Deloitte Touche Tohmatsu

Financial Sector Review and Strategy

Options

TASK 5 REPORT

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VIII. LIST OF ACRONYMS

Accelerated Microenterprise Assistance Project	AMAP
Central Eastern Europe	CEE
Center for Development Information and Evaluation	CDIE
Consulting Assistance to Economic Reform	CAER
East West Management Institute	EWMI
Economic Growth Agriculture and Trade	EGAT
Europe and Eurasia	E&E
Federal Deposit Insurance Corporation	FDIC
Financial Sector Development	FSD
Financial Sector Development Program	FSDP
Financial Sector and Privatization	FSP
Financial Sector Volunteer Corp	FSVC
Freedom Support Act	FSA
General, Business, Trade and Investment	GBTI
Indefinite Quantity Contract	IQC
Institutional Reform and the Informal Sector	IRIS
Legal and Institutional Reform	LIR
Office of Economic Analysis	EA
Office of Emerging Markets	EGAT/EM
Microfinance Insitution	MFI
Non-Bank Financial Institution	NBFI
Partners For Financial Stability	PFS
Policy Coordination Bureau	PPC
Private Enterprise Development Support	PEDS
Professional Service Contractor	PSC
Scope of Work	SOW
Security and Exchange Commission	SEC
Small and Medium Enterprise	SME
Support for Economic Growth and Institutional Reform - Finance Sector	SEGIR FS
Support for Eastern European Democracy Act	SEED
Technical Assistance	TA
Temporary Duty Assignments	TDY

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I. PROJECT SUMMARY

This summary serves three purposes. First, it provides an overview of the Financial Sector Review and Strategy Project that Deloitte Touche Tohmatsu undertook for USAID's Office of Economic Growth (EGAT/EG) - so that the reader can understand the project's structure and progress without having to read the previous three papers in this series. Second, it outlines our findings and conclusions as they relate to the objectives of the project; and third, it presents a list of options and our recommendations as to potential future directions for USAID's financial sector development activities and the role that EGAT/EG can play in supporting these activities, thus summarizing the remainder of this paper.

I.A. The Financial Sector Review and Strategy Project

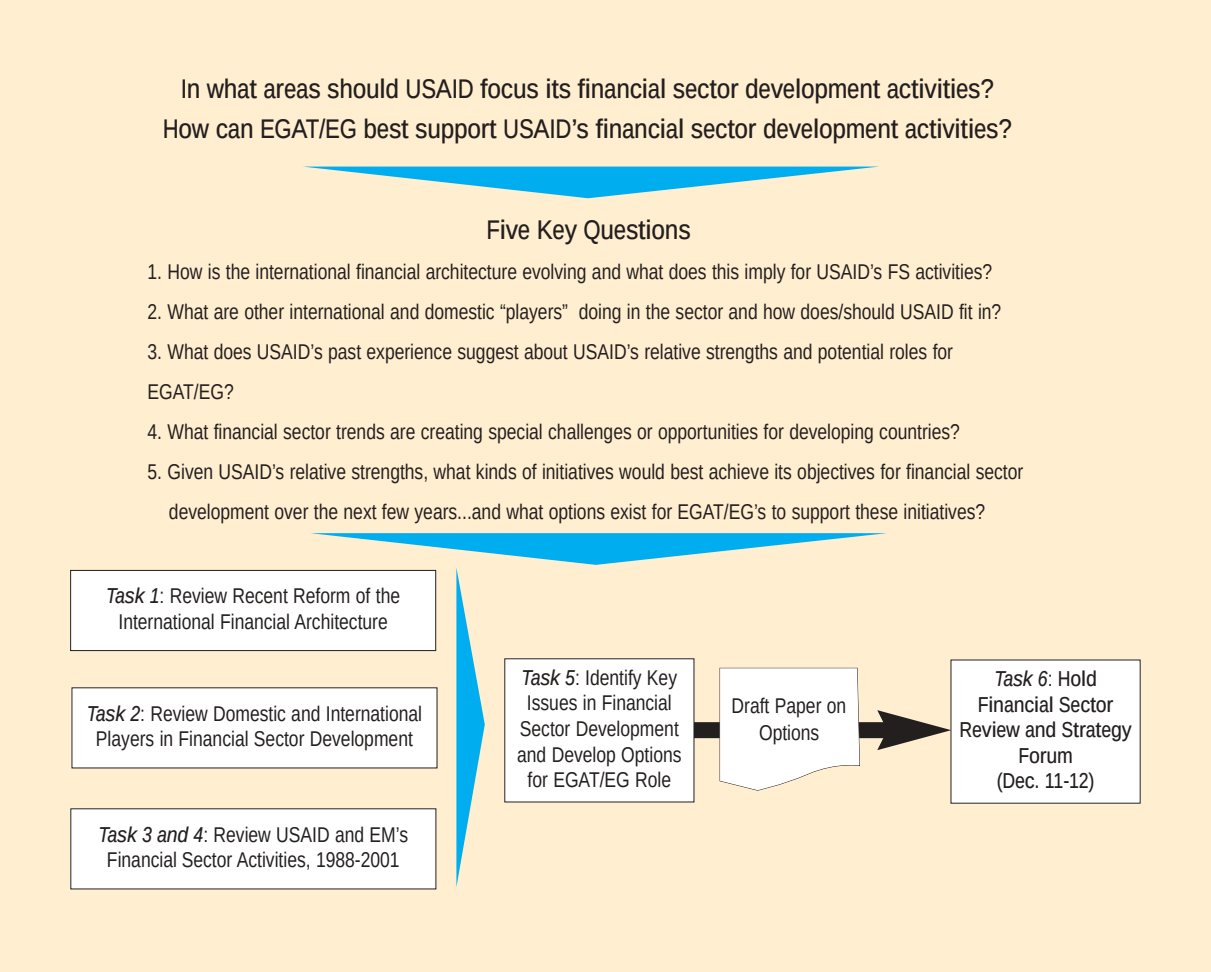
In September 2001, the Office of Economic Growth (then known as the Office of Emerging Markets) commissioned Deloitte Touche Tohmatsu (Deloitte) to conduct a study of trends in international financial sector development and a review of USAID's work in this area from 1988 to 2001. The objective of the study was to develop a list of alternative ways in which EGAT/EG could enhance its role in supporting USAID's financial sector development initiatives over the next ten years. It soon became apparent that addressing this objective would involve a broader look at the potential future of USAID's work in the financial sector.

These questions must be addressed in the context of a series of new challenges that will affect USAID's financial sector programs. First, the Agency's human and financial resources are being redirected to reflect the Bush Administration's priorities. Second, new mechanisms for funding development assistance, such as the Global Development Alliance, are starting to be incorporated into Mission interventions[1]. Third, funding for the Central and Eastern Europe region, which has received the bulk of USAID's financial sector funds in recent years, is being scaled back. Fourth, USAID has undergone a substantial reorganization that resulted in the formation of the Economic Growth, Agriculture and Trade (EGAT) Bureau, which has been tasked with providing field support and technical leadership in all economic growth areas to USAID programs worldwide - including financial sector development. Finally, the international financial architecture is undergoing substantial changes that will have broad-

[1] *The Deloitte team did not undertake a review of the Global Development Alliance. However, there does seem to be an appropriate role for a partnership with the US financial services community in a financial sector strategy. Already GDA is involved in a project with international accounting bodies to introduce professional certification in USAID partner countries. Wall Street professionals are working with USAID on corporate governance issues through GDA. Moreover, USAID collaboration in the US Treasury's Financial Sector-led Growth Initiative may provide other avenues to increase market access for US financial services firms in developing countries.*

reaching effects on the development of many USAID recipient nations. These new challenges necessitated a review of USAID's financial sector activities and the role that EGAT/EG should play in supporting them.

Accordingly, the project was structured around five key questions, the answers to which would allow us to address the project objectives in an informed and fact-based manner. The key questions were translated into specific tasks, as seen in the graphic below which illustrates how the project was structured:



This paper represents the culmination of the project team's work and is intended to serve as a starting point for discussions in the Financial Sector Review and Strategy Forum to be held at USAID on December 11-12th, 2002. While the paper itself is concerned with Task 5 above, this summary provides highlights of the findings of the previous four tasks as they relate to Task 5.

Before moving into a summary of the team's findings, it is important to clarify the scope of the project and note its boundaries. The Financial Sector Review

and Strategy Project is, by design, neither exhaustive nor definitive. The project was never intended to be a comprehensive survey of global trends in the financial services sector, nor was it intended to be the final word in setting USAID's financial sector strategy for the next decade. Rather, the project suggests a range of alternatives that EGAT/EG and its counterparts within USAID can use to set assistance priorities and determine the optimal role for EGAT/EG to play in supporting USAID's financial sector development assistance - this paper serves only to start a discussion. The breadth and depth of our analysis was constrained by both time and data availability. The project, for example, addresses only technical assistance (TA) activities and not other forms of financial assistance like enterprise funds or on-lending programs. Moreover, no responsible analysis can ever be better than the data on which it is based. In reviewing USAID's financial sector work over the past fourteen years, the team was constrained by information that was not directly comparable across projects, unconfirmed, or simply not available. In some cases, the information that was missing was more telling than the information that was available - as the following pages will explain.

TASK 1: Reform of the International Financial Architecture

Findings: Most of the general reforms to the international financial architecture (IFA) are well known - work towards greater transparency and promotion of financial market stability, for example. The key issues are already being addressed at senior levels of government and international organizations, so it is unlikely that USAID would have much opportunity to influence the general direction of the reform process at this level. Nevertheless, there are clear opportunities for USAID to support and influence the reform process on a more practical level, by working in the context of the IMF and World Bank's Financial Sector Assessment Programs (FSAP) initiative. FSAP components include Reviews of Standards and Codes (ROSCs), evaluations of domestic financial systems' vulnerability to shocks (Financial Sector Stability Assessments - FSSAs), and identification of the main development needs of a country's financial system and the required follow-up measures (Financial Sector Assessments - FSAs). In 2000 and 2001 alone, the Bank and the IMF conducted FSAPs in some 35 countries and this effort has caused them to direct much of their technical assistance resources to surveillance activities.

Implications for USAID/EGAT/EG: The FSAP initiative impacts bilateral donors in three key ways. First, FSAPs have increased the demand for technical assistance. Developing countries with potentially deficient supervisory systems are requesting pre-assessment assistance in order to improve their FSAP results. Other countries that discover unanticipated deficiencies in the course of an FSAP are requesting help in correcting the deficiencies. Second, since FSAPs identify specific development needs, they make it easier for bilateral

donors to target their technical assistance activities. Third, FSAPs might provide a ready-made impact assessment tool - bilateral donors can evaluate the success of their initiatives in terms of the recipient country's tangible improvements against FSAP criteria.

Following are specific suggestions for USAID/EGAT/EG to consider based on Task 1 findings:

1. USAID can use the FSAPs as a point of departure for designing its own TA initiatives in some cases. EGAT/EG might disseminate FSAP reports and work with Missions to design projects- perhaps by developing sample Terms of Reference.
2. USAID might also use the available FSAP results as a part of assessing the impact of its own projects. EGAT/EG might provide a focal point for standardizing this assessment methodology and applying it across relevant Missions.
3. FSAP-oriented TA activities might lend themselves particularly well to public-private partnerships. For example, twinning arrangements with US banks might be established to help a developing country's banks learn how to comply with higher regulatory standards. EGAT/EG could support Missions by helping to facilitate these partnerships.

TASK 2: Domestic and International Players in FS Development

Findings: Deloitte's Task 2 report discussed the recent activities of key players in financial sector development in some detail, ranging from international forums such as the G7 and the Financial Stability Forum to the regional development banks and the major bilateral donors. Three major findings of this report stand out in terms of their relevance to the future direction of USAID financial sector activity and EGAT/EG's potential role in supporting this activity.

The most salient finding is that there is a dearth of rigorous, objective evaluations of the impact of donor assistance projects. While approaches vary among agencies, few donors can consistently present comprehensive or measurable impact assessments. This suggests an opportunity to improve project selection and design by more systematically collecting and then more rigorously building on the lessons learned through past experience.

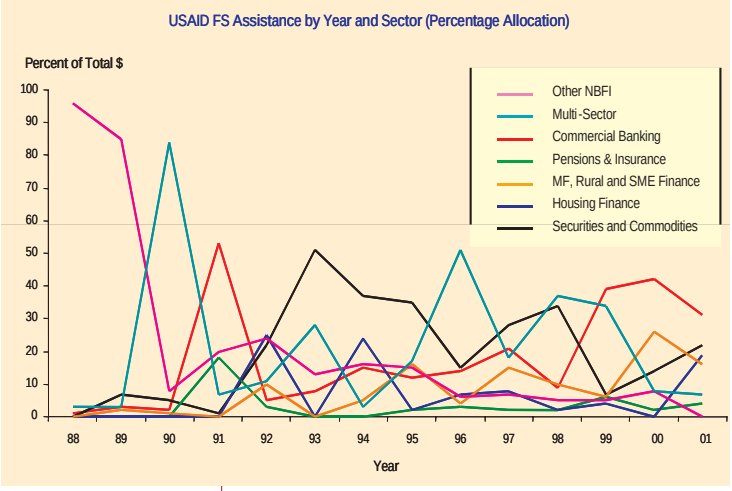
Two additional findings relate to USAID's comparative strengths and weaknesses among major donors. First, USAID has a substantial advantage over multilateral donors in that it can fund relatively large TA programs with grant funds, rather than loans, over a longer period. Second, USAID may not be as well equipped as some other donors to design and manage regional programs - this is due to USAID's fairly decentralized structure that places most program-

ming authority within country Missions - while this structure is a drawback in this context, it of course conveys other advantages.

Implications for USAID/EGAT/EG: First, EGAT/EG might support the Missions by developing and maintaining a consistent, objective impact evaluation methodology for financial sector assistance projects - this concept is discussed in more detail in the following pages. Second, USAID should continue to cooperate closely with other donors and take on areas of assistance in which it has a relative advantage. Finally, EGAT/EG can play a strong role in initiating and coordinating regional (cross-national) projects.

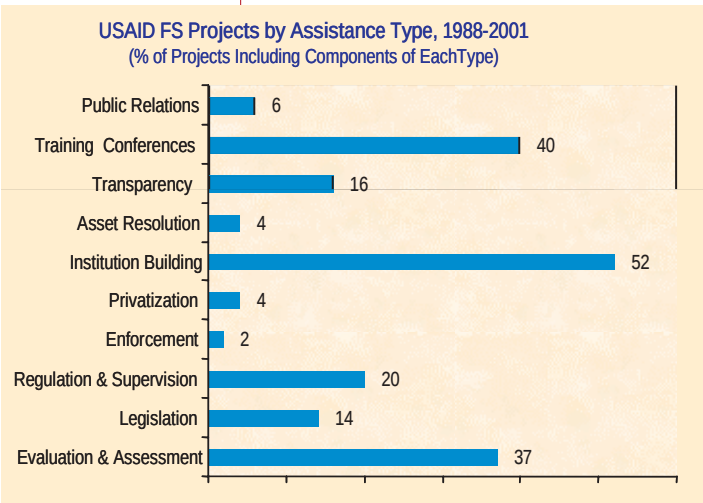
TASKS 3 & 4: USAID and EGAT/EG Financial Sector Activities, 1988-2001

Findings: Deloitte undertook an in-depth study of USAID's work in financial sector development over the past fourteen years, relying on the Agency's project files and complementary sources for primary data. During this period, USAID spent just over $1.2 billion on financial sector development TA through 761 separate projects in 87 countries - well over half of this amount went to countries in the Europe and Eurasia region. As alluded to earlier, however, the information that was missing was more telling than the information that was present - there were very few evaluations of the impact of any of the projects, and those that did exist were incomplete and the formats and contents were inconsistent with each other. This was the first and most striking finding resulting from this component of the project.



The second key finding was that USAID's financial sector assistance fluctuated fairly widely across sub-sectors during the period of analysis. For example, TA projects in the area of pensions and insurance accounted for 18 percent of total spending in 1991, but fell to 3 percent in 1992 and never rose above 4 percent thereafter. Assistance in the area of securities and commodities made up more than a third of the total in 1998, fell to 7 percent the next year and rose back to nearly a quarter by 2001. Over the same period, aid to the commercial banking subsector rose from 9 percent in 1998 to 39 percent in 1999, but had fallen back to less than a third of the total by 2001. The chart on the following page illustrates USAID's spending patterns across financial subsectors over the past fourteen years.

