year). The debentures are subordinated: In case of liquidation, debenture owners would receive payment only after all other debt obligations had been paid, but before share owners. The debentures pay an interest rate based on the market rate for Mexican Treasury bills.

Only Mexican nationals, 100 percent Mexican owned firms, and dMexican local governments or parastatals could purchase the new instruments. Individuals and private firms were each limited to a 1 percent share of each institution, and government and parastatals to 5 percent.

Two of the largest banks, Bancomer and Banamex, were the pioneers in selling the new instruments. Bancomer raised $36.7 million by selling 2.4 million shares and 1 million debentures, each priced at 24,000 pesos ($10.52 U.S. dollars). Banamex increased its capital by $42.0 million, offering 5.2 million shares

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and 3.5 million debentures, each at 11,000 pesos ($4.82 U.S. dollars).

The prices were set by each institution, at such favorable terms that the offerings were almost completely subscribed on February 4 - 6, 1987 by clients, management and staff at the banks. The remaining instruments were sold on February 6 through the Mexican Stock Exchange, creating a functioning secondary market in the securities.

A second form of privatization now under way is the emergence of privately owned brokerage houses as viable competitors of the publicly owned banks in certain financial services. Since the nationalization in 1982, brokerage houses (casas de bolsa) have grown dramatically both in size and in breadth of activities to rival the nationalized bank for large deposits. The rise of the private brokerage houses has already brought about a noticeable increase in the efficiency and dynamism of the Mexican financial markets.

The privately owned brokerage houses buy and sell stocks and money market instruments, manage mutual funds (on their own and their customers' behalf), and organize transactions in commercial paper. In a real sense, the brokerage houses are operating increasingly as banks for large savers.

The brokerage houses have been growing rapidly. The 26 casas de bolsa managed $8.3 billion in funds in 1986, up from $6.4 billion the previous year. The number of accounts rose from 118,066 to 186,023 over this same period. To administer the growth in activity, brokerage houses increased the number of their employees from 4,822 in 1985 to 7,008 in 1986, and expanded their branch network. The brokerage houses have been highly profitable. Profits rose from $33 million in 1985 to $44 million in 1986, representing a 30 percent return on capital.

One reason for the expansion of the brokerage houses was the high level of activity on the stock market, until the stock market dropped in 1988. However, a more fundamental structural driving force has been the nationalization of the commercial banks. Prior to the nationalization, wealthy individuals and executives of private firms typically established proprietary relationships with their bankers. Following the government takeover, these individuals could no longer be assured that their banking relationships and transactions would remain proprietary. Therefore, they have increasingly turned toward the services of privately run brokerage houses. At the same time, while the management quality of commercial banks has deteriorated, the brokerage houses have attracted the most qualified and entrepreneurial of professionals, who seek higher salary structures and more operational flexibility.

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The government response to the rapid growth of the privately held brokerage houses has been one of careful observation but no intervention. Insofar as they are stiff competitors of the government-owned banks in offering money and portfolio management services to large depositors, the government is watching the brokerage houses carefully. Knowledgeable observers suggest that the government views privatization of the government banks as politically unfeasible, but is pleased with the emergence of the private sector alternative to the banks.

V. RESULTS OF NATIONALIZATION AND PARTIAL PRIVATIZATION

Results of Nationalization

Nationalization of banks has had several negative implications for the Mexican financial sector. In part in response to the nationalization of banks and strict credit controls, firms are increasingly turning to other companies for financing. The growing intercompany loan market operates through brokers, which place promissory notes with cash-rich companies. Free from government interest rate controls, both borrowers and lenders are able to obtain more favorable terms dealing directly with one another rather than through the banks, thereby leading to financial "disintermediation." The nationalized banks are losing customers and fees as firms seek alternative methods of financing growth.

A second negative effect of nationalization has been reduced bank profitability. In 1985, Mexico's nationalized banks posted a return on assets of only one-half of one percent. Mexico's largest three banks, Bancomer, Banamex and Banca Serfin, hold more than half of commercial bank assets, and have posted reasonable profits in recent years. The smaller, regional banks are either breaking even or losing money. The poor financial performance of the banks is to a certain extent a reflection of the weak condition of the Mexican economy as a whole. However, this situation has been aggravated by generalized deterioration in the banks' quality of service and staff since they were nationalized. With the possible exception of the three largest banks, observers indicate that most banks have experienced a decline in the quality of their professional staffs. Salaries have declined in real terms, and staff members are no longer eligible for subsidized loans, which was previously a powerful financial incentive. Banking procedures have reportedly become more bureaucratic in nature.

On a positive note, it seems that favoritism and "less-than-arms-length" transactions have abated since the nationalization. It is not clear why government officials would have fewer incentives than their private sector counterparts to engage in these kinds of activities, especially if their compensation packages are lower. However, the general consensus in Mexico is

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that there is less corruption in the banks now that the government is the owner.

Results of Partial Privatization

The sale of 34 percent of bank capital to the private sector is likely to have several benefits for the banks, but the effects cannot be easily measured -- in part because only 18 months have passed since the share offering. The infusion of new capital will increase the amount of loanable funds. In addition, because management and employees are now partial owners, they have a higher stake in operating an efficient, profitable institution.

The emergence of the private brokerage houses has also generated benefits for the Mexican banking system, as the nationalized banks are forced to compete for large deposits and the accompanying fees by offering attractive new instruments. nI what could be taken as an effort to lure back some of the large savers to the nationalized system, the government ruled in early 1986 that banks could issue Bankers Acceptances, and could set the rate of interest on them. These instruments are similar to the Certificates of Deposit issued by U.S. banks. Mexican banks and savers responded enthusiastically to the expanded use of Bankers Acceptances, and the value of BAs in circulation doubled in real terms in 1986, to $1.7 billion. For purposes of comparison, time deposits in Mexican banks (which do offer real positive interest rates) totalled $11.6 billion in February 1987. Savings accounts, which pay a low, fixed rate of only 20 - 25 per year (while inflation is estimated at 100 percent per year), had attracted only $775 million as of June 1986. Another innovation by two of the largest banks has been the introduction of "Master Accounts," or checking accounts which pay money market rates. Thus, the private "banks" are a force for innovation and high quality service within Mexico's nationalized banks.

Some observers are concerned about what they consider lax supervision of the rapidly growing brokerage houses as well as the intercompany loan market. The brokerages houses fall under the purview of the National Securities Commission, which also regulates the stock exchanges and the mutual funds. The Commission's staff of 300 is generally regarded as highly qualified, nonetheless there is some concern that the brokerage institutions do not receive the appropriate level of oversight relative to their growing importance in the financial markets. Intercompany loans are completely unregulated.

VI. LESSONS AND APPLICATIONS

Mexico's partial privatizations offer several important lessons for other nations. Mexico successfully sold 34 percent of

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its two largest banks to management, employees, clients, and other individuals and firms. The shares were priced attractively to assure a successful sale. The partial privatization increased the amount of loanable funds available to the banks, as well as increased the management's and employees' incentives to run an efficient operation. The partial privatization is perhaps a first step toward the eventual return of the banks to private hands.

Mexico has also seen the rise of a dual banking system, as privately owned brokerage houses have increased in size and breadth, and intercompany loans have increased. The emergence of the private alternatives for large depositors and large borrowers has put pressure on the nationalized banks to offer quality service and attractive instruments.

The entrance of alternative instruments and institutions has a negative side. Some observers are concerned about a lack of supervision of the rapidly growing brokerage houses and intercompany loan markets. As savers and borrowers increasingly turn to the private alternatives, it is imperative to assure that the newly emerging institutions and markets are adequately supervised. If the "neophyte" institutions and markets are appropriately regulated and reviewed, they offer a powerful force for competition and efficiency within the nationalized banking system.

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NEW ZEALAND:

The Positive Results of Policy Reform

New Zealand: The Positive Results of Policy Reform

I. SUMMARY

The election of the Labour Party in 1984 brought wide-ranging changes in financial sector policy. It also brought about moves toward privatization of several government-owned banks. The financial policy shifts, undertaken in the context of broad reforms to make the New Zealand economy more market-oriented, have created numerous positive effects such as entry of new banks, introduction of new financial services, and improved financial performance of commercial banks. The privatization of government-owned banks has not yet taken place, but operational reforms have been undertaken in preparation for their divestment.

II. THE FINANCIAL POLICY CONTEXT

The following section describes the financial system prior to its reform in the mid-1980s. Recent policy changes have been made under the overall economic reform that has been instituted to remove market rigidities and stimulate competition and efficiency. The overall reform has resulted in the reduction of trade barriers, changes in the law on competition introduced by the Commerce Act of 1986, the removal of price controls for a number of product groups, the removal of a wide-range of controls on the production and distribution of goods and services in certain industries, and liberalization of industries considered to form a part of the industrial infrastructure, including transportation, energy and finance.

The Financial System Prior to Reform

In 1983, prior to the introduction of financial system reforms, just under 50 percent of the total resources of the financial system were owned by the government. Private trading (commercial) banks accounted for 42 percent and private savings banks had just over 4 percent. There were six trading banks, of which four were privately-owned, and 18 savings banks.

The government owned the Bank of New Zealand (BNZ), the Development Finance Corporation (DFC), the Post Office Savings Bank (POSB), the Housing Corporation (HC), and the Rural Banking and Finance Corporation (RBFC).

In 1982-1983, 1,557 enterprises of all types operated in the financial sector, with 35,040 employees. For the population of the country, 3 million, the financial sector consists of a large number of institutions and network of services.

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The government pursued several rationales for maintaining such large holdings in the financial sector:

- The government could influence the cost and availability of finance for social purposes.