The high level of fluctuation across subsectors illustrated here could be skewed somewhat by a small number of large projects or, given that projects are largely designed by Missions rather than by a centralized unit, the pattern might represent a responsive approach to changing needs across a large number of countries and a long period of time. However, the wide changes in the allocation of funds could well represent a relatively random or "fashion"-driven approach to funding priorities. In any case, the data suggest that USAID might look more closely into the criteria and processes used to determine assistance priorities both within and across Missions.



The team also analyzed the available data in terms of the types of assistance provided, using the ten categories shown in the chart below. Three observations stand out: first, only just over a third of projects involved an assessment, so for every project that conducted some sort of initial assessment to determine assistance needs, there were nearly two that did not do so. Second, less than 2 percent of projects addressed enforcement or surveillance - even of 136 projects that were aimed exclusively at regulatory agencies, only 5 included any work on enforcement. Third, only 6 percent of projects included a public relations component - even including those related to politically sensitive issues such as pension reform. On the positive side, more than half of USAID's financial sector development projects addressed institution building and about 40 percent included training.

Implications for USAID/EGAT/EG: The first two findings described above - a lack of impact evaluations and an apparently random fluctuation of assistance across subsectors - together suggest that EGAT/EG might support Missions by designing and helping implement a standard impact evaluation methodology that can be used as an input into the priority-setting process. The relative lack of attention to issues of enforcement suggests an opportunity to focus more on this area as appropriate in each recipient country. Half of all USAID projects over the past fourteen years dealt with legislation, regulation/supervision, and transparency. Assuming that these projects enjoyed at least some success, it stands to reason that a logical next step might involve helping financial sector regulators to monitor and enforce institutions' compliance with new regulations. Finally, the fact that only a very few projects included a public relations component is surprising when one considers three observations. First, many USAID projects potentially affect a large portion of recipient countries' populations - pension reform is one example, but there

are many others. Second, USAID projects promote regulatory and legal reforms that can often be controversial or that can negatively impact powerful vested interests - such projects need to create a "pro-reform" constituency if they are to succeed. Third, one of USAID's overarching objectives is to promote US interests - this objective is obviously served by "advertising" the benefits that USAID's assistance programs often deliver to recipient countries. Considered together, these three facts suggest that USAID might consider making public relations a more regular feature of its projects.

Top Ten Suggestions for USAID/EGAT/EG

The Executive Summary of Deloitte's Tasks 3 & 4 Report includes a more detailed analysis of USAID's spending patterns in financial sector development (FSD) assistance. Based on this analysis, the Report offers ten specific recommendations for USAID, summarized below. Please refer to the Tasks 3 & 4 Report for more detailed explanations of the recommendations.

1. Confirm or revise the current means of determining FSD spending levels
2. Assess the ways in which Missions prioritize and fund FSD projects
3. Allocate funding and know-how to evaluating project results
4. Continue to support legislation, regulation and supervision for with emphasis on MFIs and other NBFIs, as needed
5. Focus on enforcing existing laws and regulations rather than creating new ones
6. Emphasize the importance of public relations in more projects
7. Craft projects in response to specific country needs, not according to general trends
8. Allocate sufficient financial and human resources to central functions
9. Find opportunities to cooperate with USAID programs in other sectors
10. Strengthen the links between FSD and poverty alleviation.

TASK 5.1: Key Issues in Financial Sector Development

Findings: EGAT/EG asked Deloitte to identify global trends or issues in financial sector development that might affect the direction of USAID's programs in the near future to supplement the findings of the first four tasks. It is clearly important to understand the issues that USAID's projects might address in the future in order to determine how EGAT/EG can best support those projects. Before summarizing the key issues and considering how USAID might best respond to them, it is important to note three caveats. First, this list is by no means exhaustive - it includes some key developments that, in our opinion, could be relevant for USAID as it develops its financial sector strategy and determines the optimal role for EGAT/EG. Second, while micro- and SME finance are obviously important, they are not discussed here[2]. Those sectors are often neglected by the formal financial sector and donors have dedicated significant resources to promote SME growth as SMEs are considered to offer great potential for the creation of economic growth. However, because donor projects in these fields are typically more concerned with extending the reach of financial services rather than improving the intrinsic stability or performance of the financial sector and because micro- and SME finance can be a specialized discipline, we have not included it in this paper. Third, and most importantly, this list is not meant to form the basis of a blueprint for USAID's financial sector development activities for the next decade. As mentioned,

[2] *However, it should be noted that during the course of this project, a white paper on Microfinance was presented to EGAT/EG management for their review. Furthermore, comments on micro- and SME finance which could expand the reader's understanding of one contractor's perspectives on these financial subsectors can be found in Appendix 2.*

USAID should continue to craft its projects in tailored response to country-specific needs and resist the temptation to follow or anticipate trends. As per EGAT/EG's guidance to us, allocation of funds will of course continue to be driven primarily by local (or in some cases, regional) development needs, with an understanding of global trends in mind.

The five key issues in financial sector reform that are most likely to affect a large number of USAID client countries, with implications for the Agency's funding priorities, are as follows:

1. **Globalization, consolidation and convergence** of markets and intermediaries, which has already had a profound impact on financial sectors in many developing countries. Several countries, for example, are considering establishing single financial sector regulators to better supervise integrated and increasingly complex activities of financial institutions.
2. Improved **information disclosure and governance**, cornerstones of IFA reform, designed to promote greater transparency and accountability - and thus better protection for investors. FSAPs and particularly ROSCs, as mentioned, have proven a useful tool for identifying and prioritizing countries' needs in this area.
3. **Electronic finance**, which is spreading quickly even among developing countries, and affects not only securities trading, but basic banking and a number of other areas. The advent of e-finance could give some developing countries a chance to "leapfrog" their way into the global economy, yet also introduces new risks and challenges for less sophisticated players.
4. **Safety net reforms**, such as pensions, deposit insurance and investor protection. The former will grow in importance in developing countries in Asia and Africa as their populations rapidly age, and the latter two have become critical in the wake of recent crises. These areas all share the key effect of mobilizing savings and protecting the vulnerable.
5. **New financial products and tools**, which have done more to transform the character of financial markets than any other development over the past twenty years. They have created new sources of finance, induced disintermediation and enabled better management of risk. However, they also increase market complexity and the associated challenges of regulation.

Each of these trends presents a range of new policy, institutional, and human resource requirements for financial institutions and regulators in developing countries - and this in turn creates new opportunities for USAID to provide more valuable and targeted assistance to its client countries.

The table on the following pages summarizes some interventions, among many, that USAID field Missions might consider in light of these global financial sector developments mentioned above.

Table 1: Interventions

	Technical Area	Indicative Donor Interventions Driven by Trends
Globalization, consolidation and convergence	Crises Mitigation	• Development of contingency plans for crises management and mitigation (lender of last resort policy, capital market master planning, bank resolution master planning, etc.) • Mediation and design of cross-border cooperative arrangements for insolvency reform • Insolvency system reform • Develop innovative mechanisms for banks and regulators on the resolution and workout of troubled debt
	Capital Markets	• Targeted TA for the implementation of FSAP recommendations • Assistance in meeting EU integration requirements (CEE countries) • Support harmonization of regulatory standards and trading mechanisms - i.e. establish assistance packages that focus on standardized technology packages so that it would be reasonably easy at a later stage of development to move toward global or regional integration • TA for the deepening of financial markets. This may include new product innovations as described below, and/or more traditional product categories, such as government bond markets, that form the bedrock of fixed income markets
	Regulation and Supervision	• Support for developing regulatory strategy, policy frameworks, and market-development oriented approaches for banks and non-banks • TA to improve the legal framework and supervisory capacity for consolidated regulation (with the entry into those markets by international financial conglomerates). • Support for the implementation of policies and guidelines on the proposed new Basle guidelines • Support for implementation of risk-based supervision and early warning systems • Support for the design and implementation of integrated supervisory structures that link banks and non-banks • Mediation and design of cross-border and domestic cooperative arrangements that broaden oversight and improve regulatory coordination • Development of intervention and resolution frameworks for distressed institutions • Assistance in developing mechanisms that catalyze interaction between regulators and the institutions they supervise • Support in the development of SROs; assistance in integrating SROs into formal regulatory operations • Legal reform, including strengthening administrative agencies, developing legal standards for judicial review of supervisory decisions, alternative dispute resolution
	Banking and Non-Banking	• Support for the development and implementation of risk management systems and procedures in response the proposed new Basle guidelines • Assistance in meeting EU integration requirements (CEE countries) • Support growth in non-bank subsidiaries such as leasing and insurance companies
	WTO Accession/Trade	• Build the institutional capacity to supervise and regulate a liberalized financial sector in line with international standards
Information Disclosure and Governance	Accounting, Auditing, and Disclosure	• Continue efforts to adopt international accounting and auditing standards by: strengthening the accounting and auditing profession; development of national policies on auditor independence; development of sustainable SROs, assisting enterprises and institutions in converting their accounts to IAS, and harmonizing local accounting standards with global standards • Support for the development of laws and regulations for better disclosure; assist in the establishment of enforcement procedures and evaluative frameworks to ensure compliance with disclosure standards • Support development of credit bureaus
	Market Discipline	• Develop mechanisms that increase the role of market discipline in the operation of financial markets • Develop systems and tools that collect, aggregate, and disclose information on intermediaries, enterprises, financial products and markets (e.g. credit rating agencies, shared credit systems, etc.)
	Corporate Governance	• Assist countries to build legal framework and institutions to comply with the OECD principles of corporate governance • Increase measures for improved public sector governance, in particular of state-owned banks and asset management companies • Establishment of mechanisms to strengthen shareholder activism and communication of shareholder rights • Support in the design of governance structures for public institutions and agencies

	Technical Area	Indicative Donor Interventions Driven by Trends
Electronic Finance	Regulation and Supervision	• Assist in establishing new central policies on the regulation, extension of assurance, and payment systems access of e-finance operations • Assist in evaluating the macro impact of new operations and exposure (e.g. on lender of last resort policies, commercial organization, and market structure) • Support revision of the legal framework for protection of consumers and investors • Support for the strategic evaluation of e-finance opportunities • Development of new institutions or mechanisms that leverage e-finance to increase access to financial services in under-served areas
Safety Net Reform	General	Country assessments of safety net extension from the point of view of: suitability, design, efficiency, breadth of coverage, regulation and governance
	Pension reform	• Support for the overall development of pillar private pension schemes (policy, regulation, governance, financial management, advocacy and outreach, and capacity building) • Support for the reform and strengthening of state pension operations Assist in the set-up, organization, function and design of a pension supervisory agency • Develop pension regulations (licensing criteria for pension fund management companies, advertising guidelines, asset segregation and minimum capital/reserve requirements, investment rules, disclosure and reporting requirements) • Assist in upgrading technology for data collection and analysis to support the pension supervisory agency, pension funds and individual pensioners
	Deposit Protection	• Assessment of the suitability of depositor protection arrangements. • Support for the best practice design and development of deposit protection schemes • Assistance in the design and implementation of public consultation studies • Development of risk-based pricing approaches • TA for: improving the coordination between regulators and deposit insurance agencies; developing pricing mechanisms, reforming existing systems
	Investor Protection	• Assistance in the development and regulation of investor protection funds • Assistance in the strengthening of capital markets regulation for more precise protection of investors
New Financial Products	Derivatives and Securitization	• TA for the development and application of new product-market deepening technology; assistance in using this technology to facilitate financial intermediation where structural barriers that stand in the way of normal market development • TA on the public policies and regulation governing new technologies/products Assistance in the development of risk management policies and procedures for new products • Assistance in the development of risk management policies and procedures for new products • TA for the development of an enabling environment for special purpose vehicles, trusts, and other contractual vehicles - legal structures that facilitate risk-fencing of risk, the separation of ownership interest from beneficial interest, or secure capture of cash flow/collateral for pass thru securities • Market education, outreach and policy assistance on new technologies
	Credit Products	• Support for the development of credit products by: product design, training, infrastructure development, rating systems, etc • TA for the development of mortgage markets • TA for the development of corporate bond markets
	SME Finance	• Assistance to banks in developing strategies and service offerings under *SME banking.* (This goes beyond SME finance to include whole business strategies leveraging distribution channels, deposit products, and non-credit services) • Assistance to NBFIs and/or MFIs in providing SME-specific products

TASK 5.2: Potential Roles for the Office of Economic Growth

The majority of USAID's financial sector work will continue to be designed and implemented at the country level, based upon specific country strategies developed by the Missions. However, EGAT/EG has an important role to play in supporting the Missions' work and helping to ensure the ultimate success of their projects. Specifically, EGAT/EG has two objectives with regard to supporting the Agency's financial sector development work:

1. **Field Support:** At the country level, EGAT/EG should continue to provide information to Missions to assist them in selecting which technical assistance projects to support. When possible, EGAT/EG should assist Missions in project design, through its own resources and by facilitating access to contractor and USG resources through its global mechanisms. EGAT/EG might also consider taking on a more active role in ensuring that projects chosen by Missions and Regional Bureaus are well implemented. As mentioned, designing and rolling out a standardized impact evaluation methodology might best further this objective.

2. **Technical Leadership in New and Existing Programs:** EGAT/EG should promote excellence in ongoing field programs and should help lead other programs in technical areas that are new for USAID and that address key issues in financial sector development. Activities to support this second objective could include knowledge management, research and staff training, as well as coordination with other donor organizations.

We would suggest that a third area in which EGAT/EG might take on a leadership role would be in the design and management of cross-national (regional) programs. Some financial sector problems cannot be addressed effectively at the country level, or otherwise lend themselves to a regional approach and provide benefits that are not easily identifiable at the country level. In other areas, a regional approach can create important economies of scale. The development of capital markets among the smaller Balkan countries is one example, while harmonizing disclosure or accounting requirements for cross-border transactions is another.

A fourth broad area in which EGAT/EG might enhance its support for Mission-driven financial sector development work is in regard to assisting client countries meet WTO conditions for trade in services. WTO access has increasingly become a prominent part of many USAID country strategies, and leadership in this area from Washington could be as important as leadership from the field. Also, financial markets in some regions are beginning to integrate and regional blocs seem to be developing in the Balkans, Southeast Asia and perhaps also Central Asia. There would appear to be a need for a central USAID unit to initiate and monitor financial sector programs in response to these changes, and EGAT/EG would be well placed to take on this role.

Finally, EGAT/EG might consider initiating global programs that are consistent with its technical leadership mandate. EGAT/EG might work with Missions to implement pilot projects that address country-specific issues related to the key financial sector trends listed earlier. These projects would likely represent new approaches for USAID, would likely require specialized expertise that might not be available within a given Mission, and could require some research and conceptual work to be performed in advance of a project to identify common problems across countries and develop tools to be used in solving them. EGAT/EG is particularly well placed to launch such pilot projects because it can take on greater uncertainty than Missions - assuming its mandate explicitly includes innovation and experimentation with new project designs.

In considering the list of global trends and the possible interventions (See above), we suggest below some illustrative projects which meet the criteria for a global program for EGAT/EG to undertake. Such projects would be meaningful to many USAID partner countries over the next decade:

- **Financial regulation and supervision.** EGAT/EG, by conducting evaluations, might undertake an analysis of USAID's banking supervision projects to date, identifying what has worked and what has not. Using this data and projecting the future needs for regulation and supervision, EGAT/EG could identify those areas which require additional assistance. Based upon this analysis of gaps, EGAT/EG could suggest to Missions the scope and content of second and third generation projects, such as consolidated regulation and supervision, surveillance and enforcement as well as steps countries can take to support the development and reform of the IFA.
- **Compliance with international supervisory standards.** As described above, there is a need for extensive training and internships to upgrade supervisory capacity to meet international standards such as the Basle Core Principles or Basle II requirements, which can be done on a broad scale rather than by individual countries. EGAT/EG could employ implementers to design and deliver this training, sharing the costs of participation with Missions and with beneficiaries.
- **Rating agency/service development.** Under the new Basle capital adequacy framework, there is likely to be a significant increase in the demand for rating services, providing an additional target of opportunity for USAID work. As this is a relatively untested area (although the E&E bureau has done at least one such project in Hungary), EGAT/EG might initiate a pilot effort in specific countries. There may even be scope for GDA involvement, teaming with Standard & Poors, Moody's, Fitch, or other US-based rating services interested in investing in developing countries.