- It could bridge the lack of well-developed money and capital markets so that medium-term and long-term credit needs could be satisfied.

- It could reduce the potential for abuse by private lenders over borrowers, since government-set interest rate controls created a chronic undersupply of funds.

The previous regulatory regime had several effects upon the financial service industry, including the following:

- Dominant role of government in finance.

- Retardation of growth of money and capital markets. Because the government took strong steps to develop a government securities market, the possibility for business to satisfy its long-term credit needs through security sales was seriously impeded. In addition, because the Reserve Bank could not undertake open market operations, it had to rely on regulatory policies to control the money supply. This, in turn, reduced the potential for an open money market.

- Limitations on the competitiveness of financial firms, due to barriers to entry, resulting in high costs to the consumer and large margins for some firms.

- Reduced flexibility and adaptability of financial firms to changes in market conditions. Segmentation of financial firms often resulted in a high degree of concentration of the regulated financial firm portfolio in either narrow sectors of the economy or in a particular maturity spectrum. Financial firms could not invest in areas that would earn the highest return.

- Service rather than price competition, and product innovation and "bundling." Product innovation meant that regulated financial firms would develop new products that were a close substitute for products they were not allowed to offer, e.g., credit card services offered by firms that could not offer checking accounts. Bundling refers to the practice of requiring the customer to take other services at higher-than-market prices when the regulated service must be provided at below market rates. An example would be

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expensive home insurance required when a below-market house mortgage is provided.

- Increasing market shares for less-regulated financial institutions such as financial companies. Trading banks lost market shares due to the implicit tax of being required to hold reserves in below-market government securities. Other examples were the sharp growth in the commercial bill market and the "curb" market for mortgage financing, which both grew due to government restrictions on other financial firms.

Government Policies Toward the Financial Sector

Prior to 1984, the government exercised a series of controls over the financial sector, including market segmentation, restriction of entry to new banks, interest rate restrictions, reserve-assets ratios and restrictions, credit growth limits, foreign exchange controls, and foreign ownership limits.

MARKET SEGMENTATION: Specific financial sub-sectors were clearly demarcated. In other words, banks were restricted to banking functions, stock brokerages were restricted to stock transactions, and so forth. The government felt that segmentation was desirable because it allowed credit allocation to high-priority sectors and better monetary control. The overriding effect, however, was to limit competition among types of financial institutions.

RESTRICTIVE ENTRY TO NEW BANKS: New banks could not be incorporated except through an Act of Parliament. This limited competition within market segments, and set up an oligopolistic banking sector. Prior to 1984, only four private trading banks held more than 40 percent of the nation's total M3 deposits.

INTEREST RATE RESTRICTIONS: The government exercised direct control over the interest rates of depository institutions such as banks, savings banks and building institutions. Time deposits were subject to ceilings that varied according to the type of financial firms and the size and term of deposit involved. General lending rate ceilings were used in combination with a multi-layered rate structure, by which a variety of sectors enjoyed different preferential rates in accordance with their social priority or ranking.

RESERVE-ASSETS RATIOS AND REQUIREMENTS: Financial institutions were subject to a reserve-assets ratio requirement. The ratio was expressed as total trading bank deposits and reserve assets compared to time and demand deposits made at the Reserve Bank. Financial institutions were

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required to hold these reserves in the form of below-market-rate government securities. The reserve-assets ratios for trading (commercial) banks, for example, was 27 percent at the beginning of February 1985. The government's rationale for establishing the reserve-assets arrangement included the following factors: The perceived need to fund the government's fiscal deficit, presumably at below-market interest rates; the desire to direct funds to specific sectors; the belief that the ratios might enhance the prudential soundness of certain institutions; and the assumption that the ratio was a useful macroeconomic policy device.

CREDIT GROWTH LIMITS: The government introduced guidelines to restrict credit growth in the first half of 1983. Most major financial institutions were restricted to a maximum rate of increase of one percent per month. Such restrictions were justified due to the lack of open market operations at the Central Bank to influence the aggregate money supply. Also, selective credit controls were maintained to ensure that priority sectors had access to an adequate supply of finance. Trading banks regularly received directives regarding the allocation of their lending to agriculture, housing, export and other sectors.

FOREIGN EXCHANGE CONTROL: Exchange controls had been liberalized during the decade prior to 1984. However, several controls were still in place. Overseas borrowings were limited to a fixed term of 12 months and at an interest rate limited to 2 percent over LIBOR or the Singapore interbank rate. Foreign companies were excluded from having access to the New Zealand capital market for financing. New Zealand financial institutions could not borrow overseas, nor could New Zealand residents purchase foreign exchange for overseas investments. These regulations were justified as a means to insulate the domestic economy from adverse external economic developments. The regulations were considered important to the maintenance of fixed exchange rates and the insulation of domestic interest rate structures from the rest of the world.

FOREIGN OWNERSHIP LIMITS: Foreign firms were limited to 70 percent equity ownership of firms in the financial sector.

III. FINANCIAL POLICY REFORMS

Policy Changes Undertaken

Considerable analysis of financial services sector policy took place prior to 1984 when, after its election, the Labour Government instituted widespread reforms. One economist described the prior regulatory regime as "policies so insane

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that even the New Zealand economics profession was united in opposition to them." The financial services industry was one of the most heavily controlled among all industrial countries.

The policy changes introduced included the following:

- The Reserve Bank Amendment Bill of 1986 allowed the issuance of new bank licenses. Currently, 13 trading banks are licensed, whereas prior to 1984 there were only four trading banks.
- Reserve-assets ratios for trading banks and savings banks were repealed in 1985.
- The minimum 30-day maturity for interest-bearing deposits was repealed in 1984.
- Interest ceilings on loans and deposit rates were abolished in 1984.
- Greater reliance on the market was to be used to guide credit growth, and the one percent monthly limit was discarded.
- Foreign exchange could be handled by non-bank dealers after September 1983, and restrictions on foreign exchange purchases for investment abroad were repealed in 1984.

EFFECTS OF THE POLICY CHANGES: Some remarkable shifts have transpired since 1984 as a result of the reforms implemented:

- Nine new banks have been established.
- One bank has ceased banking operations and others were restructuring in order to remain competitive.
- The scope of financial institutions operations grew significantly.
- New financial services were introduced.
- Market shares of lending institutions were altered.
- Trading banks began to experience improved financial performances.

ENTRY OF NEW FIRMS: In the past two years, ten additional banks have applied for licensing and have been approved under the Reserve Bank Amendment Bill of 1986. Nine new banks are

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already in operation. The influx of new banks has brought increased competition, more competitive rates for financial services, and a wider range of services offered.

EXIT AND RESTRUCTURING OF EXISTING FIRMS: The National Westminster Bank has ceased its banking operations. Several others have eliminated their foreign exchange operations. NZI Bank is currently in severe financial difficulty and is restructuring after having been sold by Brierley Investment to General Accident and Life Ltd. PLC of the United Kingdom.

CHANGES IN SCOPES OF OPERATIONS: Financial firms are moving out of their previously well-defined operations and into banking, stock brokerage, insurance, real estate, and industrial investment. Trading banks have expanded into merchant and investment banking, and some have entered stock brokerage operations through acquisitions or internal development. The Bank of New Zealand has set up a life insurance company, BNZ Life. Declining margins in lending have forced trading banks to offer more forms of off-balance sheet, fee-income, and specialty services.

NEW FINANCIAL SERVICES: In trade finance, a shift has occurred from overdrafts and long-term loans to buyer's credit, forfeiting (supplier credit) and export leasing for capital goods. Trade bills, term letters of credit, pre-shipment or post-shipment finance, and revolving facilities are available when up to 180 days of credit is required. In capital finance, "Euro-Kiwi" bonds denominated in long-term, fixed rate New Zealand dollars have been issued as well as Euronotes and bonds, which are available through Europe and are denominated in U.S. dollars.

CHANGING MARKET SHARES: Trading banks have captured a greater share of M3 deposits while savings banks and finance companies have lost ground. However, this has not changed significantly as BNZ, Australia, New Zealand, Westpak and National still command the major share of the market.

IMPROVED FINANCIAL PERFORMANCE: trading banks have improved profits, achieved greater returns on average total assets, and expanded average shareholders' funds.

One outstanding effect of the reform was how quickly these changes took place. The financial firms were able to make such rapid adjustments due to their lack of asset specificity, i.e., their main asset, capital, is readily applicable to many different uses, as contrasted to the machinery of an industry.

PROBLEMS ENCOUNTERED: Several problems followed the financial reform:

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- A shortage of skilled personnel required to make and monitor lending operations emerged.

- Many financial firms have lacked dynamic, aggressive management.

- Rigid internal labor markets acted as a constraint.

- The New Zealand Post Office held a monopoly over telecommunications, possibly inhibiting the establishment of communications networks by other banks. This monopoly is undergoing deregulation that will continue through 1989.

- The clearing system (Databank NZ Ltd.) was owned by the existing four trading banks, requiring steps to allow new banks to access the system. The new banks have been allowed to use the services, and Trustbank has set up its own clearing system.

- The removal of reserve ratio requirements left some financial institutions holding large portions of government securities yielding below-market interest rates.

IV. IMPLEMENTATION OF PRIVATIZATION

After five years of the Labour Party administration, the government introduced measures in July 1988 that were both consistent with previous steps to introduce a market orientation to the economy, and necessary to avoid increases in the goods and services' tax and the income tax. The measures included the proposed sale of the following three government-owned banks:

Bank	Type	Size (Capitalization)
Bank of New Zealand	Trading bank	NZ$ 1.16 billion
Rural Banking and Finance Corporation	Rural bank lending to agriculture, fisheries and forestry	NZ$ 700 million
Post Office Saving Bank	Savings Bank	NZ$ 271 million

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The current status of the financial institutions held by the government is as follows:

- The government continues to own 100 percent of the Post Office Savings Bank (POSB), the Housing Corporation, and the Rural Banking and Finance Corporation (RBFC).