- **Regionalization of securities markets.** We propose EGAT/EG to undertake an initiative to determine how to harmonize or regionalize regulation, supervision, technology, and operations. A technical assistance gap analysis or analysis of the pre-conditions for harmonization could then be used to guide Mission development of statements of work.
- **Prevention of money laundering, terrorist financing, and financial crimes and related law enforcement** are key issues coming to the forefront and most Missions have not integrated these issues into financial sector programs. In parallel with the new World Bank initiative and those of the US Government, in collaboration with interagency partners, EGAT/EG could lead the Agency in tackling these issues on a global or regional basis.
- **Expanding markets through e-finance:** Again, this is an area in which EGAT/EG could take a technical leadership role in analyzing current research on e-finance, identifying potential interventions and then assisting Missions to design programs through which they could assist financial institutions to introduce technologies that lower operating costs and that make it possible to provide financial services more widely.
- **Expanding access to finance for SMEs and for the poor:** USAID has funded several large SME finance activities, the impact of which are still unknown. It is now critical for EGAT/EG to evaluate and synthesize the successes and failures of these SME projects for future project design. Also, USAID's commitment to microfinance indicates a commitment to facilitate access to finance for the poor. Opportunities aside from microfinance to extend finance to the poor through conventional institutions merit further study.
- **New financial instruments development,** which results in better diversification of products and improved financial intermediation, is another innovative area for USAID. Some ongoing projects (India FIRE, Jordan AMIR, others in E&E) have included financial instrument development, but there is little yet understood about the success of these interventions in bringing new products to market. Not only might EGAT/EG commission evaluations to support future project design, but it might also continue training efforts (such as upcoming debt and mortgage market seminars funded by the E&E bureau) across regions.

Aside from undertaking these potential global programs, there are four specific initiatives that EGAT/EG might consider leading in order to enhance its role in supporting USAID's financial sector development activities. These are as follows:

1. **Develop a general country classification system (topology)** to provide direction on types of technical assistance activities. While the FSAP/ROSC process provides useful data, it does not yet cover all USAID client coun-

tries nor does it address every aspect of financial sector development. There is still a need for a system of country classification that would give USAID staff a useful perspective on the position of a given country's financial sector relative to that of other countries - such a system might also prove a useful means of comparing project results across similar countries. One potential system would classify countries according to their vulnerability to financial crises, their commitment to reform, and the size of their financial sector. Classification according to this system would help determine what types of technical assistance would be most relevant and practical for each country. For example, support for non-governmental microfinance institutions in a country that is not particularly committed to reform would likely be more effective than direct assistance to the country's regulatory agency.

2. **Develop rapid responses to financial crises,** in cooperation with other donor organizations and other USG agencies. As a result of the research and conferences EGAT/EG has sponsored as part of its technical leadership, there might be scope for multi-year, multi-disciplinary regional implementation efforts in this area. EGAT/EG could play an important role in conducting research on effective (and non-effective) responses to past crises and possibly by contracting for a financial crisis rapid response team, to complement resources from US Treasury.

Table 2: Potential Roles for EGAT/EG

Scenario	Level of Resources		Area of Focus
	Staff	Program Funding	
Scenario A: Base case - Mission Support	2	$500,000	• Provide implementation guidance by drafting, negotiating, and managing the three global mechanisms: the SEGIR global contracting vehicles or their successors (SEGIR II); Cooperative Agreements, such as that with FSVC; and Inter-Agency Agreements • Undertake efforts to design country topology
Scenario B: Better Mission Support through Assessments and Evaluations	2	$2 million	*In addition to "A"* • Commission evaluations to be undertaken by CDIE and/or a contractor with the goal of developing material on lessons learned in those areas of USAID involvement • Analyze lessons learned in financial development and incorporating such practices into project designs
Scenario C: Improved Technical Leadership Through Increased Technical Staff	4	$2 million	*Differs from "B" in that there are more technical staff to:* • Conduct or participate in assessments and project design in response to Mission requests • Partially overcome constraint of CTO limitations to draft statements of work and actively negotiate and manage global projects. Accordingly, there will be scope for more active projects such as pilot programs
Scenario D: Center for Financial Sector Reform	6	$5 million	*In addition to "C"* • Dedicate resources to coordinate with other donors and FSAP program in order to assist missions in programming financial sector interventions consistent with international financial architecture • Undertake multi-year regional or global activities • Increase research capacity

3. **Design, pilot and roll-out a standardized impact assessment methodology** to evaluate USAID Missions' financial sector development projects. As mentioned, the lack of rigorous or objective project evaluations was one of the more striking findings of our project. It is obviously difficult for any organization to learn from its own experience if the results of that experience are not objectively measured and catalogued. Certainly, systematic evaluation of project results can help USAID improve project selection and design going forward, but it can also help in selecting contractors by providing an objective means of evaluating their past work. Finally, systematic project evaluation can help USAID demonstrate tangible impact - and thus secure continued support from US policymakers.

Of course, the degree to which EGAT/EG is actually able to support global programs or launch initiatives such as the ones described above depends on the level of resources that USAID management expects to dedicate to the office. Depending on this variable, the team has assembled four indicative scenarios describing potential roles for EGAT/EG. The scenarios are cumulative - that is, Scenario B encompasses the activities under Scenario A and so forth. The table on the previous page summarizes the four scenarios. Again, these are meant as discussion-starters rather than as a definitive blueprint for EGAT/EG.

As mentioned earlier, this Executive Summary sought to provide a brief review of the Financial Sector Review and Strategy Project that will culminate in the Forum on December 11th and 12th. This summary, like the project itself, is neither exhaustive nor definitive, but rather was intended to identify key trends in financial sector development and lessons learned from past experience that can inform USAID's future activities in financial sector development, and to identify realistic options as to how EGAT/EG can best support USAID's FSD activities.

The remainder of this report describes the results of Task 5 in greater detail and is organized into three chapters: 1) an introductory section that lays out the rationale for financial sector reform in the context of USAID's broader objectives, 2) a detailed discussion of the five global developments in financial services that were summarized earlier, and 3) a more in-depth discussion of alternative ways in which EGAT/EG can enhance its support for USAID's financial sector development work.

II. INTRODUCTION

This report is commissioned by USAID's Office of Economic Growth, carried out by Deloitte Touche Tohmatsu, and "proposes options for G/EGAD/EM [sic] (now EGAT/EG) to consider as important roles and activities over the next ten years. These options will be positioned in the context of an overall framework (strategy) that identifies intervention type and regional focus in light of trends in financial markets globally as well as changes in the international financial architecture." This is the concluding paper of a series of four papers. The previous three were:

1. Review of International Financial Architecture

2. Role of Domestic and International Players in Financial Sector Reform

3. USAID's Recent Efforts To Improve Financial Markets' Efficiency

The strategy put forward in this report is based upon professional judgment and long-standing experience with the USAID organization, its programs, and with financial sector reform activities globally. It is not based on exhaustive evaluative data. While substantial information on inputs was available (i.e. project costs, contracting mechanisms, statements of work, etc.); very little information concerning outputs was available. The lack of significant project evaluations and the fact that we limited our work to Washington and conducted no field visits make it difficult for us to postulate the extent to which USAID has achieved development impact. Accordingly, rather than looking backward, the review is framed in such a way as to help EGAT/EG determine its roles and activities in the future.

The paper begins with a proposed framework or strategy for USAID's financial reform programming in Chapter I: Considerations for a Financial Sector Strategy. We reconfirm why financial sector reform is relevant to USAID's present and future mandate. Also, the first chapter discusses in detail two factors that are critical in determining USAID's financial sector strategy: 1) the areas of USAID's competence and comparative advantage in providing technical assistance, and 2) the diverse conditions of the countries in which USAID works. We describe how USAID might apply a structured methodology (termed a topology) to determine which particular reforms to pursue based upon the characteristics of countries it assists and current global trends. We go on to identify the types of assistance that would likely be appropriate for USAID to provide to countries in each of the categories.

In Chapter II, with these factors as background, we describe key developments in the structure of financial markets globally. Namely, the review identifies trends in the financial sector and their implications for the growth of domestic financial markets in USAID-assisted countries. These development issues are consolidated into five sets of trends for ease of understanding. In addition to

these, there may be other trends not discussed in this paper, which we have determined to be either relatively less critical to developing countries or overshadowed by those discussed.

The influence of the change in the structure of international financial markets on USAID technical assistance programs is sufficiently important that we open Chapter II with an in-depth review of these trends[3]. In our first paper, Task 1 Report: Reform of the International Financial Architecture, we cite the efforts of international financial institutions (IFIs) and central banks to change the International Financial Architecture (IFA) to accommodate those trends. Because relevant policy decisions will be made in finance ministries and central banks, USAID staff are unlikely to have a role in designing IFA changes. We found, however, those institutions where financial sector activities are important, such as the World Bank, and those whose sole mandate is financial sector soundness and efficiency, such as the IMF and the US Treasury Department are providing more and more resources for surveillance. Yet, technical assistance needs are growing, due for the most part to the deficiencies discovered in these surveillance efforts. USAID assistance will be called upon to assist in implementing the needed reforms to fill the gap between existing and sound financial systems in developing countries.

To promote development, USAID-assisted countries must adjust their internal financial sector policies and institutions to adapt to the parallel trends of globalization, consolidation, and convergence among financial markets and intermediaries. Fortuitously, USAID efforts to change internal policies and institutions to accelerate development also contribute to financial stability. USAID's technical assistance to central bank regulators, and to the whole range of regulated financial institutions, generally entails training in prudential controls and stresses accounting transparency. Among their other virtues, these measures reduce the opportunities for the excesses that economists identify as the principal cause of international financial crises. We conclude that much of USAID's technical assistance promoting development has also supported resistance to the instability associated with integration of markets worldwide.

However, in concentrating on creating the elemental policies and institutions of competitive domestic financial markets, USAID has not yet substantially addressed some of the implications of the trends toward convergence and concentration among markets and institutions. One well-used example is that evidence now suggests that stock markets will not survive in small countries. So, we conclude that in contrast to USAID's past programs to assist each country create its own stock market, USAID's staff may in the future assist efforts to

[3] *It should also be noted that specific country situations are also a key factor in determining USAID programs. See section I.B.*

consolidate share trading systems into regional systems. There are likely to be other areas in which a regional or supranational approach might be more effective than a strictly national approach.

Chapter II goes on to describe four other sets of trends that will impact considerably USAID's future work: improved information disclosure and governance, e-finance, safety net reform (including pensions, insurance, and deposit insurance, among others) and new product development. The Chapter also sets out illustrative types of technical assistance that the Agency could pursue related to each major trend or issue area.

Chapter III proposes options for EGAT/EG's strategic involvement in financial sector development. What EGAT/EG can reasonably accomplish is directly related to the human resources and program funds it commands. Accordingly, we put forward a scenario analysis that takes into account varying levels of EGAT/EG's resources. We recommend that EGAT/EG management should match the strategic, central resources dedicated to the financial sector to USAID's future intended commitments in financial sector reform. This match should ensure that the technical areas of focus are pursued in a manner to achieve improved project selection and design and improved project implementation that will deliver accelerated economic development.

II.A. CONSIDERATIONS FOR A FINANCIAL SECTOR STRATEGY

II.A.1 Why Financial Sector Reform Is Critical to USAID's Mandate

It is widely agreed that financial sector reforms are among the key actions required to achieve dramatic reductions in poverty as well as sustainable economic growth. Therefore, financial sector reform is relevant to the work of all USAID staff who provide technical assistance, and see their work as primarily concerned with poverty reduction or general economic growth.

This is because financial markets are directly linked to people's use of, access to, and control over assets such as knowledge, technologies or infrastructure. The quality and quantity of workers' tools or assets determine the quality and quantity or their output. Financial markets, in turn, determine who can use existing assets and who can use greater and better assets. People's livelihoods - particularly those of the poor - largely depend on a strong financial sector.

USAID staff care about financial institutions and policies because improving them accelerates the creation of additional productive resources and facilitates getting those resources to the employers and self-employed workers who will put them to the most efficient uses. Improving the financial sector in a developing country accelerates growth in its stock of assets - buildings, technology, and management skills - and increases the efficient use of existing stocks of

such resources by employers and by the self-employed. In turn, such improvements increase a nation's output, thereby contributing to poverty alleviation and economic growth.

It is well known that, since USAID's early days, dozens of countries have failed to begin building - or having begun, have failed to complete building - the financial institutions and policy systems that would move productive resources to their most efficient uses. Misguided and interventionist government policies as well as underdeveloped financial institutions have discouraged both foreign and domestic investment, thereby preventing creation of additional productive resources. In such environments, resources have been put to inefficient uses, often in government-owned businesses and private monopolies. As a result, workers have fewer tools than they might otherwise have, employers use tools and workers less efficiently, and production is less than it might otherwise be. Thus, people who may have had the opportunity to experience welfare improvements if provided with more tools applied more efficiently, remain poor.

Extensive, but incomplete, reforms that initially supported growth are also not sufficient in the long run. For example, in Thailand, Indonesia, and Korea, unreformed aspects of those countries' financial sectors brought economic instability that interrupted growth and plunged millions into unemployment and reduced circumstances in 1997 and 1998. Concerns about the repeat of such crises has sharpened the focus on developing countries' financial markets by IFIs, such as the World Bank and the International Monetary Fund (IMF); bilateral donors (e.g., USAID); and organizations such as the Bank for International Settlements (BIS), Organization for Economic Cooperation and Development (OECD), and the Financial Stability Forum (FSF).

USAID has funded technical assistance for financial sector reform in at least 761 cases at a cost over $1.2 billion during the period from 1988 to 2001[4]. The Agency is an important actor in the provision of technical assistance for financial sector development, undertaking about 50 projects per year and spending between $60 million and $100 millions annually. Compared to other donor agencies, USAID has been particularly important in the economic transitions of

[4] *See the third paper in this series, Batchelder, et al., Tasks 3 and 4 Report: USAID's Recent Efforts To Improve Financial Markets' Efficiency. The figures were produced for this project by Deloitte Touche Tohmatsu and were not directly provided by USAID. The dollar figures represent the contract amount obligated, based upon the 761 project statements of work analyzed by our team. They exclude any funds provided for on-lending (direct financial assistance) or guarantees. Our team did its best efforts to collect all relevant information, however, the quality and quantity of data available for each project varied widely. In the period of 1994 to 1996, these annual figures were at $100 million, the peak level of activity in the E&E region. Before and after those peak years, the average annual figure is $60 million. We believe the figures to be comprehensive, but do not guarantee their accuracy.*

the countries of Europe and Eurasia (E&E) and the Middle East, as well as in the areas of banking supervision, securities market development, and micro-finance.

The other donors and the IFIs have, over the same years, devoted more and more resources towards assisting policy reform and institution building in financial sectors[5]. Some host governments are becoming increasingly able to extend financial sector development without outside help. USAID's challenge is to identify those situations where needed reforms would not be made without U.S. assistance and where aid and host-government self-help will contribute to dramatic gains against poverty and suffering - a sort of triage approach to funds allocation.

USAID's development work has been and will continue to be done primarily through its Missions. At the same time, it is expected that EGAT/EG will continue to guide Mission and bureaus in selection, design, and implementation of high priority financial sector programs. The vision of current EGAT management is that EGAT/EG's overriding objective should be to support the Mission's core services of project selection and implementation, while providing technical leadership. In pursuing this objective, EGAT/EG faces a number of key challenges, such as:

- Which programs should EGAT/EG suggest the Missions select?
- It should also be noted that specific country situations are also a key factor in determining USAID programs. (See section I.B). What are the implications of the key issues in financial sector development for EGAT/EG?
- How will EGAT/EG support Missions and provide technical leadership that allows USAID to capitalize on its comparative advantages?

Many factors specific to, and independent of, financial sector development will affect these decisions. The answers to these questions cannot easily be deduced, because, above all else, the options for EGAT/EG are determined by the decentralized structure of USAID and budgetary considerations.