- The Development Finance Corporation has been sold to the National Provident Fund (80 percent) and Salomon Brothers (20 percent).

- The government still holds the majority share of the Bank of New Zealand, although 25 percent has been sold on a share market float in 1987, and the remaining 75 percent will be sold in 1988.

- The government intends to sell both the RBFC and POSB to private interests in 1988-89.

RATIONALE FOR THE PRIVATIZATION: New Zealand is undergoing policy reforms to shift its economy to one that is more market-oriented. Financial sector reforms have been made as described above. Privatization of the three remaining government-held banks is seen as the next logical step in this process.

PRIVATIZATION METHODOLOGY USED: Minimal privatization has taken place to date. Considerable preliminary rationalization has been accomplished to make the POSB and RBFC more competitive, and therefore more attractive to private investors. The nature of various privatization activities is described below.

BANK OF NEW ZEALAND: The governmet sold 25 percent of the BNZ in 1987 through a share market float and plans to sell an additional 75 percent during 1988. Potential buyers of those shares are preparing for that sale. They are reported to be two Australian banks and two New Zealand multinational corporations, Fletcher Challenge and Brierley Investments.

RURAL BANKING AND FINANCE CORPORATION (RBFC): The following steps have been undertaken:

- General ledger implementation, which involves revamping the accounting system and developing a management information system.

- Review of cost of funds by source.

- Valuation of assets, review of loan portfolio.

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- Employee relations strategic plan (in anticipation of personnel shifts).

RBFC raised all of its capital from private sources in 1987, as government funding was curtailed in 1986. An immediate need was to set up a treasury function. Once created, this unit instituted a bank float and a "telephone call" deposit system to attract funds. Capital Market and Money Market units were also established together with a customized management information system. RBFC gradually raised interest rates to the market level for most borrowers and its total income and after-tax profits increased sharply.

POST OFFICE SAVINGS BANK: The following work has been performed:

- Review of all business operations and the organization structure plus the management information systems inherited from the Post Office.
- Curtailing of many non-banking activities, e.g., money orders, postal notes and money telegrams.
- Closure of over 500 branch locations.
- Hiring of a completely new top management team, CEO and board of management.
- Development of new corporate goals and objectives plus public relations and marketing campaigns.
- Development of management information system implementation plans.

DEVELOPMENT FINANCE CORPORATION: The DFC has been sold to the National Provident Fund, which owns 80 percent of the shares, and Salomon Brothers, which owns 20 percent.

V. LESSONS

1. Privitization can entail political risks. The Labour Party government has lost considerable credibility among voters. The government initially stated that "corporatization" was not the first step to privatization; that has obviously not been the case. Before the last election, the Labour Party declared that Post Bank would never be sold, but the government now intends to sell it. Governments should clearly state their intentions with regard to privatization. Corporatization is probably a good intermediate step

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for the privatization of a government-owned bank to enable it to face market forces and achieve profitability prior to a stock float or negotiated sale.

The problem in typical developing countries is that banks cannot be moved beyond the corporatization state. In cases where inertia is a factor, it may be preferable to move directly to the privatization stage.

2. The freeing of controls without setting up compensatory monitoring processes has led to an image of New Zealand's financial sector as unreliable. Bankers' aggressive pursuit of loans in a highly competitive market has led to massive bad debts. Bankruptcies of borrowers increased by 50 percent and several major companies collapsed. This implies that the supervisory mechanisms must be in place to monitor rapidly changing events, once a reform is set in motion. Otherwise, bank failures may endanger depositors' funds.

3. Interest rates on loans have not fallen dramatically because real competition is not yet possible with four major trading banks continuing to hold an oligopolistic position. It will take time for new banks to build up their deposit and asset bases in order to compete with previously existing, well-entrenched banks. This implies that some elements of financial reform will take time, and program personnel would be well-advised to couch their reform programs as a "process" rather than as an "event." It takes time to reverse the errors made and patterns set over decades.

4. Several banks have had to revise their strategies and reduce their operations because the expected "bonanza" did not occur.

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THE PHILIPPINES:

Dismantling Government Domination

The Philippines: Dismantling Government Domination

I. SUMMARY

In 1980-81 the Philippines instituted several banking reforms, including the liberalization of interest rates and establishment of universal banks (unibanking), that caused increased savings mobilization, growth in commercial bank deposits and credit, and a lengthening of loan maturities. Unfortunately, these reforms were insufficient to stave off the financial crisis of 1983-84, which resulted in the acquisition of failing commercial banks by the government. Since President Aquino took office in 1986, several of these commercial banks have been fully divested and one additional bank has been partially divested as the result of the government's privatization program. The Philippine National Bank, which accounts for one-quarter of all commercial banking activity, remains to be privatized. Unibank formation continues as a trend, with twelve such banks now in operation.

II. THE FINANCIAL POLICY CONTEXT

The banking system of the Philippines is historically one of the most competitive and highly specialized in Asia. The banking sector is composed of nearly 1,500 institutions, including private and government-owned commercial banks, savings and mortgage banks, savings and loan associations, private and official development banks, and rural banks. The non-banking sector comprises investment houses, finance companies, insurance companies, and a number of other non-bank financial institutions.

The Central Bank has the overall responsibility for regulation and supervision of banking as well as non-banking institutions. The Department of Commercial and Savings Banks conducts regular examinations of over 1,200 institutions. The Central Bank's Department of Financial Intermediaries regulates the operations of all institutions performing quasi-banking functions.

The basic monetary policy followed by the Philippine monetary authorities has been to increase private sector credit levels while restraining inflationary pressures. The Central Bank controls the money supply and credit conditions by dealing in government securities, setting commercial banks' reserve requirements, imposing selective credit controls, and adjusting its rediscount rates. It also influences credit markets by imposing compulsory cash deposits on imports.

Two government-owned financial institutions have played major roles in implementing government policy. The two institutions, the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP), were used by the government in this way because

they could provide services which, due to market imperfections, private sector banks were not willing to provide. Together these two banks have accounted for up to one third of all resources in the financial system.

The PNB, established in 1916, grew to become the largest commercial bank in the country, holding approximately one fourth of all deposits in the commercial banking system. The PNB had the same powers and functions as any other commercial bank, but because of its size and government ownership it served as a tool for implementation of government economic policy.

Since 1975, commercial banks have been required to maintain a minimum paid-in capital of 100 million pesos. This requirement resulted in a number of domestic mergers and affiliations with U.S., Japanese, and European banks. Foreign banks are allowed to hold equity positions of up to 40 percent of the voting stock of a domestic commercial bank.

Prior to 1981, the Central Bank set maximum interest rates on various types of loans. The overall savings rate was low and loan maturities were generally short term. The lack of long-term credit stemmed primarily from the legislated specialization of the financial institutions. Even institutions designed to specialize in long-term credit, such as investment houses, dealt primarily in high interest, short-term credit and money market operations.

III. FINANCIAL POLICY REFORMS

Beginning in 1981, the financial system of the Philippines underwent a series of policy changes aimed at making the system more streamlined and efficient. The Monetary Board approved a number of circulars intended to allow market forces to determine interest rates. Virtually all forms of deposits and nearly all loans with maturities in excess of one year became free of interest rate ceilings. Loans with maturities of less than one year remained subject to interest rate ceilings set by the Central Bank.

To increase the supply of long-term credit, the government also began a series of reforms with the purpose of increasing competition among banks to foster greater efficiency in the financial system. The most significant reform was the introduction of the "unibanking" concept, which allows eligible institutions to engage in a range of financial activities.

These financial reforms, primarily the liberalization of interest rates and lifting of restrictions on commercial banking activity, were quite successful. The volume of savings mobilized increased rapidly in the 1980-1983 period; commercial banks' deposits and credit outstanding increased; and a significant lengthening of loan maturities was achieved.

These reforms, however, were mostly curtailed because of overriding economic events. A massive investment program to utilize non-petroleum energy sources and considerable lending to businesses owned by cronies of President Marcos led to the near-collapse of the financial system. The most outstanding event contributing to the weakening of the financial system was the assassination of opposition leader Benigno Aquino, which ignited enormous capital flight, signaling a lack of confidence in the political and economic system.

The major deficiency in the financial system, however, which contributed to the 1983-84 banking crisis, was the poor performance of the PNB and the DBP. Their poor performance, manifested by portfolios clogged with non-performing assets (NPAs), raised serious questions regarding their extensive role in the economy. In practice, the PNB and DBP competed with private banking institutions and actually impeded the private banks' development.

During the subsequent financial crisis, the government took control of many troubled firms, converting debt owed to the Philippine National Bank and the Development Bank of the Philippines. As a result of acquisitions made during the financial crisis of 1983-84, the government came to own seven commercial banks that competed with 28 private, domestic commercial banks. During the process of financial consolidation, monetary policy was disregarded on numerous occasions due to the government's provision of emergency liquidity assistance to ailing businesses and government investment programs. Monetary policy came completely unravelled in 1984 when the money supply was allowed to grow by 50 percent, causing interest rates to peak at 45 percent in June of that year.

In October 1983, the government placed a moratorium on principal payments of foreign debt, and in November of that year launched extensive foreign exchange controls including the requirement that banks turn over their foreign exchange to the Central Bank. These moves were taken in response to the massive capital flight following Aquino's assassination. The economy underwent a period of considerable financial shallowing: Savings fell to an all-time low, credit to the private sector severely contracted, and real interest rates rose sharply.

One of the most disturbing features of the Philippine financial sector is the high spread between commercial deposit and lending rates, averaging about 16 percent, whereas in most countries spreads range between 3 and 4 percent. The main cause of high intermediation costs is the high implicit and explicit taxation on banks. The implicit taxes include high reserve requirements, forced investment in agrarian reform bonds, and inflation. There is also an explicit tax of 5 percent on gross receipts plus a tax on profits. The high spreads could be reduced

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by lowering the reserve requirements, increasing interest paid on reserves, and eliminating the agricultural bonds requirement and the gross receipts tax.

It is important to note that the trend toward unibanking, a financial policy initiated during the Marcos period, has continued. Nine unibanks were in operation as of February 1984; that number had increased to twelve as of February 1988. With traditional banking becoming less profitable due to stiffer competition and with a political situation more favorable to long-term commitments, more and more banks have turned to investment banking to diversify their services and remain competitive within the industry.

IV. IMPLEMENTATION OF PRIVATIZATION

Several banks continued to experience liquidity/solvency problems after being acquired by the government. These banks were originally taken over from the private sector because they were in serious danger of failure. The original intention of the government was to sell them back to the private sector after rehabilitation. However, the rehabilitation was not successful and their condition deteriorated further.

When President Aquino took over in early 1986, the government was burdened with an estimated 330 government-acquired corporations of all types, the vast majority of which were insolvent. Included among these corporations were six government-acquired commercial banks. Many of the corporations designated for privatization were included in the portfolios of the Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB) as non-performing assets.

In August 1986, President Aquino approved the Government Reorganization Plan and named an interministerial Committee on Privatization (COP) whose main task was to formulate policies and guidelines governing privatization. An Asset Privatization Trust (APT) was established in December 1986 to be the disposal entity for major state-owned enterprises. The first step in the privatization process was the formulation of a privatization plan for a specific state-owned enterprise by either the responsible government department or the Asset Privatization Trust (APT). The plan was then forwarded to the Committee on Privatization for approval. Initially, the preparation/study phase for divestiture candidates was carried out carefully, and potential buyers were provided with comprehensive background materials. Eventually, motivated by the desire to speed up the privatization process, the government changed its selling approach to an "as is, where is" basis.

The government of the Philippines signed an agreement with the World Bank through which the latter agrees to provide $310

million in development credits. The agreement was conditioned, however, on the privatization of all six government-acquired commercial banks by October 1988, a condition that has not yet been fully met.

The Financial Institutions Involved

Among the six government-acquired commercial banks, three have already been partially or completely divested to the private sector, and the government has plans to privatize two additional institutions. The status of each privatization is described below:

1. International Corporate Bank (Interbank) -- Size: P579M paid-in capital

   Status: Forty percent was sold to American Express International Banking Corp. on July 4, 1986 through a debt to equity conversion. Some 59.7 percent is still held by the National Development Company (NDC), a government entity. The remainder of less than 1 percent is held by Filipinio investors. As of September 1988, the COP has designated NDC to act as the disposition entity for Interbank and to draw up a detailed privatization plan. American Express expressed interest in purchasing the 30 percent share of the Rizal Commercial Banking Corporation (RCBC) for the purpose of merging International Corporate Bank with RCBC. This would allow RCBC to go into unibanking, while holding total American Express equity below the government limit of 40 percent ownership by foreign banks.

2. Commercial Bank of Manila -- Size: P322M

   Status: The government shareholdings were fully disposed of and the new private shareholders took over management of the bank on December 11, 1987. Among its shareholders are the First National Bank of Boston, Three Eight Corporation, Ace Solid Holdings Corp. and Cabien Corporation. The First National Bank of Boston purchased $19 million by converting into equity some of its Philippine debt that had been blocked since the imposition of a debt moratorium by the central bank in 1983. The purchase will allow the U.S. bank to upgrade its operation in the Philippines to a fully licensed local bank able to lend in pesos. Bank of Boston will supply management expertise. The U.S. bank cannot repatriate its investment until 1991.

3. Pilipinas Bank -- Size: N/A

   Status: In March 1988, the government signed an agreement disposing of its shareholdings in Pilipinas Bank to Prudential Bank and Bank of Tokyo. The former owner of the Pilipinas

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Bank was suing to delay the sale of that institution. As of October 1988, it appears that the suit will be dismissed allowing the APT to proceed with the sale before year-end.

4. Union Bank of the Philippines -- Size: P500M

Status: Land Bank (a government bank) holdings in the Union Bank (39 percent) were sold to the Aboitiz Group of Companies on August 31, 1988. Union Bank increased its authorized capital from 500 million pesos to 1 billion pesos, although it was undergoing privatization. At least 20 percent of the bank's new shares were set aside for sale to its employees and to the general public. Union Bank is profitable, posting a P32 million in the first quarter of 1988.

5. Associated Bank -- Size: N/A

Status: APT is currently preparing a privatization plan and will act as the disposition agency for Associated Bank.

The Philippine National Bank and the Republic Planters Bank have been directed to draw up their own divestment program in preparation for eventual privatization. The PNB privatization is now scheduled for discussion with the COP. Both banks have a positive net worth, although Republic owes the government P238 million.

Rationale for Privatization

The Philippines government is carrying out a major government enterprise sector reform. The government intends to withdraw from the provision of all marketable goods and services. In a May 1986 speech to the 19th Annual Meeting of the Board of Governors of the Asian Development Bank (ADB), President Aquino stated that "this regime means business when it says it will not meddle in private business. Government will provide the usual public services and facilities, preserve order, vindicate rights and protect liberties. But the private sector should be the main propeller of the economy. I believe that the restoration of a genuine private enterprise economy will foster competition, productivity and efficiency." As commercial banking is essentially considered an area of private sector activity, the privatization of these banks plays an important part in the overall government restructuring strategy.

Privatization Methodology Used

The government shareholdings in the above-described banks were fully or partially disposed of through private sale agreements. The agreements were based on offers made in an auctioning process,

administered by the APT. No attempts have been made to issue shares for sale to the public.

Implementation of Privatization

In the cases of the Commercial Bank of Manila, Pilipinas Bank (once the lawsuit is settled or dismissed) and Union Bank of the Philippines, the privatization process was or will be completed through a full disposition of the government holdings. In the case of the International Corporate Bank, 40 percent of the government holdings was sold. The COP has designated the National Development Company (NDC), which still holds 59.7 percent of the stock, to act as the disposition entity for the bank. The privatization plan for the Associated Bank is being drawn up and the privatization of Philippine National Bank is scheduled for discussion with the COP. The privatization of the Republic Planters Bank has yet to be undertaken.

V. RESULTS

Banking reforms instituted prior to the financial crisis of 1983-84 yielded good results in terms of increased savings, commercial bank deposits and credit, and longer loan maturities. The privatization of individual government-held banks is viewed as a positive sign, but the greatest impact will come from the disposal of non-performing assets of the Philippine National Bank and the eventual divestment of the bank itself.

It appears that in the privatization of the banks, the government is selecting groups with considerable experience in banking to take-over the operations, perhaps avoiding problems caused by inexperienced management in running financial institutions.

The utilization of debt-equity swaps in the privatization of the government-acquired commercial banks, if implemented appropriately, can serve as a means to reduce external debt.

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Annex B

Inventory of Privatizations of Financial Institutions

Annex B:

Inventory of Privatizations of Financial Institutions

This annex contains a comprehensive list of all examples of privatizations of state-owned financial institutions that are in process or have been completed in developing and developed countries around the world. The list, in alphabetical order by country, was assembled from a comprehensive survey of materials from the World Bank, AID, and other development assistance agencies. In each case in which information is available, we specify the institution privatized (or to be privatized), the privatization technique employed, and the date the privatization occurred.

Australia In a private sale, the government sold its minority interest in the Primary Industry Bank of Australia.

Austria In 1988, the government of Austria reduced its share of Creditantstalt-Bankverein from 60 percent to 51 percent. In addition, the government diminished its participation in Landerbank to 53 percent through a public offering in October, 1987.

Bangladesh The government returned the Pubali and Uttara Banks to private owners, and reduced its holdings in the Rupali Bank to 51 percent. SEE CASE STUDY IN ANNEX A.

Benin Benin is currently engaged in two partial privatizations, the liquidation of the BBD Development Bank and the private sale of the Banque Commercial du Benin.

Brazil In a public offering, the government transferred its minority ownership of the Banco do Brazil to the private sector.

Chile Chile has experienced two waves of privatizations, one in the 1970s, and a second in the 1980s. In the most recent privatization activity, the government has sold 12 banks, pension funds and insurance companies to local and foreign private businesses, utilizing both private sales and public offerings. SEE CASE STUDY IN ANNEX A.

France The French government has initiated nine full or partial privatizations. In each case, 10 percent of the shares were reserved for employees, and foreign investors were limited to 20 percent of the shares offered for sale. In many cases, the government privately sold between 30 and 50 percent of the shares to institutional investors, as a security measure to guard against a take-over.

(1) The public offering of 25 percent of the shares in the Banque Nationale de Paris netted the government 4.0 billion French francs (FF).

(2) The state sold its 47 percent holding in the Societe Generale Alsacienne de Banque (SOGENAL) in a public offering, netting FF0.7 billion.

(3) In the largest flotation of banking sector shares in France's history (FF13.6 billion), the government sold its holdings of the Compagnie Financiere de Paribas in a combination private sale and public offering.