II.A.2. Factors that Influence USAID's Programs

USAID's evolving programs must take into account the changes in the structure of global financial markets. Within this context and as the provider of financial sector leadership for USAID, EGAT/EG should encourage a process that includes a rigorous analysis on a country-by-country basis that will indicate an appropriate USAID program for each country, based upon the following factors (some of which could be directly correlated):

[5] *See the second paper in this series, Garcia, et al., Task 2 Report: Review of Domestic and International Players in Financial Sector Reform. We estimate that the donors and IFIs spend approximately $700 million per year on financial sector reform.*

1. The USAID budget as compared to the size and type of technical assistance required;

2. What other donors are doing ;

3. USAID's ability to influence financial sector policy makers;

4. US foreign policy objectives;

5. USAID's current level of competence in the country and technical area (discussed below);

6. The political, economic, social and legal/regulatory characteristics of the country (which we also discuss further below) and the circumstances of the development of its financial sector.

Because of the relatively large array of possible interventions available to assist financial sector development in any one country, USAID's scarce resources must be allocated wisely to achieve optimum developmental impact. Consideration of different initial conditions in each country will help in determining not only how to proceed with reforms, but also how to sequence those reforms.

Those involved in implementing changes in the IFA, especially the World Bank and the IMF, are primarily concerned with maintaining financial stability and avoiding financial crises. As such, they advocate for the implementation of massive critical reforms simultaneously. Such an approach often requires several donors (or their contractors) to work on different pieces of the domestic financial market at the same time. Which "piece" USAID chooses to work on may be determined by what it has done before and how much money it has to offer.

Politics are another intervening, and sometimes confounding factor in developing a strategic approach to financial sector reform. In the United States, many Congressional policy makers believe that foreign aid should be considered part of the national security budget. USAID's involvements in post-conflict countries such as Kosovo or Afghanistan are examples of the implementation of that perspective. Such decision-making results in a situation in which a relatively small financial system, such as that of Kosovo, receives $53 million of US foreign assistance money for financial sector reform. Other countries or regions with needs that may be considerably larger remain neglected. The amount of financial sector development work being undertaken in Kosovo is large, and arguably disproportionate given its influence on global financial markets. USAID is the primary donor providing financial sector assistance in Kosovo. This situation meets the US political interests in the area, but not necessarily those of the international financial system. The economy of Kosovo has little

impact on the stability of the US dollar or the euro and is not a large potential market for the US financial services industry. Nevertheless, political stability in the Balkans is linked to stability in Europe as a whole and therefore technical assistance in Kosovo has become a US priority. USAID's role in providing non-humanitarian assistance to foster economic growth is critical.

Given the considerable work this process entails, how do Missions obtain sufficient information to weigh these factors and make a determination regarding how and when to assist in financial sector development? We conclude that EGAT/EG has a pivotal and central role to play in providing this information to Missions.

USAID competence and country situations should be, in our opinion, the most important inputs to financial sector program development. Accordingly, we discuss them in greater detail. An understanding of USAID's level of competence or experience in the area requires that evaluations be conducted and that past scopes of work and resulting output be readily available. To understand country conditions, a financial sector assessment is probably required. Results of the Financial Sector Assessment Program (FSAP) overseen jointly by the Bank and the IMF are another important source of information. Below, we offer an additional suggested approach, in addition to an FSAP or structured assessment, which might yield the required information.

Areas of USAID's Competence In Providing Technical Assistance

As noted earlier, USAID's technical assistance helps governments take the multiple steps needed to implement lasting financial sector reform. Residence and consulting contracts permit Mission staff to respond as fast as or faster than other donors to requests for assistance. Despite the constraints of limited Congressional support for policy reform and a high level of earmarks, the numbers of financial sector reform activities identified in the course of this work (761) testify to USAID staff's success in mobilizing needed resources. As in the past, the USAID managers supporting financial sector development should continue to:

- Offer multi-year technical assistance as needed
- Deploy private sector skills quickly and in line with the requirements of specific projects
- Address special US foreign policy needs (e.g., Balkans, Afghanistan) as required

When assisting with financial sector reform, USAID's strength is the depth, breadth, and speed of response of the experts the Agency can field. On several occasions, USAID staff have stated that an area of USAID competence is

working with the private sector[6]. While other donors, such as DfID and the EU, may also work with private sector groups, USAID's philosophy of market-directed financial sector development is an area of strength. These strengths have continued despite the organizational changes affecting USAID's Mission network and its technical capacity.

The Agency's once very extensive system of well-staffed Missions has been reduced by Mission closings and by reductions in the number of staff assigned to Missions. Perhaps more important, USAID's internal stable of economists, MBAs, and other private business sector professionals, has been substantially reduced by resignations and retirements[7]. Fortunately, Mission cutbacks and the attrition of technical resources have been offset in four ways:

1. SEED and FSA funding facilitated financial sector reform in the former Communist countries by providing funding for personal service contracts with technical professionals and the Financial Services Volunteer Corps (FSVC).
2. Mission, E&E Bureau, and EGAT/EG staff arranged cooperative agreements and contracts with private consulting firms that provided generally speedy access to a wide range of highly knowledgeable financial area professionals.
3. To preserve assistance quality in the absence of Mission technical expertise, some 37 percent of consulting contracts required the contractors to begin their work with an assessment of needs and means of appropriate assistance.
4. Staff have arranged inter-agency agreements with USG regulatory agencies to obtain short-term technical advice from experienced professionals on their staffs.

In their financial sector work under USAID contracts and agreements, MBAs, economists, bankers, regulators, and other experts have gained many additional years of hands-on experience with the character of deficiencies, the barriers to remediation, and the means to help officials in governments - or at least in sub-sectors of governments - who are committed to reform.

Experienced professionals are available to or are at present working for USAID offices to move reforms forward. The work of USAID-funded technical professionals assisting the banking sector is a notable example. The following table

[6] *Our work on Task 2 of this project does not provide the level of detail to support or deny this claim. However, it is noted by USAID staff as a strength and is, therefore, important to recognize.*

[7] *For example, during the 1990s, at least 29 economists (listed in Tasks 3 and 4 Report) left the Agency while none were hired. In 2002, about 9 financial sector specialists on personal services contracts were released from the E&E Bureau.*

provides some examples of the types of work that USAID has accomplished through its financial sector development work.

Furthermore, USAID contractors have often stayed or returned to oversee implementation of their recommendations and to assist with making the many parts work together. While these activities apply to banking and banking regulation, the professionals contracted by USAID have addressed the same range of activities in securities markets, housing finance, microfinance, other non-bank finance institutions, and, although to a lesser extent, insurance and pensions.

Table 3: Examples of USAID Activities in Financial Sector Reform

Banking	Regulatory Oversight
Privatization of state-owned banks	Introduction of draft legislation and passage into law
Introduction and passage of banking legislation	Provision of new and improved policies
Implementation of higher quality bank organization and management plans	Trained regulatory, auditing and management staff
Implementation of new personnel and management policies	Assistance with workouts or asset resolution in failing banks
Programs to educate the public about the availability and use of banking services	Development of deposit insurance schemes

Inter-agency agreements with United States government (USG) regulatory agencies have stemmed from recognition by Missions, contractors, and Washington offices that all financial institutions that serve the public must answer to regulatory institutions that impose rules intended to assure transparency, accountability, fairness, and that prevent corruption. Sometimes using former staff from the US regulators, many USAID contractors have been directed to assist in formulating legislation and organization plans for host governments' regulatory institutions. Eighteen percent of the USAID task orders surveyed have concentrated on market regulators, and 36 percent provided technical assistance to both regulatory institutions and regulated financial institutions.

This appreciation of the regulatory role, and this extensive experience with both levels of institutions, are special competencies that USAID can offer its client countries. Simultaneous attention to the two layers of operation is in fact desirable, and is a principle to which USAID staff have aspired to a greater degree than other assistance agencies with the positive result of greater consideration of private sector/market considerations in policy development.

After reading 761 task orders and interviewing dozens of USAID staff, contractors, and professionals from other government agencies, we have found three main weaknesses that might be cited: 1) excess creation of stock markets for small economies; 2) training bankers in numbers beyond absorption prospects; and 3) failure as yet to concentrate on support for enforcement systems that will

assure the effectiveness of the many regulatory agencies USAID has assisted.

Allowing for the tendency of our interviewees to report that their work has gone well, we conclude that over the past dozen years, USAID's staff have generally been choosing financial sector projects sensibly and that the Agency's financial sector reforms appear to have contributed to both client country development and the Agency's policy goals. We further conclude that, in future, USAID offices should continue undertaking the kinds of institutional strengthening described above. Retrospective evaluations, focusing on lessons learned, could add considerable value to present and future work. Putting in place mechanisms for ongoing evaluation and exchange could also yield valuable information and contribute to improved programming.

Country Conditions

Adequate financial sector diagnostic studies are key to the ability of USAID staff to select projects knowledgeably. EGAT/EG should encourage general USAID use of the IMF/World Bank Financial Sector Assessment Program - by obtaining the publicly available outputs, the Financial Sector Appraisals (FSAs) and FSSAs (Financial Sector Stability Assessments). These provide thorough diagnostic tools that require no use of USAID resources. While highly desirable, USAID will likely not be involved in the formal FSAP efforts going forward. In lieu of such efforts, EGAT/EG should assist Missions to obtain the data that are produced as a result of the FSAP in each Mission's host country. Where FSAPs have not been completed or even undertaken, EGAT/EG should urge missions to consider obtaining an assessment, contracting for it if necessary, before arranging for any new financial sector initiatives - it is obviously important to understand and obtain agreement on what aspects of a country's financial system are 'broken' before making plans to fix them.

Topology: A Country Classification System

To assist in this process, we would propose that USAID, under EGAT/EG's leadership, consider developing a "topology", or country classification system, that can be used by Mission staff to develop a useful perspective on the position and performance of a country's financial system relative to that of other developing countries. This perspective would then drive the allocation of assistance efforts across subsectors of the financial system as well as the design of specific projects. While the FSAP process already provides useful information on the countries it covers, there are other, broader aspects that it does not cover - and these aspects are particularly important to consider in designing assistance programs.

For example, a national financial system that is highly vulnerable to crises - or

one that is already in crisis - would likely need different types of assistance than one that is merely small or underdeveloped. Countries in the former category might be best served through urgent assistance in bank restructuring, establishing asset resolution mechanisms or improving surveillance; while countries in the latter category would benefit more from training and capacity-building activities carried out over a longer time period.

In a situation of high vulnerability or actual crisis, perhaps the most important determinant of types of assistance is the degree to which the country's government has demonstrated its commitment to financial sector reform. It is widely acknowledged that donor assistance works best in countries where the government is committed to reform; but this acknowledgement is not always reflected in practice. This is not to say that all financial sector assistance should be ceased in countries with laggard governments; on the contrary, the poor of such countries are typically in great need of donor help. Assistance in non-reforming countries, however, might best be limited to working directly with non-governmental organizations such as microfinance institutions, or providing training on transparency and governance directly to privately-owned commercial financial institutions.

Finally, the types of assistance that would be most effective for a country with a relatively small financial market are likely to be different than those for a country with a larger market. As alluded to earlier, establishing a national stock market would seem to make more sense in, say, Rumania or Bulgaria than it would in Montenegro. Small countries, like many in the Caribbean, that have few or no nationally-owned banks may not need a full-blown bank regulatory capacity - New Zealand provides an instructive example of this model.

Therefore, vulnerability, commitment to reform and market size might be three of the main criteria that USAID can use in developing a more rigorous country topology. Each is discussed below:

Vulnerability To Financial Crises: Developing countries' financial systems differ in the breadth, depth and nature of their vulnerabilities. The key vulnerability comes from the expectation of liability holders that they might not be repaid, which in turn depends on the perceived strength of banks and other intermediaries, as well as the extent to which liability holders, such as depositors, believe that their government can or will step in to protect their interests. This vulnerability is exacerbated to the extent that liability holders' doubts pertain to institutions holding a substantial percentage of financial sector assets.

One potential, albeit imperfect, measure of vulnerability is the quality of the system's assets as measured by the level of existing and expected non-performing assets (NPAs). Countries with high levels of NPAs need systemic reform

to lessen the possibility of financial crisis. Countries with high levels of NPAs need not just bank recapitalizations that reduce NPA levels, but real sector restructuring to prevent recurrence of the problem in banks and to reduce the size of NPAs in other institutions. NPA levels, however, are somewhat of a lagging indicator of vulnerability and are specific to the banking sector. Other, more prescient and less subsector-specific measures should also be considered, such as perhaps foreign portfolio investment as a percent of total stock market capitalization.

Commitment to Reform: If a country is determined to be highly vulnerable to crises, it then makes sense to differentiate between countries committed to systemic reform and countries lacking commitment to reform. Admittedly, commitment to reform is difficult to measure in any quantitative fashion, but it should be possible to leverage Missions' experience and knowledge to develop fairly objective, if qualitative, indicators of this characteristic. At the time a financial sector strategy is being formulated, some vulnerable countries will be prepared to address their deep, systemic financial and real sector problems, while others simply will not. Such nations are rarely able to address longer-term development issues effectively when their short-term situation is problematic.

USAID should obviously avoid providing financial assistance to vulnerable countries that do not commit themselves to addressing the systemic problems that have caused their vulnerability. Missions may do best to hold support in finance at a minimum, consider assistance in other areas, and make it clear to the host government that USAID would support a serious reform program when the government demonstrates its commitment. Providing assistance through the mainstream financial institutions in these countries is likely to be counter-productive. Line-of-credit funds would likely be misused, that is, channeled to non-productive loans or loans that would not be repaid. Microfinance programs, however, may still be feasible and effective in these countries because these programs typically lie outside the financial core, utilize different intermediaries, and have staff not biased by crisis conditions.

USAID should likewise exercise great caution in providing technical assistance in such cases, because history shows that under such adverse conditions, reform activities are seldom successful and the support provided could well be wasted if target reforms are not implemented. TA could be provided to improve accounting and disclosure and provide honest rating services that could reveal the condition of the financial sector and its constituent firms. Learning about financial sector weaknesses might lead the press and the public to pressure authorities to embrace reform. Moreover, limited technical assistance to pro-poor NGOs offering micro- and SME finance independent of government interference might also still be promising in this context.

Market Size: Turning to countries that are not seen to be extraordinarily vulnerable to crisis, a primary distinction might be between countries with large and those with small financial sectors. Among "moderately vulnerable" countries, the large financial systems are quite diverse. It is feasible to support many activities in such systems, including capital market development, infrastructure or housing finance, pension reform, etc. While, we make several suggestions for project selection later in this report, there is no proven technique for identifying the best project in any given country. Attempting to do so would be misplaced. Rather USAID should continue to employ a pragmatic approach based in which project selection and design is determined by appraisals of past project results, USAID's staff capabilities and resources, host country priorities, US foreign policy imperatives, and the activities of other donors. Co-financing with other IFIs may be necessary for projects in large, diverse financial systems. Or, given the diversity of needs, USAID should choose projects within its staffing and funding capabilities. Still, it is useful to be mindful of what other donors are doing in order to avoid duplication and ensure strategic intervention.

A number of assistance programs that might be effective in larger countries are not likely to work well in countries with very small financial systems (60 countries have total financial assets of less than $1 billion). Studies show that countries with small financial systems benefit from importing financial services, particularly more sophisticated services, as their small size places them at a comparative disadvantage in producing financial services. Such countries may be best served by encouraging respectable foreign institutions to open branches in their country and having those branches supervised by the parent bank and its supervisor, rather than by building an independent financial system with domestic supervision. Alternatively, they could join other local small countries to provide regulation and supervision at a regional level as in CARICOM and CEGLA in the Western Hemisphere.

Overall we believe that size is an important consideration in financial development. The types of markets that are feasible depend upon volume of business. For example, only larger economies can support a securities market. Development of international e-finance, particularly in the securities market area, is likely to reduce further the viability of small markets - but at the same time, could make regional or global integration easier for small countries to achieve. In planning its country support programs, USAID should, in our opinion, consider the importance of scale and the comparative disadvantage of small countries in the domestic production of financial services.

Resource trade-offs may present an additional challenge to USAID Mission staff that are focused on one country. At a central level within USAID, priority should be given to countries that are vulnerable, but eager and willing to

reform. Countries whose financial markets are in a weak condition require technical and financial assistance, but that assistance will only be useful in countries that have committed themselves to reform and have demonstrated the political will to make the often painful decisions needed to rescue or strengthen their financial systems.