(4) The combination private sale/public offering of the Compagnie Financiere de Credit Commercial de France (CCF) net FF4.3 billion.

(5) The Banque Industrielle et Mobiliere Privee was sold through both a private sale and a public offering to the French public, employees, and institutional investors. The proceeds totalled FF0.5 for the government.

(6) Utilizing a public offering and private sale, the government completely divested its holding in the Banque du Batiment et des Travauz Publics for FF0.4 billion.

(7) The government sold 49 percent of its holdings in Societe Generale for FF17.7 billion in a combination public offering/private sale.

(8) The government netted FF15.5 billion from the public offering of the Compagnie Financiere Suez.

(9) In January 1988, the French government sold the Credit Agricole for FF1.2 billion in a private sale to the bank's 94 regional member banks.

Gambia In a first step toward the privatization through a public share offering of the Gambia Commercial and Development Bank, the Bank was incorporated. In addition, the government sold its minority shareholdings of the National Standard Bank in a public offering.

Germany (Federal Republic of) In preparation for selling approximately half of its stake in the Deutsche Siedlung und Landesrentenbank, DSL, the government created a holding company whose only asset is the DSL. The government expects to earn approximately DM400 million from the public offering, which will

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take place late 1988. In March 1988, the government disposed of 25 percent of its participation in the Deutsche Verkehrs Kreditbank, (DVKB) in a public offering.

Grenada The government is currently assessing the value of and writing prospectus for two commercial banks, the Grenada Bank of Commerce and the National Commercial Bank, in preparation for public offerings.

Italy The government plans to reduce its 56 percent share in Mediobanca, an investment bank, to 25 percent through a private sale. The government has already taken part in three partial privatizations (of Banca Commerciale Italiana, Banco di Santo Spirito, and Credito Italiano) and one complete privatization (the sale of Banco di Roma's 74 percent participation in Banca Centro Sud to Citibank in May 1985).

Ivory Coast In a private sale, the government of the Ivory Coast returned the BNEC bank to private ownership.

Jamaica In a public offering that was oversubscribed by 170 percent, the government of Jamaica sold the National Commercial Bank to more than 30,000 Jamaicans, many of whom bought stock for the first time. SEE CASE STUDY IN ANNEX A.

Korea The Korean government has fully divested its shares in national commercial banks, and is engaged in an additional privatization and two partial divestitures of regional or sectoral institutions. In 1982/83, the government placed its shares in commercial banks in private hands through private sales. Concerned about ownership control by a single large industrial group, the government placed strict restrictions on maximum share holdings. The government is currently selling its holdings in the Korea Exchange Bank, and part of its shares in the Industrial Bank of Korea and the Citizens National Bank.

Mexico The government has sold minority shares in three banks. In February 1987, 34 percent of Banco Nacional de Mexico (Banamex) was sold in a combination public offering and private sale, 12 percent to employees and 17 percent to selected bank customers. A 23 percent stake in the Banco de Comercio (Bancomer) was also sold. The following month, 34 percent of Banca Serfin was sold to staff and clients. SEE CASE STUDY IN ANNEX A.

Netherlands The government is slowing reducing its stake in NMB from 35 percent to 7 percent through a series of public offerings.

New Zealand The government of New Zealand has sold partial shares in several commercial banks, and is readying additional banks for privatization. SEE CASE STUDY IN ANNEX A.

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Nigeria The government of Nigeria has plans to sell at least one third of its participation in four banks, the Federal Mortgage Bank, Industrial Development Bank, Bank for Commerce and Industry, and the Federal Savings Bank. All four banks are currently 100 percent government owned.

Philippines Three of the government's six commercial banks have been partially or completely divested to the private sector, and there are plans to privatize two additional institutions. In 1986, forty percent of the International Corporate Bank was sold to American Express through a debt-to-equity conversion. The following year, the government sold all of its participation in the Commercial Bank of Manila to a group of private shareholders that included the First National Bank of Boston, among others. In 1988, the government completely divested its minority share in the Union Bank. The government is making plans to sell its shares in the Pilipinas bank and the Associated Bank. SEE CASE STUDY IN ANNEX A.

Singapore The government is planning to sell its share of Development Bank of Singapore Finance, Ltd, but may wait until the current recession is over in order to secure a higher price.

Spain The government sold the Banco Atlantico Group for US$35 million in a private sale to Arab Banking Corp., Banco Exterior and Banco Arabe Espanol.

Sweden In 1984, the government sold 15 percent of its hares in PK Banken, a commercial bank, through a public offering.

Turkey The Turkish government is preparing Sumerbank for a public offering by transferring it to the Public Participation Administration, a holding company.

Annex C

Government-Owned Financial Institutions in USAID Countries

Annex C: Government-Owned Financial Institutions in USAID Countries

This annex lists government-owned banks in countries in which USAID has an interest. A government-owned bank is defined as a bank partially, majority or completely owned by the government, whether local, regional, or national. The list is compiled from information available in the International Monetary Fund's "International Financial Statistics: Supplement on Public Sector Institutions," No. 13, 1987, as well as SRI International field research and interviews. The annex is in alphabetical order by country according to the three AID regions worldwide: Africa; Asia and the Near East; and Latin America and the Caribbean.

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AFRICA

Benin

Banque Centrale des Etats de l'Afrique de l'Quest (Central Bank)
Banque Beninoise pour le Developpement
Banque Commerciale du Benin
Caisse d'Epargne (savings bank)
Caisse Nationale de Credit Agricole
Centre de Cheques Postaux
Societe Nationale d'Assurance et de Reassurance (insurance)

Botswana

Bank of Botswana (Central Bank)
Botswana Building Society
Botswana Development Corp. (holding company) and subsidiaries, comprising:
  Botswana Insurance Co. (Pty) Ltd.
  Finnancial Services Co. of Botswana (Pty) Ltd.
Tswelelo (Pty) Ltd. (financial assistance for industry and enterprises)
Military Pensions Fund
National Development Bank
Post Office Savings Bank

Note: Proprietary (Pty) indicates a nonpublic company with limited liability.

Burkina Faso

Banque Centrale des Etats de l'Afrique de l'Quest (Central Bank)
Banque Internationale du Burkina (commercial bank)
Banque Internationale pour le Commerce, l'Industrie et l'Artisanat du Burkina (commercial bank)
Banque Nationale de Developpement du Burkina
Caisse Autonome d'Investissement (investment fund)
Caisse Nationale de Credit Agricole (agricultural credit)
Caisse Nationale des Depots et des Investissements (development bank)
Office National des Postes (postal checking and savings services)
Societe Nationale d'Assurance et de Reassurance (insurance)
Union Revelutionnaire des Banques (commercial bank)

Burundi

Banque de la Republique du Burundi (Central Bank)
Caisse d'Epargne du Burundi (savings bank)

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Caisse de Mobilisation et de Financement (commercial bank)
Fonds de Promotion Economique
Holding Arabe Lybien Burundais
Societe Burundaise de Financement

Cameroon

Banque des Etats de l'Afrique Centrale (Central Bank)
Banque Camerounaise de Developpement
Caisse d'Epargne Postale (postal savings bank)
Caisse Nationale de Reassurance (insurance)
Cameroun Bank (commercial bank)
Credit Foncier du Cameroun (mortgages)
Fonds d'Aide et de Gerantie aux Petites et Moyennes Enterprises (assistance for small and medium-sized enterprises)
Fonds National de Developpement Rural (development fund)
Societe Nationale d'Investissements (holding company)

Central African Republic

Banque des Etats de'Afrique Centrale (Central Bank)
Banque Centrafricaine d'Investissement
Banque Nationale Centraficaine de Depots (commercial bank)
Enterprise d'Etat d'Assurances et de Reassurances (insurance)
Union Bancaire en Afrique Centrale (commercial bank)

Chad

Banque des Etats de l'Arifque Centrale (Central Bank)
Banque de Developpement du Tchad
Banque Internationale pour l'Afrique au Tchad
Banque Tchadienne de Credit et de Depot (commercial bank)
Caisse Nationale d'Epargne (savings bank)
Centre de Cheques Postaux (postal checking accounts)

Djibouti

Banque Nationale de Djibouti (Central Bank)
Caisse de Developpement (development bank)

Gambia, The

Central Bank of The Gambia
Agricultural Development Bank
The Gambia Commercial and Development Bank
The Gambia National Insurance Corp.

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Government Savings Bank
Social Security and Housing Finance Corp. (provident fund)

Ghana

Bank of Ghana (Central Bank)
Agricultural Development Bank
Bank for Housing and Construction
First Ghana Building Society
Ghana Commercial Bank
National Investment Bank
Office of Business Promotion
Post Office Savings Bank
Social Security Bank (commercial bank)
Social Security and National Insurance Trust (provident fund)
State Insurance Corp.

Guinea

Banque Centrale de la Republique de Guinee (Central Bank)
Societe Nationale d'Assurances et de Reassurances (insurance)
Banque Internationale pour le Commerce et l'Industrie de la Guinee (BICI-GUI)
Banque Internationale pour l'Afrique en Guinee (BIAG)

Guinea-Bissau

Banco Nacional da Guine-Bissau (Central Bank)
Caixa Economica Postal (postal savings institution)

Ivory Coast

Banque Centrale des Etats de l'Afrique de l'Quest (Central Bank)
Banque Ivoirienne de Developpement Industriel
Banque Nationale pour le Developpement Agricole
Caisse Autonome d'Amortissement - Depots (amortization fund, deposits)
Credit de la Cote d'Ivoire (commercial bank)
Fonds de Garantie des Entreprises Ivoiriennes (enterprise guarantee fund)

Kenya

Central Bank of Kenya
Agricultural Finance Corp.
Agricultural Settlement Fund

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Cereals and Sugar Finance Corp.
Cooperative Bank of Kenya Ltd. (agriculture)
Development Finance Co. of Kenya Ltd.
Dyer and Blair Ltd. (stockbrokers)
Housing Finance Co. Kenya Ltd.
Industrial and Commercial Development Corp.
Industrial Development Bank
Kenya Commercial Bank Ltd.
Kenya National Assurance Co. Ltd.
Kenya National Capital Corp. Ltd.
Kenya Post Office Savings Bank
Kenya Reinsurance Corp.
Minet Industrial and Commercial Development Corp. (insurance)
Minet Larkman Ltd. (insurance)
Minet Mulcock and Co. Ltd. (insurance)
National Bank of Kenya (commercial bank)
National Housing Corp.
National Social Security Fund (provident fund)
Savings and Loan Kenya Ltd.