The table below provides an illustration of one potential classification process:

Table 4: Potential Classification Process

Condition of Financial Markets				
Characteristic	Highly Vulnerable (Systemic)		Moderately Vulnerable (not Systemic)	
	Willingness to Reform		Size and Complexity	
	Nonreforming	*Reforming*	*Small*	*Large*
Example	Nepal	Vietnam	Maldives	India, Thailand
Possible TA Types	• Microfinance • Disclosure and Governance	• Regulatory Reform • Asset Management	• E-Finance Access • Regionalism	• Pension Reform • New Financial Instrument

There are doubtlessly other criteria that can be useful in determining the most appropriate types of assistance for a given country, and the criteria we have proposed above are admittedly open to different interpretations. Moreover, once conceptual criteria have been identified and agreed upon, specific, measurable and objective indicators will need to be determined - developing a robust and useful topology is easier said than done. Our recommendation here is simply that USAID should consider developing a more standard, structured and objective approach to determine funding priorities among countries and selecting and designing projects within countries. The Office of Economic Growth would be particularly well placed to lead this effort, with substantial input from USAID Missions.

Once an initial topology has been developed, it can be tested and piloted in a number of countries and then revised as circumstances change. An election or other change in government can improve or decrease the authorities' commitment to reform, as has been seen in Asia and Latin America, for example. Natural or man-made disasters can increase a country's vulnerability. As the classification of the country changes, so will USAID's recommended options for TA and its country strategy. On an ongoing basis, EGAT/EG might take the responsibility to initiate the necessary rethinking and join with the USAID Mission in carrying out the assessment.

Eventually, a 'living' country topology that has been successfully field-tested and that yields reliable results might potentially form the basis of two other tools. First, USAID might develop separate topologies at the subsector level. A standard assessment mechanism could be designed, for example, to determine what type of assistance would be most useful in the pensions area or in commercial banking. Second, after sufficient experience has been accumulated, USAID/EGAT/EG might develop a "menu" of project types across and

within subsectors, possibly with sample terms of reference that Missions can use as a basis from which to tailor country-specific projects.

Finally, while the specific needs and characteristics of each client country are and should of course remain the prime determinants of USAID's Mission-level assistance efforts, it is also important to ensure that these efforts help client countries integrate their financial sectors into the global economy. Doing so requires an understanding of the main global issues and trends affecting financial sector development - precisely the subject of the next section.

II.B. KEY GLOBAL TRENDS IN FINANCIAL SECTOR DEVELOPMENT

II.B.1 Introduction

As described above, country-specific development needs should remain the primary driver behind the selection and development of USAID financial sector assistance programs. However, programs should take into consideration and reflect global trends in financial sector development to the extent they are relevant to the country in which the program operates. If helping client countries to integrate themselves into the international financial architecture is an overriding concern of all USAID programs, then it is important that USAID staff understand the larger trends that are affecting the global financial landscape.

This section describes several key trends in global financial sector development that we believe are most relevant to USAID in designing and implementing assistance projects in client countries. The analysis is based on developments in the international financial architecture (Task 1), the activities of domestic and international players (Task 2), and our own observations of the way in which institutions and markets - in both mature and developing markets - have responded to forces shaping their financial systems. As mentioned in the Executive Summary, it was not our intention to make a rigorous or exhaustive categorization of all major trends or to predict the form and structure of financial institutions and markets in the future. Trends are by nature generalizations, and none will impact every USAID country in the same way or be relevant for markets still building basic two-tier banking systems. Nevertheless, global trends provide an important background to country-specific project design because they represent the likely future of international financial markets, and the overarching goal of most technical assistance projects is to help client countries prepare for a future in which they can compete successfully in a global marketplace.

After discussing what we believe to be the most salient trends affecting the global financial marketplace, we provide examples of how USAID assistance

programs might respond most effectively to those trends, again subject to the primacy of country-specific considerations.

Important Trends

Over the last two decades, financial sectors globally have undergone a sea change. The key drivers of this change have been new technology, product innovation, opening of markets, and, ironically, financial crises. Technology has helped to reduce the costs of processing information and has empowered institutions to conduct transactions from around the world and created new platforms for trading almost every financial product imaginable. Product development has expanded the scope of intermediation from credit intermediation to risk intermediation. Broadened intermediation and the convergence of financial products have led banks into greater competition among themselves as well as with non-banks. Financial activities are harder to understand and increasingly take place outside of the traditional regulatory framework. There is a groundswell of debate around how public policies should be revised to reflect this evolution.

Moreover, the disruption to markets from financial crises - unprecedented in both frequency and scale over the last several years - have given rise to sweeping reforms to financial sectors. The US savings and loan crises provided a powerful reminder of the need to maintain skill and knowledge parity between regulators and the institutions they supervise, as well as the importance of early intervention. The Asian crises revealed the depth of interdependency among global financial markets and highlighted the importance of transparency and proportionality in regulation. The collapse of BCCI exposed significant weaknesses in the framework for regulating global institutions and the need for cooperation across borders. Crises in Mexico, Russia, Argentina, Central and Eastern Europe, and Turkey, as well as the scandals that beset Barings and Daiwa Securities, all hold their own lessons on the failure or inadequacy of traditional models of regulation.

5 Keys Trends Influencing Financial Sectors Internationally

1. Globalization, Consolidation, and Convergence of Intermediaries and Markets
2. Information Disclosure and Governance
3. E-Finance
4. Safety Net Reform
5. New Financial Products

The confluence of these developments in the global financial sector has triggered several important reform trends with implications for developing countries. We evaluated the relative influence of these key trends in the context of USAID's past work to identify which trends are likely to be most broadly applicable to USAID client countries over the coming decade. These trends are grouped into five headings, as shown in the box above.

Globalization, consolidation and convergence of intermediaries and markets are by-products of change in the industrial organization of financial services. As financial intermediaries face substantial competition in traditional lines of business, they are seeking new markets, reconfiguring their product/service portfolios, developing more efficient conglomerate structures, and exploiting regulatory imperfections by entering new businesses. These developments are combining to change the dynamics of the financial marketplace and have created new challenges in managing risk for regulators and institutions alike.

Information disclosure and governance have become the central focus of IFA reform, stemming from a need to increase market efficiency and reduce information asymmetry among intermediaries and issuers of securities. Three important elements of this movement are accounting reform, corporate governance, and facilitation of market discipline as an invisible hand of risk containment.

Electronic finance - electronic banking, electronic money and the provision of other financial services through electronic means - is spreading quickly, both in the developed and developing countries. This has significant implications for consumers, financial institutions, and supervisory authorities alike[8].

Safety net reforms are primarily centered on pension reform and financial assurances vis-à-vis deposit insurance and investor protection. While these areas are technically and administratively disparate, they both serve similar purposes for financial sector development. This is to harness long-term savings for productive investment and reduce the explicit and implicit cost of state funding for the sustenance/financial safety of consumers. Pension reform in transforming economies is further driven by the realities being faced in development economies from the rapid aging of the world's population.

New financial products and tools have done more to transform the character of financial markets than any other development observed over the last 20 years. They have created new sources of finance, induced disintermediation, enabled better management of risk, and increased the complexity of financial services, further burdening the already limited capacity of financial sector regulators in many developing countries.

These trends are admittedly broadly defined and not all will not be immediately relevant for every country in which USAID works. However, they are all applicable across a number of financial subsectors - banking, regulation, insurance, etc. - and all will in some way have tangible impact on USAID assistance projects in a majority of client countries.

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[8] *Two reports worth reading are as follows: Group of Ten, Electronic Money: Consumer Protection, Law Enforcement, Supervisory And Cross-Border Issues, Basle, April 1997 and Basle Committee on Banking Supervision, Risk Management for Electronic Banking and Electronic Money Activities, Basle, March 1998.*

Micro-and SME Finance

The growth and increasing commercialization of microfinance has undoubtedly been one of the most significant global developments in financial services over the past quarter-century. More recently, the expansion of financial services to SMEs has been a major area of focus for donors, not least USAID.

Our rationale for omitting these two important trends from our list stems from the fact that, while critical, micro- and SME finance programs are concerned with extending the reach of financial services in the interest of general economic and private sector development, not with the inherent stability or performance of financial sectors per se.

II.B.2 Globalization, Consolidation, and Governance of Intermediaries and Markets

Globalization and Systemic Risk

Globalization of financial markets has been, on balance, positive for developing countries. Intermediaries from developed countries have brought new capital, expertise, and credibility to nascent financial systems through inward investment. Governments and top-tier companies have been able to tap global markets to raise capital for investment, strengthen their profile, better manage liquidity, and trade foreign currency in a range of financial centers across the world. Companies list on foreign exchanges, borrow debt through foreign security markets and international banks and conduct their payments through a range of global facilities. As a result, market players are much better informed about the international alternatives to local financial products and are able to assess the value to be had from the domestic financial sector in that light. World Bank data show an enormous rise in cross-border portfolio and direct investment over the last decade. Much of this investment has been directed towards developing countries, although disproportionately towards a small number of relatively promising markets.

However, financial crises have demonstrated the severe risks inherent in heavy reliance on international capital flows as a means of growth, particularly for countries with unbalanced macroeconomies, weak domestic financial intermediaries, poor financial sector regulation and supervision and over-leveraged corporations. As recent experience from Thailand, Russia, Mexico, and Argentina shows, capital movements by both domestic and foreign participants can exacerbate crises and facilitate their spread to other countries.

The depth of the country crises in recent years and the danger of contagion have sparked serious consideration of the need for reform along three dimensions:

1. Reform of the International Financial Architecture (IFA) under which cross-border transactions take place;
2. Reform of domestic financial systems to withstand external shocks and contain systemic risk; and
3. Emphasis on real economic growth over direct investment as a means of development

Our Task 1 Report discussed the IFA in some detail along with the changes to be made by developing countries, international financial institutions, and finan-

cial intermediaries in developed countries in order to reduce both the likelihood and severity of crises. IFA reforms deal primarily with safeguarding the conditions for international financial transactions. As such, most trends are focused on strengthening exchange rate regimes, improving macroeconomic policy setting and coordination, strengthening payment systems, enhancing transparency, and other broad-based initiatives.

Trends that are more relevant to the donor community are those that pertain specifically to strengthening national financial system stability and initiatives that support real economic growth. Important developments are being seen in the following areas:

Cross-Border Insolvency Reform: In response to the failure of Barings in 1995, international organizations and investor groups have started to examine cross-border insolvencies more carefully, with a view towards understanding and reducing risk exposure to global financial institutions and the potential systemic risks[9]. There has been growing concern by policymakers, multilateral lending agencies, and some global financial institutions that many economies remain unprepared to deal with the cross-border dimensions of insolvency. Development work has focused on areas such as the following: strengthening insolvency and debtor-creditor regimes; develop innovative debt contracts; promotion of creditor cooperation; enhancing mechanisms for orderly workouts; and encouraging better risk management by the private sector.

While many developing countries are challenged by the prospect of developing an effective domestic insolvency system, developments on a global scale underscore the need to look beyond conventional mechanisms and consider the cross-border implications of business failures. Recent experience in Asia, Latin America, and Eastern Europe suggests that the risks associated with weak contract enforceability, ineffective netting, clearing and settlement obstacles, imperfect collateral and security interests, and conflicts of law on a national level in effect weaken the global infrastructure for insolvency.

International Insolvency Regime for Sovereigns: Anne Krueger, Deputy Managing Director of the IMF, recently proposed the introduction of a system akin to domestic bankruptcy procedures for developing countries experiencing financial crisis. It would allow a country, with the consent of the IMF, to impose a temporary standstill on debt repayment while the country negotiated with its creditors. (Whether the IMF or some less conflicted body should consent to a debt payment standstill or other possibly quicker alternatives is still a subject of

[9] *The Group of Thirty has been studying cross-border insolvency. Their work has centered on the direct effect of insolvency on other firms and attempt to identify measures to limit risk after insolvency begins. This project was undertaken in conjunction with INSOL, the international association of lawyers and judges interested in international insolvency.*

debate.) Agreements reached with the large majority of creditors would then be binding on all creditors, preventing small creditors from demanding favorable treatment as recently happened in the case of Peru. The measure proposed is certainly interesting, but controversial; and the prospects for near-term implementation are weak. This idea and variations of it, nevertheless, reflect a move to bring more order to resolving country crises.

Crises Prevention and Contingency Planning: Policymakers and regulators in many countries have undertaken initiatives to prevent and manage contingencies arising from financial crisis. This includes, among other elements: coordination of supervisory policies for the intervention and resolution of troubled institutions; arrangements for the timely application of bankruptcy laws and regulations; guidelines for the treatment of capital market instruments in times of distress; well set out roles and responsibilities of intermediary managers, policymakers, and regulators; as well as a clearly defined set of policies and triggers for lender of last resort intervention. It is also widely recognized that crises prevention requires a clear understanding of non-bank financial intermediaries, the extent of their activities in the economy, and the nature of their financial commitments and risks.

Harmonization of Standards: There is a growing consensus that financial supervision and regulation should be harmonized across national boundaries due to the ever-increasing global interdependence of financial markets. As developing countries grow and prosper, the integration of domestic financial markets with the larger international financial system will become more and more important so that distortions are minimized. Much of the discussion around harmonization has centered on the importance of developing and implementing internationally recognized principles and codes of good practice. International standard-setting bodies, such as those identified

International Standard-Setting Bodies

- *Basel Committee on Bank Supervision:* Accounting task force addressing issues related to transparency, accounting and audit standards in the banking system.
- *International Organization of Securities Commissions (IOSCO):* Drives implementation of standards and codes around market transparency, accounting and auditing and most importantly, enforcement of these standards.
- *IAIS:* Established in 1994, the IAIS seeks to establish international standards on insurance supervision and conducts training seminars for insurance supervisors from emerging markets. The Association also seeks to coordinate its efforts with other global financial regulators, particularly those from the banking and securities industries.
- *Financial Stability Forum (FSF):* Forum of government officials, regulators, financial firms and representatives of the profession whose objective is to enhance international cooperation to promote stability in the financial system. They are instrumental in driving implementation of standards and codes including IAS and ISA.
- *The World Bank/IMF Report on Standards and Codes (ROSC)*: The ROSC process is designed to monitor compliance with standards and codes in a variety of areas including accounting and auditing, corporate governance, transparency in monetary and financial policies, etc.
- *International Forum on Accountancy Development (IFAD):* Formed in 1997 this industry group is focused on improving standards and practices worldwide.
- *International Federation of Accountants (IFAC):* Professional body consisting of 156 national accounting organizations. Sets International Standards on Auditing (ISA).
- *International Accounting Standards Board (IASB):* The International Accounting Standards Board is an independent, privately funded accounting standard setter based in London.

in the text box, are perhaps the most influential in promoting change in developing countries as they seek to harmonize their regulatory environment internationally and "globalize" their financial institutions. From a positive economic perspective, meeting international standards benefits developing countries by increasing the stability of the domestic financial markets and making them more attractive to foreign and domestic investors alike.

The Basle Committee introduced new capital standards and model principles for supervision of banks. The Financial Stability Forum has addressed issues relating to the systemic impact of banks across borders. The World Bank and IMF introduced the FSSAP reviews and have carried out a wealth of comparative studies that form the basis for defining best practices. The organization of International Organization of Securities Commission (IOSCO), Forum of European Securities Commissions (FESCO) and International Association of Insurance Supervisors (IAIS) are international attempts to set global standards for securities and insurance businesses. The European Parliament has been active in setting standards of harmonization for members of the EU, and technical assistance has been provided for accession candidates in Central Europe.

In most of these areas, codes of best practice have been drafted and an attempt is being made to monitor the degree to which countries are implementing best practices. The World Bank and the International Monetary Fund are monitoring twelve areas: data dissemination, fiscal transparency, monetary and financial policy transparency, banking supervision, securities markets supervision, insurance supervision, payments systems, money laundering, corporate governance, accounting, auditing and insolvency regimes and creditors rights[10].