Lesotho

Central Bank of Lesotho
Lesotho Agricultural Development Bank
Lesotho Bank (commercial bank)
Lesotho Building Finance Corp.
Lesotho National Insurance Co. (Pty) Ltd.

Note: Proprietary (Pty) indicates a nonpublic company with limited liability.

Liberia

National Bank of Liberia (Central Bank)
Agricultural Co-operative and Development Bank
Liberia Bank for Development and Investment
National Housing and Savings Bank
National Insurance Corp.

Malawi

Reserve Bank of Malawi (Central Bank)
Post Office Savings Bank

Malaysia

Bank Negara Malaysia (Central Bank)
Bank Bumiputra Malaysia Bhd. (commercial bank)

Bank Islam Malaysia Bhd. (commercial bank)
Bank Kemajuan Perusahaan (development bank)
Bank Pembangunan (development bank)
Bank Pertanian (agricultural bank)
Bank Rakyat (commercial bank)
Employees Provident Fund
National Savings Bank
Pilgrims Management and Fund Board

Note: Bhd. (Berhad) indicates a form of incorporation.

Mali

Banque Centrale des Etats de l'Afrique de l'Quest (Central Bank)
Banque de Developpement du Mali
Banque Malienne de Credit et de Depots
Banque Nationale de Developpement Agricole
Caisse d'Assurance et de Reassurance (insurance)
Caisse d'Epargne du Mali (savings bank)
Centre de Cheques Postaux (postal checking accounts)

Mauritania

Banque Centrale de Mauritanie (Central Bank)
Banque Arabe-Libyenne-Mauritanienne (commercial bank)
Banque Internationale pour la Mauritanie (commercial bank)
Banque Mauritanienne Arabe Africaine (commercial bank)
Banque Mauritanienne pour le Developpement et le Commerce (commercial bank)
Cheques Postaux (postal checking system)
Fonds National de Developpement (development bank)

Niger

Banque Centrale des Etats de l'Afrique de l'Quest (Central Bank)
Banque de Developpement de la Republique du Niger
Caisse Nationale de Credit Agricole
Caisse Nationale d'Epargne (savings bank)
Caisse de Prets aux Collectivites Territoriales (loans to local governments)
Cheques Postaux
Credit du Niger (housing loans)
Fonds de Garantie des Petites et Moyennes Entreprises Nigeriennes (small and medium-sized business guarantee fund)
Office de Promotion de l'Entreprise Nigerienne (loans to enterprises)
Societe Nigerienne d'Assurance et de Reassurance (insurance)

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Nigeria

Central Bank of Nigeria
Allied Bank of Nigeria Ltd. (commercial bank)
American International Insurance Co. Ltd.
British-American Insurance Co. Ltd.
Chase Merchant Bank
Crusader Insurance Co. Nigeria Ltd.
Federal Mortgage Bank
First Bank of Nigeria (commercial bank)
International Bank for West Africa (commercial bank)
International Merchant Bank
Law Union and Rock Insurance Co. Nigeria Ltd.
Lion of Africa Insurance Co. Ltd.
Mercury Insurance Co. Nigeria Ltd.
National Employers Mutual Insurance Co. Nigeria Ltd.
National Insurance Corp. of Nigeria
New India Assurance Co. Nigeria Ltd.
Nigeria Acceptances Ltd. (merchant bank)
Nigeria Re-Insurance Corp. Ltd.
Nigerian Agricultural and Cooperative Bank
Nigerian Arab Bank (commercial bank)
Nigerian Bank for Commerce and Industry (development bank)
Nigerian Industrial Development Bank
Nigerian Merchant Bank
Royal Exchange Assurance Co.
Savannah Bank Nigeria Ltd. (commercial bank)
Sun Insurance Co. Nigeria Ltd.
Union Bank (commercial bank)
United Bank for Africa (commercial bank)

Rwanda

Banque Nationale du Rwanda (Central Bank)
Banque Commerciale du Rwanda
Banque de Kigali (commercial bank)
Banque Rwandaise de Developpement
Banques Populaires (cooperative savings banks)
Caisse d'Epargne du Rwanda (savings bank)
Caisse Hypothecaire du Rwanda (mortgage bank)
Societe Nationale d'Assurance du Rwanda (insurance)

Senegal

Banque Centrale des Etats de l'Afrique de l'Quest (Central Bank)
Banque de l'Habitat du Senegal
Banque Nationale de Developpement du Senegal
Caisse Nationale de Credit Agricole (commercial bank)
Compagnie Senegalaise d'Assurances et de Reassurances (insurance)
Direction des Services Financiers et de la Caisse d'Epargne (post

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office financial services and savings bank)
Societe Financiere pour le Developpement de l'Industrie et du Tourisme (investment bank)
Societe Nationale de Banque (commercial bank)
Societe Nationale de Garantie (commercial bank)
Union Senegalaise de Banque (commercial bank)

Sierra Leone

Bank of Sierra Leone (Central Bank)
Bentworth Finance (Sierra Leone) Ltd.
National Development Bank
National Insurance Co.
Post Office Savings Bank
Sierra Leone Commercial Bank
Sierra Leone Housing Finance Corp.

Somalia

Central Bank of Somalia
Civil Servants Social Security Agency
Commercial and Savings Bank of Somalia
Post Office Savings Bank
Somali Development Bank
State Insurance Co. of Somalia

South Africa

South African Reserve Bank (Central Bank)
Black Communities Development and Revolving Fund
Bophuthatswana National Development Corp. Ltd.
Central Energy Fund (Pty) Ltd.
Ciskeian Peoples Development Bank
Corporation for Public Deposits
Development Bank of Southern Africa
First National Development Corp. of South West Africa Ltd.
Industrial Development Corp. of South Africa Ltd.
KaNgwane Economic Development Corp. Ltd.
KwaNdebele Development Corp. Ltd.
KwaZulu Finance and Investment Corp. Ltd.
Land and Agricultural Bank of South Africa
Land and Agricultural Bank of South West Africa
Lebowa Development Corp. Ltd.
Local Authorities Loans Fund
Motor Vehicle Accident Assurance Fund
National Building and Investment Corp. Ltd. (South West Africa)
National Savings Certificates (Department of Posts and Telecommunications)
Post Office Savings Bank

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Public Investment Commissioners
QwaQwa Development Corp.
Rehoboth Investment and Development Corp. Ltd.
Re-insurance Fund for Export Credit and Foreign Investments
Shangaan/Tsonga Development Corp.
Transkei Development Corp. Ltd.
Venda Development Corp.

Note: Proprietary (Pty) indicates a nonpublic company with limited liability.

Sudan

Bank of Sudan (Central Bank)
Agricultural Bank of Sudan
Estates Bank of Sudan
Industrial Bank of Sudan
Post Office Savings Bank

Swaziland

Central Bank of Swaziland
Swaziland Development and Savings Bank
Swaziland National Provident Fund
Swaziland Royal Insurance Corp.
Tibiyo Taka Ngwane Fund (development programs: financial activities)
Tisuka Taka Ngwane Fund (development programs: financial activities)
Unified Teaching Service Provident Fund

Tanzania

Bank of Tanzania (Central Bank)
Co-operative and Rural Development Bank
National Bank of Commerce
National Insurance Corp.
National Provident Fund
Post Office Savings Bank
Tanzania Housing Bank
Tanzania Investment Bank

Togo

Banque Centrale de Etats de l'Afrique de l'Quest (Central Bank)
Banque Arabe Libyenne Togolaise pour le Commerce Exterieur
Banque Togolaise de Developpement
Caisse Nationale de Credit Agricole (agricultural credit fund)

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Caisse Nationale d'Epargne du Togo (savings bank)
Compte Courant Postal (postal checking account)
Groupement Togolais d'Assurance (insurance)
Societe Nationale d'Investissement et Fonds Annexes (investment)

Uganda

Bank of Uganda (Central Bank)
Housing Finance Co. of Uganda Ltd.
National Insurance Corp. and 1 subsidiary:
  Uganda Hire Purchase Co. (vehicle hire purchase)
Post Office Savings Bank
Uganda American Insurance Co.
Uganda Commercial Bank
Uganda Development Bank

Zaire

Banque du Zaire (Central Bank)
Banque du Credit Agricole (development bank)
Banque du Peuple (commercial bank)
Caisse Generale d'Epargne du Zaire (savings bank)
Societe Nationale d'Assurances (insurance)

Zambia

Bank of Zambia (Central Bank)
Development Bank of Zambia
Industrial Finance Co.
Lima Bank (agriculture)
National Savings and Credit Bank of Zambia
Widows and Orphans Pension Fund
Zambia Civil Service Pension Fund
Zambia National Building Society
Zambia National Commercial Bank Ltd.
Zambia National Insurance Brokers Ltd.
Zambia National Provident Fund
Zambia State Insurance Corp. Ltd.