Diminishing Importance of Local Exchanges: There are a number of globalization and technology-related developments affecting developing countries' national stock and commodity exchanges. First, in the face of volatile and shallow domestic markets, blue chip companies in many developing countries increasingly seek listings on developed country share trading systems through Global Deposit Receipts (GDRs) or American Deposit Receipts (ADRs) traded in New York, London and Frankfurt. The movement of securities trading to developed markets is putting liquidity pressure on local exchanges. This issue has received substantial attention in recent conferences and literature (e.g., Brookings-Wharton Conference on Financial Services, January 2002). These studies conclude that trading will become increasingly concentrated among a small number of exchanges. Furthermore, evidence in support of the trend in the migration of listings from emerging markets to the largest industrialized markets shows a sort of paradox of financial development in which the more

[10] *Various groups have been responsible for the drafting of these standards and codes. US supervisory agencies have contributed to those drafted by the international organizations of supervisory bodies.*

successful a country is in strengthening its financial infrastructure, the more likely are its firms to list on larger, more liquid foreign markets[11]. The trend appears to be away from small, domestic securities markets. If these markets are to survive in some form, many will have to merge into broader coalitions of regional rather than national or local exchanges.

Second, trading systems are moving toward electronic platforms, which reduces the relevance of where an exchange may be physically located. In many markets the physical location of an exchange is simply a function of one or more of the following: domestic regulatory constraints, telecommunications infrastructure, sophistication of investors, tradition, and market appetite. This has direct implications for future donor support for exchange development and policies on harmonization of standards.

Recent Responses to Consolidation of Financial Intermediaries and Convergence of Financial Products

The ongoing consolidation of financial institutions is an important feature of modern financial systems. Mergers among and between banks, non-bank intermediaries, and non-financial enterprises have led to the emergence of large, complex institutions that operate across borders and across traditional product/service lines. While a majority of the consolidation that has taken place in recent years has been in the banking industry, the level of activity among insurance and other non-bank intermediaries has increased. The consequence of this is twofold. First, ironically, financial institutions are becoming both larger and smaller. While some institutions are transforming themselves into universal providers of diversified financial services, others are choosing (or are forced) to specialize in a small range of functions or products as the traditional wholesale/retail supply chain is deconstructed through outsourcing and divestment[12]. Second, in so far as regulations will allow it, there is a high level of convergence in financial products. This had led to overlaps among institutions in the provision of services in banking, insurance, securities trading and underwriting and investment management, as well as across national boundaries through the creation of global networks.

The long-term effect of consolidation and convergence on the performance and efficiency of financial intermediation has not been studied in depth at the global level. However, banks are likely to face increasing pressure from non-bank

[11] *Claessens, Stijn, Daniela Klingebiel, Sergio L. Schmukler, "The Future of Stock Exchanges in Emerging Markets: Evolution and Prospects," Center for Financial Institutions Working Paper No. 02-03, February, 2002, Wharton School Center for Financial Institutions, University of Pennsylvania.*

[12] *An example of this can be gleaned from a review of the roles various participants play in the financial services industry. There are at least five distinct roles around which separate niche industries have emerged: back office services, financial product providers, financial inter-*

providers of payments services, both from other financial institutions and from outside the financial system. Funds managers are gravitating towards the banking market and associations have been formed between banks and non-financial companies[13]. Technological developments seem likely to open the market to other players[14].

USAID assistance programs inevitably do not take place in a vacuum, and must work alongside and support other initiatives that might already be underway in client countries. Some key reform trends stemming from the developments described above include:

De-Regulation: The US passed the Financial Services Modernization Act (FMA) in 1999. FMA repealed the Glass-Steagall legislation from the 1930s, which mandated separation of the securities, insurance and banking industries. Similarly, convergence is also prompting many developing countries to enact or propose new laws allowing intermediaries to provide a broader range of financial services.

Reform of Regulatory Structures: There are important regulatory implications of the developments noted above. The first is that the world is moving into an era of unprecedented complexity with regard to how financial service providers can and should be regulated. This complexity stems from the bundling together of risks that were previously isolated in separate legal entities, the emergence of new types of risk that regulators have not traditionally dealt with, and the increasing need to understand how risk is being managed on a global basis. It has placed an enormous strain on systems with multiple and overlapping regulatory structures.

It stands to reason therefore that one of the most important issues facing policymakers is identifying the appropriate form of regulation for different classes of institutions and where regulatory responsibility should reside[15]. Regulatory efficiency is a significant factor in the overall performance of the economy. Inefficiency ultimately imposes costs that can hinder market functioning and development, or create distortions that divert financial resources from their most productive uses.

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[13] *In the USA, companies like General Electric Corporation have already developed to become major providers of payments services.*

[14] *Technology companies like Microsoft already participate indirectly in the industry by servicing banks' needs.*

[5] *A new global study group has been composed of various senior regulators and market practitioners from the banking, securities, and insurance industries worldwide. The group is examining the evolving linkages and interactions between institutions and markets in an increasingly global financial marketplace and how they are being addressed by banking, securities, and insurance regulators. The aim is to identify the appropriate direction of evolution in supervision for evolving systemic safety of the global financial system in the medium term.*

In response to these developments, regulators in many countries have sought to change the way they supervise institutions. For example, Canada created a single federal banking regulator to improve bank supervision after a series of bank failures, and then moved to integrate regulation of banks and insurance companies. France revised its bank oversight structure to address perceived regulatory inequities among financial institutions. Germany replaced its system of state bank oversight with a federal system, involving both a single federal bank regulator and the German central bank, to better address the increasing complexity of the banking industry. Bank oversight in the U.K. became more formal in nature and driven by a comprehensive risk assessment framework that allocates regulatory resources to the greatest threats. The U.S. has introduced a series of reforms with the introduction of risk-based, consolidated supervision, and new capital standards, among other initiatives. Some developing countries, such as Indonesia, are now considering similar changes. Among the most significant regulatory changes underway are the following:

- **Integrated Regulation:** In a number of other countries regulatory reforms are being designed around new oversight structures that unify regulation between banks and non-banks. The solution that has been introduced to differing degrees by countries as diverse as the United Kingdom, Denmark, Australia, Norway, South Korea, Singapore, Jamaica, Mauritius and others is to adopt a unified regulatory approach for financial institutions and supervise them under a single integrated institution. The broad goals in doing this are to: achieve neutrality in regulation among financial institutions; scale the intensity of supervision by the degree of market failure each institution represents; improve the coordination of regulation towards different objectives - i.e. for safety and soundness, market conduct, and consumer protection; sharpen oversight towards financial conglomerates; and achieve economies of scale by organizing functions to minimize overlap, duplication and conflicts in regulation.

- **Special Regulation For Conglomerates:** As financial conglomerates have played increasingly significant roles in the financial service sectors of developed economies, financial regulators have become more concerned with proper capital and regulatory approaches to these entities. There is also a perception that these institutions present new forms of risk that existing forms of prudential regulation are not suited to handle. Closely intertwined Financial Industrial Groups (FIGs) have caused problems in Japan, Korea, Russia, and other countries as intermediaries seek risk dispersion through the creation of broader corporate structures.

  Consolidated regulation of financial conglomerates requires a comprehensive review of an institution and its affiliated companies. It has created a

broader context for inspections in recent years[16]. Forging a regulatory strategy to deal effectively with financial conglomerates requires greater integration among domestic regulators. It also requires harmonization in the approaches traditionally utilized by bank, securities and insurance regulators, whose objectives and methods may vary. New methodologies are being developed to address a wide range of issues such as: impairment of capital for inter-group exposures and/or holdings in other supervised entities; calculation of capital requirements to cover market risks on a group wide basis; group wide application of limits on large exposures in the banking book and the capital requirements against large exposures in the trading book; inter-group transactions; the adequacy of internal control on a group wide basis (especially control over the information which will be relied upon for the application of consolidated supervision); and access to information and power of inspection in all areas of prudential supervision, applicable to both supervised and unsupervised group members; assessment of distribution of capital between group members within a group.

- **Cross-Border Cooperation Among Regulators:** Overseas expansion, increasing globalization of financial markets, and wider use of technology that enables financial intermediation without physical presence have combined to create a need to pursue cross-border cooperation in the supervision of financial intermediaries. In the last few years, home country regulators have heightened their efforts to develop partnerships with foreign regulators. These partnerships take the form of cooperation agreements for the sharing of information, collaboration in the examination of international conglomerates, harmonization of policies, cross-training, and sharing of technical assistance. The trend in developed countries is well advanced of that in developing countries.

- **Domestic Cooperation Among Regulators:** Financial regulation is strongly influenced by national policy, notably monetary policy and public policy. It is also influenced by the mandates of other domestic regulators, which alone may or may not be fully compatible with each other in the overall scheme of financial sector development. Differences exist due to legitimate divergences in objectives and regulatory methodologies. Bank regulators, for example, are most concerned with prudential control and financial system stability, and thus tend to take a more narrow view of what constitutes capital than non-bank regulators. In contrast, securities regulators are concerned with ensuring market integrity and efficiency. They are concerned with

[16] *In the EU consolidated supervision is seen as indispensable to effective supervision of banking and investment services activities. Not only does consolidated supervision form part of the European Union's supervision standards, it is also emphasized in the Basle Core Principles for Effective Banking Supervision.*

information disclosure, liquidity, investor protection and market conduct. To counter these differences, domestic financial services regulators are seeking greater cooperation and coordination with each other. This trend is evidenced by the increasing use of MOUs and policy level interaction between bank and non-bank regulators.

- **Risk-Based Supervision:** In recent years supervisors in many countries have been changing their procedures for supervision to become more risk focused. By employing risk-based reviews, an assessment can then be made of the likelihood that financial institutions are managing and will continue to manage such risks effectively in the future. For most regulators, a risk-focused approach is a shift in emphasis away from assessing past results and transaction testing towards assessing exposure to events in the future and likely performance trends. Risk based supervision also helps regulators better allocate their resources, since the focus is placed on promoting safety and soundness. The approach emerged from a goal shared by banks and their regulators to find a more efficient way to interact between each other. Banks with a strong understanding of risk and driven by the desire to mitigate loss have an inherent incentive to be "better" at managing risks than regulators are in evaluating them.

  Contrasting approaches to risk-based supervision demonstrate that supervisors in different countries can and should fine tune the concept of risk based supervision to reflect the particular nature and size of the institutions they supervise and the markets in which they operate. This is particularly promising for developing countries. The more standardized processes of the OCC's Supervision by Risk reflect the large number of banks subject to OCC supervision, while in other countries the number of locally incorporated regulated banks is much smaller and requires a different approach. Risk assessment procedures in the U.S. and the U.K. take into account differences among institutions, such as complexity or size (e.g. large banking groups versus non complex banks). Other countries have also emphasized strong reliance on internal risk management processes and reports throughout the supervisory cycle.

- **Integrated Approaches to Risk Management:** Following a number of high profile losses in recent years, the need for comprehensive risk management policies and procedures has become more important. Traditional controls are being swept away as organizations change. New technologies are introducing new risks. Business transactions and practices are increasing in complexity, and fraud continues to be a problem. Risk-management systems in complex institutions are being built to continually monitor all relevant risks--including credit, market, liquidity, operational, reputation, and off-balance sheet. Current thinking on risk control embraces the idea that risk management

must be an ongoing and organization-wide endeavor. Rather than treat risk management as a series of one-off activities, it should be converted to an integrated process of checks, warning signs, and balances. Such a model must be flexible enough to address both uncontrollable and controllable risks.

The new Basle requirements governing capital adequacy of banks reinforces the trend towards integrated risk management. While the new guidelines are still under global consultation and have faced considerable debate, they are based on the assumption that bank failures stem not from more than just credit or market risk, but from operational, strategic and other risks as well.

- **EU Accession in Post Socialist Europe:** The European Commission launched its Financial Services Action Plan in November 1999, which sets out an ambitious work program to ensure the review of existing Directives and the implementation of new legislation to ensure the completion of the single market by 2005. The areas for action fall mainly into three categories of relevance to financial services: 1) establishing a single EU wholesale market; 2) creating open and secure retail markets; and 3) updating prudential rules and supervision.

  In 1993 a council of the EC adopted a principle of enlargement for many countries of post socialist Europe, and established a series of accession partnerships to advance preparations for eventual integration into the common market. These accession partnerships are broad-based programs that include routine assessment, technical assistance, and policy dialogue between target countries on a range of sector strengthening initiatives, including the development of capital adequacy standards, building governance capacity, and compliance with prudential standards in line with Basle/EU standards. While these developments are not global, they are important to a large number of donor countries, particularly those served by USAID. Efforts by countries to prepare for EU accession underlie major reform trends[17].

The trends toward globalization, consolidation and convergence in financial markets and intermediaries has prompted a series of responses on the part of national regulators and international organizations alike, some of which were described above. While, as mentioned, globalization and convergence appear to bring net-positive benefits to the world economy, they also give rise to important new challenges. Not least of these is the need to ensure that investors, regulators and other interested parties have access to timely, accurate and meaningful information and the need for transparent and responsible governance of increasingly-complex financial institutions. Recent efforts to meet these needs are the topic of the next section.

[17] *USAID's Partners for Financial Stability program recognizes the importance of EU Accession in its objectives.*

II.B.3 Information Disclosure and Governance

From the fall of Barings through the Asian crisis to the more recent corporate fiascos in the United States, participants in financial markets have become acutely aware of the risks of a lack of transparency. Cases of misleading reporting have ranged from understated government deficits to overstated foreign exchange reserves, and from understated corporate debt to overstated corporate earnings. All of these forms of deception can result in gross misallocations of economic resources and can ultimately undermine the credibility of capital markets. When transparency fails in the financial system and when supervisory authorities are weak, the risk of systemic collapse increases substantially.

Attention is now focused on building fair and transparent markets based on principles of market integrity, good information, and investor protection. Efforts to reduce information asymmetry and improve the efficiency of resource allocation in financial markets and among intermediaries cut across five major areas of reform: 1) improvements in the quality of information; 2) stronger corporate governance; 3) establishment and enforcement of disclosure standards; and 4) increased reliance on market discipline.

Improving the Quality of Information

Recent developments in the United States indicate that accounting standards have failed to keep up with the changing business landscape. Innovation in business practices and financial instruments has made accounting standards in some areas rapidly obsolete. For example, the use of derivatives, the valuing of intellectual property, brand equity and other intangible assets all present difficult accounting issues and create potential loopholes for firms willing to use an aggressive approach to accounting. In emerging markets, accounting abuses are common; corporate accounts are not easily available and those that are issued often cannot be trusted.

Reforms aimed at improving the quality of information available to stakeholders of public companies and financial institutions center on six principles of application: comprehensiveness, relevance, timeliness, reliability, comparability, and materiality. Improving accounting and auditing standards, release of timely and accurate information, professional training and integrity in the accounting profession and corporate management is now seen as one of the hallmarks of any financial reform program in both the developed and developing countries. There are widespread efforts underway to strengthen standards at both national and international levels:

- **Moving Toward Global Accounting Standards:** In a recent interview with The Financial Times (26 May 2002), Bob Herz, the incoming chairman of the US Financial Accounting Standards Board (FASB), made it plain that he wants to bring US accounting standards, which are heavily dependent on a

rule-based approach, closer to the principles-based approach of International Accounting Standards (IAS) favored in much of the world. This has been called a "revolution", directly attributable to the lessons learned from Enron and other accounting scandals. It will likely hasten the move towards IAS. More and more developing countries have announced a desire to adopt IAS but this involves a good deal of effort in adopting standards, making necessary changes to regulations and providing training to accountants in both the public and private sectors.

- **Strengthening of the Accounting Profession:** Efforts to improve accounting and auditing practices have been complicated by a lack of professionalism both in the subject companies themselves and within the accounting profession. Many developing countries are focusing on revising accounting curricula in their university systems, strengthening professional certification and continuing education and enforcing ethical standards. The World Bank's ROSC process on Accounting and Auditing has provided useful analyses of the state of the accounting profession in various countries and the areas most in need of improvement. USAID has a logical role to play in improving accounting education, certification and continuing education. Assistance in this area could involve the reform of university programs, certification tests and procedures and continuing education arrangements.