Zimbabwe

Reserve Bank of Zimbabwe (Central Bank)
Agricultural Finance Corp.
Industrial Development Corp.
Post Office Savings Bank
Zimbabwe Development Bank
Zimbabwe Reinsurance Corp.

ASIA AND NEAR EAST

Bangladesh

Bangladesh Bank (Central Bank)
Bangladesh House Building Finance Corp.
Bangladesh Investment Corp.
Bangladesh Krishi Bank (agricultural development)
Bangladesh Shilpa Bank (industrial bank)
Bangladesh Shilpa Rin Sangstha (industrial credit corporation)
4 boards of trustees for Government Servants Benevolent and Group Insurance Fund
4 commercial banks, comprising:
  Agrani Bank
  Janata Bank
  Rupali Bank
  Sonali Bank
2 insurance corporations, comprising:
  Jiban Bima Corp.
  Shadharan Bima Corp.

Burma

Union of Burma Bank (Central Bank)
Myanma Agricultural Bank
Myanma Economic Bank
Myanma Foreign Trade Bank
Myanma Insurance Corp.

Egypt

Central Bank of Egypt
Authority for the Principal Bank for Development and Agricultural Credit (with 17 regional banks)
Bank of Alexandria (commercial bank)
Bank of Cairo (commercial bank)
Egyptian Real Estate Credit Bank
Financing Fund for Housing Constructed by Ministry of Reconstruction and New Communities
Government Insurance Fund for Guaranteed Deposits
Land Reclamation Fund
Misr Bank (commercial bank)
mortgage banks
Nasser Bank (commercial bank)
National Bank of Egypt (commercial bank)
National Investment Bank
Post Office Savings Bank
Public Authority for Supervision over Insurance

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Fiji

Reserve Bank of Fiji (Central Bank)
Fiji Development Bank
Fiji National Provident Fund
Government Employees Provident Fund
Home Finance Co.
Housing Authority (housing loans)
National Bank of Fiji (commercial bank)
Unit Trust of Fiji Ltd. (investment trust)

India

Reserve Bank of India (Central Bank)
Employees Provident Fund
Export Credit and Guarantee Corp. Ltd.
Export-Import Bank of India
General Insurance Corp. of India and 4 subsidiaries
Housing and Urban Development Corp. Ltd.
Industrial Development Bank of India
Industrial Finance Corp. of India
Industrial Reconstruction Bank of India
Life Insurance Corp. of India
National Bank for Agriculture and Rural Development
National Film Development Corp. Ltd.
National Small Industries Corp. Ltd.
20 nationalized banks
Postal Savings Bank
Power Finance Corp.
193 regional rural banks
Rural Electrification Corp. Ltd.
State Bank of India and 7 subsidiaries
18 State Financial Corps.
26 State Industrial Development Corps.
Unit Trust of India
Urban Development and Urban Water Supply Financing Corp.

Indonesia

Bank Indonesia (Central Bank)
Asuransi Angkatan Bersenjata Republik Indonesia (insurance and provident funds)
Asuransi Ekspor Indonesia (export insurance)
Asuransi Jasa Indonesia (general insurance)
Asuransi Jasa Raharja (accident insurance)
Asuransi Jiwasraya (life insurance)
Asuransi Kredit Indonesia (credit insurance)
Asuransi Tenaga Kerja (labor insurance)
Bahana (financial investment)

Bank Bumi Daya (commercial bank)
Bank Dagang Negara (commercial bank)
Bank Ekspor Impor Indonesia (export-import bank)
Bank Negara Indonesia 1946 (commercial bank)
Bank Pembangunan Indonesia (development bank)
Bank Rakyat Indonesia (commercial bank)
Bank Tabungan Indonesia (savings bank)
Danareksa (securities issue)
Husada Bhakti (civil servants and pensioners health insurance)
Kliring dan Jaminan Bursa Komoditi (commodity stock exchange)
Pegadaian (pawnshop)
Pengembangan Keuangan Koperasi (development financing)
Reasuransi Umum Indonesia (underwriting)
Taspen (pension fund)
27 bank pembangunan daerah (provincial development banks)
59 bank pasar (municipal petty traders banks)

Jordan

Bank Markazi (Central Bank)
Agricultural Credit Corp.
Housing Bank
Industrial Development Bank
Jordan Cooperative Organization
Municipal and Village Development Bank
Pension Fund
Postal Savings Fund
Public Institution for Social Security

Morocco

Bank Al-Maghrib (Central Bank)
Banque National pour le Developpement Economique
Caisse Centrale de Garantie (guarantee fund)
Caisse de Depot et de Gestion (investment management)
Caisse d'Epargne Nationale (savings bank)
Caisse Marocaine des Marches (guarantee and credit company)
Caisse Nationale de Credit Agricole
Credit Immobilier et Hotelier (hotel and building loans)
Credit Populaire (commercial bank with regional branches)
Societe Centrale de Reassurance (insurance and reinsurance)
Societe Nationale d'Invstissement

Nepal

Nepal Rastra Bank (Central Bank)
Agricultural Development Bank
Credit Guarantee Corp. Ltd.
National Insurance Corp.

Nepal Bank Ltd. (commercial bank)
Nepal Industrial Development Corp.
Provident Fund
Rastriya Banijya Bank (commercial bank)
Security Marketing Centre Ltd.

Oman

Central Bank of Oman
Oman Agriculture and Fisheries Bank
Oman Development Bank
Oman Housing Bank

Pakistan

State Bank of Pakistan (Central Bank)
Agricultural Development Bank of Pakistan
Allied Bank of Pakistan Ltd. (commercial bank)
Baluchistan Provincial Cooperative Bank
Bankers Equity Ltd.
Central Directorate of National Savings
Equity Participation Fund
Federal Bank for Cooperatives
Habib Bank Ltd. (commercial bank)
House Building Finance Corp.
Industrial Development Bank of Pakistan
Investment Corp. of Pakistan
Muslim Commercial Bank Ltd.
National Bank of Pakistan (commercial bank)
National Development Finance Corp.
National Insurance Corp.
National Investment Trust
Pakistan Industrial Credit and Investment Corp.
Pakistan Insurance Corp.
Pakistan-Kuwait Investment Co. Ltd.
Pakistan-Libya Holding Co. Ltd.
Pakistan Refugees Rehabilitation Finance Corp.
Pakistan-Saudi Investment Co. Ltd.
Provincial Frontier Cooperative Bank
Punjab Provincial Cooperative Bank
Sind Provincial Cooperative Bank
Small Business Finance Corp.
State Life Insuranc Corp. of Pakistan
United Bank Ltd. (commercial bank)

Philippines

Central Bank of the Philippines
Development Bank of the Philippines
Home Financing Corp.
Land Bank of the Philippines
National Home Mortgage Finance Corp.
Natural Resources Development Corp. (financial activities)
Pag-ibig Fund (provident fund)
Philippine Amanah Bank
Philippine Crop Insurance Corp.
Philippine Deposit Insurance Corp.
Philippine Export and Foreign Loan Guarantee Corp.
Philippine National Bank (commercial bank)
Philippine Veterans Bank

Portugal

Banco de Portugal (Central Bank)
A Social - Companhia Portuguesa de Seguros (insurance)
Alianca Seguradora E.P. (insurance)
Banco Borges e Irmao (commercial bank)
Banco Comercial dos Acores (commercial bank)
Banco Espirito Santo e Comercial de Lisboa (commercial bank)
Banco de Fomento Nacional (development bank)
Banco Fonsecas e Burnay (commercial bank)
Banco National Ultramarino (commercial bank)
Banco Pinto e Sotto Mayor (commercial bank)
Banco Portugues do Atlantico (commercial bank)
Banco Totta e Acores (commercial bank)
Caixa Geral de Depositos (savings bank)
Companhia Europeia de Seguros (insurance)
Companhia Porutguesa de Resseguros (insurance)
Companhia de Seguros Acoreana E.P. (insurance)
Companhia de Seguros Bonanca E.P. (insurance)
Companhia de Seguros de Creditos E.P. (insurance)
Companhia de Seguros Garantia (insurance)
Companhia de Seguros Imperio E.P. (insurance)
Companhia de Seguros Metropole (insurance)
Companhia de Seguros Mundial Confianca E.P. (insurance)
Credito Predial Portugues (savings bank)
Empresa Mediadora de Seguros Lda. (insurance)
Euro-Financeira - Sociedade de Investimentos S.A.R.L. (investment financing)
Euro-Travelers Cheques Portugueses S.A.R.L.
Fidelidade Grupo Segurador E.P. (insurance)
Mediadora de Seguros Lda. - Becim (insurance)
O Trabalho Companhia de Seguros (insurance)
Portugal Col. Mediadora de Seguros Lda. (insurance)

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Portugal Previdente - Companhia de Seguros (insurance)
Sociedade Mediadora de Seguros Lda. - Secre (insurance)
Sociedade Mediadora de Seguros Lda. - Soseguros (insurance)
Sociedade Portuguesa de Seguros (insurance)
Tranquilidade Seguros E.P. (insurance)
Uniao de Bancos Portugueses (commercial bank)

Notes: S.A.R.L. (Sociedade Anonima de Responsibilidade Limitada) is a form of incorporation.
E.P. (Empresa Publica) indicates a state-owned company.