- **Auditor Independence and Oversight:** Many new proposals are being considered to improve auditor independence and oversight. These include rotation of audit firms (or at a minimum audit teams), independent commissioners to oversee auditors and restrictions on auditors performing consulting services for their audit clients. In addition, the traditional peer review process followed in many countries is coming into question as proposals are put forward to further strengthen the regulation of the audit profession. In the post-Enron debate, many have posited that a decline in independence and ethics of the American accounting profession is to blame. But this is not a problem limited to the US; most developing countries face greater challenges in this arena. All international professional bodies stress the importance of providing practical education on professional ethics and mechanisms for Institutes of CPAs or CAs to enforce ethical standards. Yet, in many developing countries, ethics is not part of the core curriculum in accounting programs and self-regulation within the profession is very weak. Although the vast majority of accountants are ethical, the lack of enforcement allows the unethical to act without fear of punishment or liability. There is also a trend toward development and strengthening of SROs, such as Institutes of CPAs, to promote improvement of ethics and standards in financial disclosure.

Strengthening Corporate Governance

The ominous tone of much of the treatment of corporate governance issues by investors, international institutions, commercial leaders, academia, and policy-makers underscores the relevance of the topic to economic development. There have been a plethora of official reports on the subject. These have included the American Law Institute report (1992), the Cadbury (1992), Greenbury (1995) and Hampel (1998) reports from the UK, the Hilmer report (1993) in Australia, the Vié not report (1995) in France, the King report (1995) from South Africa, the OECD report in 1998, as well as studies in Hong Kong, Singapore, Malaysia, and elsewhere.

In response to several spectacular company collapses in the UK, the Cadbury Committee reported on the financial aspects of corporate governance - this report led to similar initiatives in other countries. Essentially, Cadbury called for a strengthening of the board's conformance and compliance role. The report advocated the strengthening of the role of independent non-executive directors, the creation of compliance committees using these independent directors in audit committees (to liaise with the company's outside auditors), remuneration committees (to oversee directors' remuneration) and nomination committees (concerned with the nomination of new directors). The strengthening of checks and balances over executive management also recommended more transparency of board matters and the separation of the roles of the chairman of the board from the chief executive officer of the business. Subsequently, the UK Hampel Committee in 1998 consolidated these ideas into a set of Principles of Good Governance and a code of best practice for unitary boards in listed companies to be incorporated into the listing rules of the London Stock Exchange. Many of the official reports provide a code of best practice in corporate governance, detailing expectations on matters such as board structure, audit and audit committees, transparency in financial accounting and director accountability. Some institutional investors, particularly in the United States, have also called for codes of corporate governance practice. Increasingly, to obtain access to international equity finance, companies around the world have to respond to the corporate governance requirements of these codes.

Corporate governance has been slow to improve in many developing countries because their policy and institutional environments are less conducive. There are many commonalities among countries with weak governance structures: regulations are weakly enforced; shareholders are not aware of their rights or loath to intervene; mechanisms to intervene are weak, governance systems are not robust or incentive incompatible; economic wealth and influence is concentrated; there is little or no external pressure from market forces, ownership rights are uneven; information asymmetries eliminate the possibility of effective external monitoring, and there is a weak culture of respect for shareholder

democracy. Time and again, cross-country comparisons around the globe identify these factors.

The application of corporate governance reform in transitional countries has many dimensions. Many of these cannot be adequately addressed given the scope limitations of this paper. However, some important areas of reform are noted below.

- **Tailored Development of Corporate Governance Frameworks:** In April 1998 the Business Sector Advisory Group on Corporate Governance issued its report "Corporate Governance -improving competitiveness and access to capital in global markets". The Committee was comprised of distinguished experts from the US (chair), France, Germany, Japan and the UK. Their report proposed that the OECD recommend minimum standards of corporate governance to promote fairness, transparency, accountability and responsibility. However, it rejected a "one-size-fits-all" approach to corporate governance, advocating pluralism and adaptability. In addition, it is more and more accepted that the corporate objectives of maximizing shareholder value requires not only superior competitive performance and transparency, but also responsiveness to the demands and expectations of employees, local constituencies, and other stakeholders. Corporate governance systems are being developed to reflect the specific features of unique markets.

- **Common Features of Corporate Governance Reform:** Of the governance reforms that are being implemented around the world, there are common features that appear time and again. These include: adaptation of corporate governance regulatory frameworks to changing competitive and market forces; formulation of minimum standards of corporate governance designed to promote fairness, transparency, accountability and responsibility; issuing suggested guidelines for voluntary "best practices" for boards to improve accountability, as well as to promote board independence; establishment of common principles for addressing comparability, reliability and enforcement of corporate disclosure; and emphasis on the impact which changes in corporate governance practices would have on society at large, and on the need to clarify responsibilities between the public and the private sector.

- **Shareholder Activism:** In the past, when capital markets played a smaller role in financial intermediation, shareholders were relatively few and close enough to the board of directors to exercise a degree of control. Most institutional investors ignored their rights as shareholders, preferring to sell their shares rather than get involved in challenging corporate performance. But for major corporations, particularly those, which have their shares listed on

a stock exchange, the governance situation has changed[18]. In many countries, shares of public companies are now held by a diverse body of shareholders: some by private individuals, some by institutional investors such as banks, pension funds and insurance companies, and some by other companies, who might have business relationships with the company. The growing complexity of corporate structures has led to trend towards greater shareholder activism, particularly in the United States, Great Britain and Australia. Shareholders are becoming pro-active, calling for boards to produce better corporate performance, questioning directors' remuneration, and calling for greater transparency on company finances and more accountability from directors.

- **Strengthening Governance of the Financial Sector:** In April 2002, the World Bank conducted a seminar on Financial Sector Governance to examine the governance of regulators, self-regulatory organizations (SROs), accountants, analysts, and that of banks, fund managers and securities firms. This seminar highlighted the weak links in the financial system and the assistance needed to improve conditions in emerging markets. Recognizing this, many donors, international financial institutions, and domestic governments have provided generous financial and intellectual support for the development of an enabling environment for corporate governance of financial institutions. This support has included the development of market institutions, legislation and regulations, standards, and educational programs.

- **Public Sector Governance in the Financial Sector:** The public sector plays a dominant role in financial markets, either as an owner of intermediaries and markets and/or as their regulator. Governments regulate, as well as own, banks and other financial institutions, issue debt, intervene in currency markets, and play an important role in pension systems, all closely linked to financial markets. With such a dominant role, a sound financial market depends on public sector transparency, accountability, and fairness and the absence of corruption or conflict of interest. Recent experience has shown that new institutions, rules and procedures can become as corrupt as the practices and institutions they replace. For this reason, donors continue to assist in rationalizing the states' role in the financial markets, accompanied by measures geared towards building a culture of good public sector governance.

[18] *Experience in U.S. is an exaggeration of the dramatic change in the institutional ownership composition of public companies globally, but it is indicative of the trend. According to the flow of funds accounts published by the Federal Reserve, the combined share of household equity managed by mutual funds, pension funds, and life insurance companies grew from only 3 percent in 1952 to over 50 percent at the end of 2001. Mutual funds held 16 percent of household equity at the end of last year, and public and private pension funds held about 10 and 20 percent, respectively. Life insurance companies held about 7 percent of household equity at that time, mainly through separate accounts that were, in effect, mutual funds with insurance wrappers.*

Establishing and Enforcing Disclosure Standards

Disclosure standards for both banks and non-banks are being strengthened to reflect the growing complexity of financial services and concerns regarding poor corporate governance. They are an essential component of market conduct and prudential regulation across the financial sector and are necessary in order to provide participants with the information necessary to evaluate performance and make informed investment decisions.

New disclosure standards are being set forth for a range of activities including: cross-border offerings of securities, derivatives transactions, group transactions, related party transactions, loan concentrations across geographic and client lines, cross-border investments, foreign exchange activities, reporting across multi-jurisdictions and numerous other areas.

Standards mean little without continuous monitoring and enforcement. This is a particular problem in developing countries where securities regulatory commissions typically lack the systems, staffing and capability to adequately monitor financial reporting by companies and often lack the will and "teeth" to enforce these rules. Donors can play a role in assisting developing countries to improve accounting and disclosure related law and regulation, clarify the organizational roles and responsibilities of governmental and industry oversight agencies and professional bodies and provide capacity building assistance to these organizations.

Reliance on Market Discipline As a Regulator

Regulators play an important role in preserving financial stability and credibility of markets. But the increasing complexity of the financial sector present challenges to even the most skilled of regulators in identifying where risk is latent. The liberalization of markets by de-regulation has intensified the challenge.

Policymakers are recognizing that a balance between prudential supervision and market discipline is critical to promoting long-term stability of both individual institutions and banking systems[19]. There is a growing realization that market discipline, when facilitated by strong disclosure practices, is a powerful regulator of both risk and efficiency in capital allocation. Market discipline approaches to market development seek to maximize the scope for competition and innovation and help to mitigate moral hazard. The aim of this type of regulation is to make markets themselves work better, rather than substituting the decisions of government with those of the market. Market discipline is

[19] *European markets tend to emphasize self-regulation and to rely on market forces to produce incentives to disclose important information. This trend is especially characteristic of the Eurodollar market and has been perceived by participants in that market as highly successful.*

enhanced by better public disclosure. Public disclosure of risk indicators puts pressure on financial institutions to improve their risk management practices and policies, reinforces the accountability of senior management and is less intrusive or restrictive that other measures such as entity licensing, price fixing, product vetting or investment targeting.

Two ways in which regulators are seeking to achieve balance between formal regulation and market discipline are by: 1) enhancing comparability of analysis among intermediaries through stylization, standard reporting classifications and data definitions; and 2) by promoting mechanisms designed to ensure compliance with disclosure standards and the strengthening of standards that ensure reliability of information.

As part of the effort to strengthen market discipline, there are important trends related to the development and use of SROs in the regulation of certain institutions and markets. International guidelines on financial sector regulation recommend the use of SROs to the extent appropriate to the size and complexity of the markets. In the face of scarce resources, regulators have mostly supported the development of SROs for stock exchanges, the stock brokerage industry, clearing, depository, and settlement institutions, specialized institutions, such as credit cooperatives and microfinance institutions.

Self-regulation has demonstrated substantial benefits. For instance, self-regulation should promote the reputation of the relevant industry as a whole, and it might facilitate the creation of technical standards that will benefit the industry itself more generally. In addition, self-regulation may be better than a pure government solution. The same factors that can make self-regulation better than the market may also make it better than government. Self-regulation may also be adopted in order to stave off mandatory government regulation, and may thereby gain some of the good attributes of both government regulation and industry participation.

Legal Reform

Greater support for supervisors and enforcement efforts has more recently been accompanied by support for legal reform. Increasing the capacity of administrative courts, development of alternative dispute resolution mechanisms, and/or development of judicial review standards should all be considered as critical to improving the regulatory and supervisory system overall.

II.B.4 E-Finance

New payments mechanisms like ATMs, telephone banking, EFTPOS, and electronic funds transfer can increase access to bank account services. Internet platforms have enabled the establishment of new distribution channels in the form of 'virtual banks', which can transact as a traditional deposit-taking institution

as well as offer securities[20]. In a similar vein, consumers are able to use electronic media to search for financial products that best meet their desired specifications. The application of information technology in this manner should help reduce the information difference between financial institutions and individuals.

While electronic finance is spreading quickly, there is considerable dispersion among countries in the degree of penetration of e-finance. That dispersion is expected to continue over the next five to ten years, and then will begin to narrow. The World Bank estimates that 50 percent of banking will be on-line in industrial countries by 2005, up from 9 percent in 2000. In developing countries the estimate is 10 percent in emerging countries by 2005, compared to only one percent in 2000. Those living in emerging countries under a rapid evolution of telecommunications are likely to find viable opportunity by adopting the new technologies. Brazil, the Czech Republic, Estonia, India, Mexico and the Republic of Korea already have substantial penetration in either e-banking or e-trading.

The full impact of these developments, both their benefits and their risks, remains largely unknown. But it is becoming clear that the potential growth of e-banking and the elusive nature of the activity could have a revolutionary impact on the financial services industry and its supervision, as it is known today. Governments and donors must seriously consider how the coming of e-finance will affect the development of financial systems and distribution of financial services in emerging markets.

The following key topics are of an emerging nature, and were selected based on recent industry trends, as well as their expected relevance to regulators, and thus donors.

International Cooperation: There is a real concern that international cooperation is necessary for effective supervision of e-finance, and that premature domestic regulation may not be enough to address the issues that emerge. In November 1997, the OECD held an international conference in Finland on the subject of "Dismantling the Barriers to Global Electronic Commerce." While finance and insurance as topics were only in passing many of the more general conclusions reached applied to these sectors. Emphasis was placed on reducing regulatory uncertainty in the new electronic environment, balanced by minimal government intervention, which should be specific, precise, and transparent. The concept of "branding" or accreditation was introduced as mechanisms for legitimizing providers of services. International cooperation in the formulation of rules was urged, as was the need for uniformity of rules across jurisdictions.

[20] *Prospectuses have already been authorized for release on the internet in the U.S.*

Regulation of E-Finance: Most governments are continuing to rely on existing laws and regulations rather than enacting comprehensive new measures for the regulation of the area. However, internal policy discussions have begun in many countries around several important issues, such as the following:

- How should public policies be fashioned to facilitate the growth of e-finance, while also safeguarding financial stability and the protection of consumers of financial services?
- Under what jurisdictions of e-finance activities fall and are existing regulations adequate to meet the public policy objectives?
- What are assurances, if any, extended to the public vis-a-vis deposit insurance and other protection mechanisms?
- How does e-finance affect lender of last resort policies?
- What are the risks to the payments systems?
- How far should regulations extend in respect of electronic security and privacy?

Developing International Standards: In terms of prudential regulation for e-finance, most developed countries have in the past followed a hands-off approach. But this seems no longer adequate. The prudential measures that need be taken are presently under review in international forums, such as the Electronic Banking Group of the Basle Committee on Banking Supervision. (See box above on standard-setting bodies.) Once standards of best practice are developed, governments of developing countries will have to consider how best to apply them in their particular situation. Development of e-finance will also depend upon the development and regulation of the telecommunications industry.

Increasing Financial Sector Competition through E-finance: The benefits of e-finance will be largely driven by the competition created by new entrants to the markets. But not all market participants welcome greater competition, raising the issue of competition policy. Governments will have to balance the advantages of competition to users of financial services with the costs to existing providers, which are often government owned. This issue is heightened by globalization and competition from foreign providers. Here competition can be stymied or at least slowed by differences in laws, such as bank secrecy acts or money laundering rules. Furthermore, the introduction of e-finance will not in itself assure competition. Complex conglomerates may well develop from liaisons of telecom providers and financial institutions able to control content and limit access to networks by competing service providers. International coordination of competition policy will probably be necessary to maintain adequate Internet service provider access.

Expanding Access to Financial Services through E-finance[21]: The rationale supporting direct government intervention in financial markets is based on arguments around market imperfections and market failure. Providing poor individuals and small firms with financial services has in many countries been prohibitively expensive. To make serving these groups sustainable, new technologies are needed. E-finance may fulfill this role. Lower operating costs makes it possible to provide financial services more widely and better information makes markets more complete. Smart cards are now in use for payment services in 16 African countries. Mortgage and insurance services are increasingly being offered on-line in developing countries. Internet services are expanding finance for SME and a small number of financial intermediaries are beginning to offer microfinance services to quite poor people. E-finance will not enable everyone to access financial services but will make it possible to expand the availability of services to new classes of customers. Instead of direct intervention to assist the poor and small business obtain adequate financial services, which has not worked well, governments should in the future concentrate on building the enabling environments required for the private provision of financial services to these groups, though some incentives may be necessary to speed action.

Donors' Considerations for Introduction of E-Finance

- E-finance will have a major impact on financial institutions and on the manner in which finance is conducted, particularly in developing countries.
- E-finance will almost certainly increase competition from existing firms adopting cheaper on-line technologies, from new firms able to enter the industry because of the falling cost of entry and reduced economies of scale and from foreign providers of financial services over the Internet.
- Greater competition and lower production costs will reduce the price of financial services, the spreads of intermediaries, the revenues of established firms and probably their profits. This will adversely affect banks and other intermediaries with weak portfolios, excessive operating costs and precarious financial conditions, many of which are government owned.
- E-finance provides more than new delivery channels. It will enable providers to personalize service and to use enhanced information to price risks better. This will be particularly true in retail finance.
- Purely on-line banks have not been very successful, but competition is forcing existing intermediaries to offer on-line services. Other types of firms, such as telecommunication companies and Internet providers are entering the financial field, sometimes on their own, but more frequently in partnership with financial firms. New types of firms are being established, such as those that allow customers to compare on-line mortgage rates or insurance costs.