Sri Lanka

Central Bank of Ceylon
Acland Finance and Investment Ltd.
Agricultural Insurance Board
Bank of Ceylon (commercial bank)
Development Finance Corp. of Ceylon
Employees Trust Fund Board
Insurance Corp. of Sri Lanka
Lady Lochore Loan Fund
Loan Board
National Development Bank
National Housing Department
National Insurance Corp.
National Savings Bank
People's Bank (commercial bank)
Sri Lanka Export Credit Insurance Corp.
State Mortgage and Investment Bank

Thailand

Bank of Thailand (Central Bank)
Bank of Agriculture and Agricultural Cooperatives
Exchange Equalization Fund
Government Housing Bank
Government Savings Bank
Krung Thai Bank Co. (commercial bank)
125 municipal pawnshops

Tunisia

Banque Centrale de Tunisie (Central Bank)
Banque de Cooperation du Maghreb Arabe (development bank)
Banque de Developpement Economique de Tunisie
Banque Nationale de Developpement Agricole
Banque Nationale de Developpement Touristique
Banque Nationale de Tunisie (commercial bank)
Banque du Sud (commercial bank)

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Banque de Tunisie et des Emirats d'Investissement
Banque Tuniso-Koweitienne de Developpement
Banque Tuniso-Libyenne de Developpement et du Commerce Exterieur
Banque Tuniso-Quatarie d'Investissement
Caisse d'Epargne Nationale Tunisienne (savings bank)
Caisse Nationale d'Epargne Logement (housing)
Centre de Cheques Postaux (postal checking sytem)
Compagnie Tunisienne pour l'Assurance du Commerce Exterieur (insurance)
Societe Tunisienne d'Assurances et de Reassurances (insurance)
Societe Tunisienne de Banque (commercial bank)
Societe Tuniso-Seoudienne d'Investissement et de Developpement

Yeman Arab Republic

Central Bank of Yemen
Cooperative Agricultural Credit Bank
Housing Credit Bank
Yemen Co. for Investment and Finance Ltd.
Yemeni Bank for Reconstruction and Development
Yemeni Industrial Bank

LATIN AMERICA AND THE CARIBBEAN

Barbados

Central Bank of Barbados
Barbados Development Bank
Barbados National Bank (commercial bank)
Standing Insurance Committee

Belize

Central Bank of Belize
Development Finance Corp.
Government Savings Bank
Reconstruction and Development Corp.

Bolivia

Banco Central de Bolivia (Central Bank)
Banco Agricola de Bolivia (agricultural bank)
Banco del Estado (commercial bank)
Banco Minero de Bolivia (mining development bank)
Banco de la Vivienda (housing finance)
Caja de Ahorro y Credito Popular (savings bank)
Consejo Nacional de Vivienda (housing finance)
Consejo Nacional de Vivienda del Magisterio (housing finance)
Consejo Nacional de Vivienda Minera (housing finance)
Consejo Nacional de Vivienda Petrolera (housing finance)
Consejo Nacional de Vivienda Policial (housing finance)
Consejo Nacional de Vivienda de Trabajadores de Comercio y Ramas Anexas (housing finance)
Consejo Nacional de Vivienda de Trabajadores Fabriles, Constructores y Graficos (housing finance)
Fondo Nacional de Exploracion Minera (mining development)
Instituto National de Preinversion (development bank)
Servicio Nacional de Desarrollo Urbano (urban development)

Costa Rica

Banco Central de Costa Rica
Asociacion Bananera Nacional (banana development)
Banco Hipotecario de la Vivienda (mortgage bank)
Banco Popular y de Desarrollo Communal (workers bank)
4 Bancos Nacionales (commercial banks)
Comision Nacional de Prestamos para la Educacion (education loans)
Corporacion Costarricense de Desarrollo (development)
Departamento Central de Ahorro y Prestamo (savings and loans)

Instituto de Desarrollo Agrario (agricultural development)
Instituto de Fomento y Asesoria Municipal (municipal finance)
Instituto de Fomento Cooperativo (cooperatives promotion)
Instituto Nacional de Seguros (insurance)
Instituto Nacional de Vivienda y Urbanismo (housing finance)

Dominica

Dominica Agricultural, Industrial, and Development Bank
Government Housing Loans Board
Government Savings Bank
National Commercial Bank

Dominican Republic

Banco Central de la Republica Dominicana (Central Bank)
Banco Agricola de la Republica Dominicana (development bank)
Banco Nacional de la Vivienda (mortgage bank)
Banco de Reservas de la Republica Dominicana (commercial bank)
Caja de Ahorros para Obreros y Monte de Piedad (savings bank)
Corporacion de Fomento Industrial (industrial development)
Instituto de Auxilios y Viviendas (welfare and housing)
Instituto de Desarrollo y Credito Cooperativo (cooperatives development)
Instituto Nacional de la Vivienda (housing)
San Rafael C. por A. (insurance)

Note: C. por A. (Compania por Acciones) indicates a form of incorporation.

Ecuador

Banco Central del Ecuador (Central Bank)
Banco Ecuatoriano de Desarrollo (development bank)
Banco Ecuatoriano de la Vivienda (housing developnent)
Banco Nacional de Fomento (development bank)
Corporacion Financiera Nacional (development bank)
Fondo Nacional de Preinversion (development fund)
Instituto Ecuatoriano de Credito Educativo y Becas (education loans and scholarships)

El Salvador

Banco Central de Reserva de El Salvador (Central Bank)
Banco de Fomento Agropecuario (agricultural loans)
Banco Nacional de Fomento Industrial (development bank)
13 commercial banks
Corporacion Salvadorena de Inversiones (industrial finance)

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Financiera Nacional de Tierras Agricolas (agricultural loans)
Financiera Nacional de la Vivienda (housing finance)
Fondo de Financiamiento y Garantia para la Pequena Empresa (small business development)
Fondo de Garantia para el Credito Educativo (student loans)
Fondo Salvadoreno para Estudios de Preinversion (industrial projects)
Fondo Social de la Vivienda (housing finance)
Instituto Nacional de Pensiones de los Empleados Publicos (public employee pensions)
Instituto Salvadoreno de Prevision Social de la Fuerza Armada (armed forces pensions and welfare)

Grenada

Government Savings Bank
Grenada Bank of Commerce
Grenada Development Bank
National Commercial Bank of Grenada Ltd.

Guatemala

Banco de Guatemala (Central Bank)
Banco Nacional de Desarrollo Agricola (agricultural credit)
Banco Nacional de la Vivienda (mortgage bank)
Corporacion Financiera Nacional (development)
Credito Hipotecario Nacional de Guatemala (agricultural and industrial credit)
Fondo de Regulacion de Valores (stabilization of government issued or guaranteed securities)
Instituto de Fomento de Hipotecas Aseguradas (mortgages)
Instituto de Fomento Municipal (municipal development)
Instituto de Prevision Militar (loans to military personnel)
Oficina Administradora del Plan de Prestaciones del Empleado Municipal (loans to municipal employees)

Guyana

Bank of Guyana (Central Bank)
Guyana Co-operative Agricultural and Industrial Development Bank
Guyana Co-operative Insurance Service
Guyana Co-operative Mortgage Finance Bank
Guyana National Co-operative Bank
Guyana National Co-operative Bank (Trust) Corp.
National Bank of Industry and Commerce Ltd.
Republic Bank (Guyana) Ltd.

Haiti

Banque de la Republique d'Haiti (Central Bank)
Banque du Credit Mobilier (commercial bank)
Banque Nationale de Credit (commercial bank)
Banque Nationale de Developpement Agricole et Industriel (agricultural and industrial development)
Banque Populaire Haitenne (commercial bank)
Bureau de Cedit Agricole (agricultural credit)
Fonds de Developpement Industriel (industry development fund)
Office Assurance Vehicule contre Tiers (automobile insurance)
Office National d'Assurance (insurance)

Honduras

Banco Central de Honduras (Central Bank)
Banco Municipal Autonomo (municipal bank)
Banco Nacional de Fomento (development bank)
Corporacion Nacional de Inversiones (investments)
Credito Prendario (household loans)
Financiera Nacional de la Vivienda (housing finance)

Jamaica

Bank of Jamaica (Central Bank) and subsidiaries, comprising
- Export Development Fund Jamaica Ltd.
- Jamaica Export Credit Insurance Corp. Ltd.
- Jamaica Stock Exchange Ltd.
- Premier Investment Corp. Ltd.
- Securities Fund (Jamaica) Ltd.

Agricultural Credit Bank
Caribbean Housing Finance Corp. Ltd.
Jamaica Development Bank
Jamaica Mortgage Bank
National Commercial Bank Jamaica Ltd. and subsidiaries, comprising:
- Carp Corp. Ltd.
- National Commercial Bank Jamaica (Nominees) Ltd.
- National Commercial Mortgage and Trust Ltd.
- West Indies Trust Co. Ltd.

National Development Bank
National Housing Trust
National Provident Fund
Workers Bank Trust Co. Ltd.
Workers Savings and Loan Bank

Panama

Banco de Desarrollo Agropecuario (agricultural financing)
Banco Hipotecario Nacional (mortgage bank)
Banco Nacional de Panama (commercial bank)
Caja de Ahorros (savings bank)
Instituto del Seguro Agropecuario (agricultural insurance)

Peru

Banco Central de Reserva (Central Bank)
Banco Agrario (development bank)
Banco Central Hipotecario (mortgage bank)
Banco Industrial (development bank)
Banco de Materiales (construction finance)
Banco Minero (development bank)
Banco de la Nacion (commercial bank)
Banco de la Vivienda (housing bank)
Corporacion Financiera de Desarrollo (development financing)

St. Lucia

National Commercial Bank
St. Lucia Development Bank
St. Lucia Mortgage Finance Co.
Urban Development Corp.

St. Vincent

National Commercial Bank
National Insurance Scheme

Annex D

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Annex D: References

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