As shown in the text box above, many donors are now considering the potential role of e-finance in improving the depth of competition, transparency, and access by the poor and by small businesses to financial services. There is a genuine need to understand the implications of e-finance for the emerging markets and support governments in building an infrastructure in which e-finance can flourish.

[21] *The EGAT Bureau is using a new development tool, the Global Development Alliance (GDA). Alliance partners make financial and/or in-kind contributions to increase the impact and sustainability of development efforts. Due to the need for specialized skills and a significant investment in technology that may be required for the introduction of e-finance, USAID might consider using the GDA structure for piloting e-finance projects in selected countries.*

II.B.5 Safety Net Reform

Over the past several years, many donors have begun devoting increasing resources towards strengthening and reforming "safety nets" - broadly defined here as the set of programs and legal/regulatory measures designed to protect the public at large, particularly those of modest means, from falling into poverty. In the financial sector, this has centered on pension systems, insurance and financial assurance mechanisms, such as deposit protection and investor protection.

Pension Reform

The pensions system is a financial sub-sector that had previously been sometimes overlooked by international donors, though the performance of a country's pension system can have far-reaching impacts on many aspects of society and many sectors of the macroeconomy. Successful pension systems provide basic incomes to retired workers and help mobilize savings for investment in the capital markets, an aspect that is particularly important in developing countries. All pension systems strive to achieve four basic objectives:

- To provide adequate old age income to those individuals participating in the system;
- To provide coverage to as many workers as feasible, focusing resources on those workers most in need of old age income support;
- To ensure the long-term financial sustainability of the pension program; and
- To support, or at least not hinder, economic growth through appropriate financing mechanisms

Many pension programs in countries across different regions and levels of development, are now confronting similar issues. A combination of demographic trends, economic conditions and poor plan design has rendered many pension systems financially unsustainable. In response to these problems, many countries are adopting a "multi-pillar" system with a mandatory, government administered, pay-as-you-go first pillar, a second pillar that is a fully funded, defined contribution system with individual accounts often managed by private fund managers, and a voluntary third pillar based on retirement savings plans sponsored either by employers or individuals. The individual pillars are tailored to meet each country's unique issues and constraints.

Most donors are well placed to provide technical assistance for pension reform. Providing assistance for pension reform is in line with strategic objectives of fostering private sector growth, reducing poverty, and building institutional capacity. Some trends in reform are as follows:

- **Overall Pension Policy and Reform:** There is considerable work on a policy level to develop an appropriate, long-term pension strategy and set the direction and framework for its implementation. It also includes support for pension modeling with parametric variations (i.e. increasing retirement age, strengthening link between contributions and benefits, indexation, etc.). Work is also being done to determine whether to introduce new programs and to design corresponding structures and management of the transition phase.
- **Regulation and Supervision:** Without proper regulatory and supervisory systems, funds are susceptible to misappropriation or improper investment. Assistance efforts help to define the set-up, organization and functions (licensing of fund management companies, monitoring and inspection systems, problem resolution and punitive sanctions) of a pension supervisory agency and to develop pension regulations (licensing criteria for pension fund management companies, advertising/marketing guidelines, asset segregation and minimum capital/reserve requirements, investment rules, disclosure and reporting requirements).
- **Information Technology and Management Systems:** Data collection is critical for policymakers, the pension supervisory agency, pension funds and individual pensioners. IT/MIS systems must be able to capture data to perform both administrative and monitoring/surveillance tasks. Reforms involve upgrading records management systems, improving accuracy and timeliness of data collection systems, designing and implementing IT systems.
- **Corporate Governance:** The governance of pension funds is critically important, since the quality and performance of fund management can determine the income flows to which retirees are entitled, as well as the level of government funding of any shortfall between what the plans may promise (if they are defined benefit) and what they are capable of delivering. There is evidence of poor performance by many publicly managed pension systems is highly correlated with the extent of government-imposed restrictions on investments and the absence of pension board authority to govern investment decisions. There is growing awareness that public pension programs must be given a clear mandate-to maximize the returns for retirees-and not be assigned collateral social objectives; that the boards be insulated, to the maximum extent possible, from political influence; that the members of the board meet rigorous qualifications for serving and that they understand and avoid any conflicts of interest when administering these plans; and that the performance of the plans be disclosed regularly so that boards can be held accountable to their stakeholders.
- **Financial Management and International Accounting Standards (IAS):** Proper financial accounting is important to determine fund performance,

track individual accounts, and monitor compliance. There is broad potential to help pension administration agencies to upgrade their financial management capabilities. This can be undertaken in conjunction with broad accounting reform programs and/or corporate governance programs.

- **Public Education and Advocacy:** Public education and advocacy programs are needed to educate the general public about the need and benefits of pension reform and to help existing pensioners determine whether or not to switch to newly established pension programs. Assistance efforts include surveys to determine what issues need to be addressed, followed by the design of a corresponding, comprehensive public education campaign. In addition, tools are being developed to help existing pensioners analyze the costs and benefits of switching to new systems.

- **Skill Development and Training:** In order for a pension system to be sustainable, those charged with implementing it must understand its complexities and have the capacity to oversee and refine the system. Activities include specific training programs in areas such as: (1) basic principles of pension reform including policy and financing, (2) actuarial analysis, (2) pension fund regulation and supervision, (3) pension fund management and (4) pension fund administration.

While pension systems form an integral and often very large part of many countries' financial systems, they are distinct from other subsectors, such as banking and securities trading, in two important respects. First, the primary objective of a publicly-funded or guaranteed pension program is to promote the well-being of its participants, and not to generate growth in national capital markets or provide a source of financing for government projects. This distinction becomes important in real-world decisions often faced by donors, such as whether to advocate for the allowance of foreign investment by a pension fund. Second, pension programs are often mandatory, whereas participation in the stock market or in the banking system is - at least nominally - voluntary. This carries an important implication for governments, and by extension, donors, in that it implies a government guarantee of fund performance, even if no explicit guarantee exists.

Depositor Protection Reform

As witnessed during the 1997-1998 Asian crisis, external shocks and even rumours can stimulate an unwarranted and immediate drop in confidence in a bank, or of group of banks (for example, all banks which are owned by or associated with a particular country or region), causing a run on deposits and present the risk of failure of one or more banks. Explicit deposit protection schemes are increasingly being introduced as a mechanism to boost depositor confidence and add a further layer of comfort to reduce the risk of withdrawal and the flight of funds from one bank to another, or one jurisdiction to another.

There is a growing trend in favor of explicit forms of deposit protection. For example, deposit protection arrangements have been harmonized throughout the countries of the European Union. More recently, the G22 Working Party on Strengthening Financial Systems has recommended that each country should put in place explicit deposit protection arrangements, with a clear specification of the nature of protection provided and the means of defraying the costs. The IMF has endorsed a limited form of deposit protection in its code of best practices. In addition, the Financial Stability Forum ("FSF"), a forum formed by the G7 countries to promote international financial stability, has created a Working Group to develop international guidance on deposit insurance in recognition of the crucial role of deposit insurance in contributing to confidence in the financial system.

- **Move towards limited explicit protection:** Many countries currently offer explicit comprehensive guarantees to all bank depositors and other creditors. However, there is a trend to create systems of explicit limited protection[22]. Policymakers are increasingly becoming aware that a well-designed system of explicit limited protection can limit the government's financial commitment by requiring banks to contribute toward the compensation that is to be paid, contain moral hazard, offer prompt protection to the small depositor and reduce his/her propensity to run[23].

- **Need for best practice design:** Sixty-seven countries currently have systems of explicit limited protection. Unfortunately, most of them depart from good practice in a number of respects. The deposit insurance schemes in place in Japan and Korea proved unable to protect the financial system from the Asian crisis, and the authorities granted blanket coverage temporarily. Mexico followed a similar path. The operative phrase here is "well-designed." Recent efforts to develop better deposit protection design have

[22] *Finland and Sweden offered explicit full guarantees during their crises, but have now removed them and replaced them with limited coverage. Honduras, Indonesia, Japan, Jamaica, Korea, Mexico, and Thailand plan to replace their blanket guarantees in due course. Kuwait currently has an implicit full guarantee, but is considering switching to limited coverage. Costa Rica offers full guarantee by law to depositors and creditors of its state-owned banks, but is planning replacing it with an explicit limited system for both publicly and privately-owned banks.*

[23] *The World Bank's (WB's) position on limited explicit protection seems more ambiguous. Operational departments have frequently been instrumental in initiating deposit protection schemes in a number of emerging-market countries. But recent research at the WB (Demirguc-Kunt and Detragiache, 1998 and 2000 and Honohan and Klingebiel, 2000) has stressed an historical association between the existence of a deposit protection scheme and the incidence of financial crisis. This correlation may be valid, but in fact, likely results from the poor design of the systems in operation in the countries that have experienced crises or indeed simply reflect that countries at risk tend to impose such schemes to lessen risk to the general public.*

centered on aspects such as: reducing moral hazard risks by limiting protections to small depositors, the introduction of risk-based premiums, making operations more transparent, public outreach to reduce expectations around implicit guarantees, increasing reliance on market discipline as an early warning of distress.

Investor Protection Reform

Efforts to strengthen protection of investors have centered primarily on three areas: 1) More stringent setting and enforcement of disclosure requirements of publicly traded securities; 2) tougher regulation of the market conduct, promises, and undertakings of financial intermediaries; and 3) statutory requirements for the creation of investor protection schemes. All of these areas are integral components of capital market development initiatives being implemented in various parts of the world.

II.B.6 New Financial Products

New financial product and market designs have been made possible by improved computer and telecommunications technology as well as advances in the theory of finance during the past quarter-century. Product innovations have led to dramatic changes in the structure of global financial markets and institutions, in particular a partial shift from intermediaries to markets in the provision of finance.

Markets are developing to meet the needs of a wider range of users. These developments include securitization and its application to a wider range of financing activities, the development of corporate debt markets and continuing growth of investment in market-linked instruments relative to deposits and similar instruments offered by intermediaries. In addition, markets are providing a means of managing risk through a wide range of derivative instruments. Key developments related to the emergence of new products and services are summarized below:

Derivatives - From Credit Risk Intermediation to Global Risk Intermediation: Nowhere has product innovation had a more profound impact on the evolution of financial markets than the development, refinement, and broad-based adoption of derivative securities such as futures, options, swaps and other contractual agreements. Those innovations in financial-contracting technology have improved efficiency by expanding opportunities for risk sharing, lowering transaction costs and reducing information and agency costs.

In providing the means for pricing and risk measurement of derivative securities, finance science has contributed fundamentally to the remarkable rate of globalization of the financial system. The flexibility created by the widespread use of derivatives as well as specialized institutional designs provided an

effective offset to dysfunctional country-specific institutional rigidities. Furthermore, derivative-security technologies provide efficient means for creating cross-border interfaces among otherwise incompatible domestic systems, without imposing invasive, widespread changes within each system. For that reason, future development of derivative-security technology and markets within smaller and emerging-market countries may help form important gateways of access to world capital markets and global risk sharing.

The use of derivatives has been growing rapidly in recent years. The most recent statistics from the Bank for International Settlements indicated that the notional amount of over-the-counter derivatives outstanding totaled $111 trillion in December 2001, up from $80 trillion just three years earlier. For exchange-traded derivatives, notional amounts outstanding rose from $14 trillion to $24 trillion over the same period.

Increasing Reliance on Sophisticated Tools: Today no major financial institution in the world, including central banks, can function without the computer-based mathematical models of modern financial science. The specific models that these institutions depend on to conduct their global derivative pricing and risk-management activities are based on the option pricing methodology. Growing complexity of products and the need for more rapid decision-making will require increased reliance on computer models and with that, a need increased managerial attention to the reliability of those models along with a more seamless interface between computer-model generated recommendations and human judgment. All of this implies a growing need for higher skill among financial practitioners and regulators.

Disintermediation and Corporate Bond Market Development: Disintermediation is the process of borrowers bypassing balance sheet intermediaries and obtaining finance directly from the capital markets. The development of corporate bond markets and securitization in many countries indicates the competition faced by traditional intermediaries for the provision of credit. The increasing capacity of large firms to access capital markets for credit is both a by-product of technology and the increasing sophistication of markets in developed economies.

Securitization: Securitization[24] as a technique gained popularity in the US in the late 1970s and was substantially supported by legislation, favorable tax treatment, government-guarantee mechanisms, and a pragmatic regulatory environment. The market for securitization in the US has since diversified from

[24] *Securitization is a process through which illiquid assets are transferred into a more liquid form and distributed to a broad range of investors through the capital markets. The lending institution's assets are removed from its balance sheet and are instead funded by private investors through the sale of negotiable financial instruments with credit-worthiness, which is of higher quality than the underlying assets themselves or than that of the originator.*

mortgage loans into a wide range of securities, including credit card receivables, small business loans, and other types of cash flow-generating assets. On a very limited basis special purpose vehicles are even being employed by banks and finance companies as a vehicle to securitize non-standard credits such as corporate loans, including real estate-backed non-performing and under-performing loan portfolios. The UK is the second largest source of asset securitizations. Other countries in Europe have been relatively slow starters, although regulatory and legislative changes have helped fuel new activity in some markets. Japan is the largest user of asset securitization in Asia, and is positioned for strong growth in the future. Following an amendment of its laws last year, it now has no restrictions on the activity.

Several types of securitization have grown rapidly over the past decade. One of the fastest growing has been asset-backed commercial paper, which soared from only $16 billion outstanding at the end of 1989 to more than $700 billion as of the second quarter of this year. Commercial mortgage securitizations have also proliferated noticeably since the early 1990s. The dollar amount of outstanding securities backed by commercial and multifamily mortgages has risen from $36 billion at the end of 1989 to nearly $400 billion as of this past June. In addition, commercial banks and finance companies have moved business loans off their books through the development of collateralized debt obligations. Securitized business loans amounted to $125 billion in the second quarter of 2002, up from a relatively miniscule $2 billion in 1989.

Special Purpose Vehicles: The past several years have witnessed significant developments in the use of special purpose vehicles ("SPVs"). Initially used by western banks in relatively simple transactions, such as the securitisation of self-liquidating mortgage loans, the notion of the SPV is now applied all over the world to more complicated financing transactions and for a variety of asset management and commercial purposes. In the context of asset restructuring, there are two general areas in which SPVs have been widely employed: troubled debt securitisation transactions and government-run asset management companies.

Product Bundling: Increasingly, banks are realizing the importance of non-interest (fee) income. Particularly with regards to middle market and SME lending, credit relationships are not seen as ends in themselves, but rather as one component of a larger client relationship that can include fee-based products such as payroll services, cash management and even financial advisory.

These trends will affect USAID Missions around the world to varying degrees. The table below on the following pages provides examples of some interventions, among many, that USAID might consider in response to the challenges that its client countries may face as a result of the trends discussed above.

Table 5: Examples of Interventions

	Technical Area	Indicative Donor Interventions Driven by Trends
Globalization, consolidation and convergence	Crises Mitigation	• Development of contingency plans for crises management and mitigation (lender of last resort policy, capital market master planning, bank resolution master planning, etc.) • Mediation and design of cross-border cooperative arrangements for insolvency reform • Insolvency system reform • Develop innovative mechanisms for banks and regulators on the resolution and workout of troubled debt
	Capital Markets	• Targeted TA for the implementation of FSAP recommendations • Assistance in meeting EU integration requirements (CEE countries) • Support harmonization of regulatory standards and trading mechanisms - i.e. establish assistance packages that focus on standardized technology packages so that it would be reasonably easy at a later stage of development to move toward global or regional integration • TA for the deepening of financial markets. This may include new product innovations as described below, and/or more traditional product categories, such as government bond markets, that form the bedrock of a fixed income markets
	Regulation and Supervision	• Support for developing regulatory strategy, policy frameworks, and market-development oriented approaches for banks and non-banks • TA to improve the legal framework and supervisory capacity for consolidated regulation (with the entry into those markets by international financial conglomerates). • Support for the implementation of policies and guidelines on the proposed new Basle guidelines • Support for implementation of risk-based supervision and early warning systems • Support for the design and implementation of integrated supervisory structures that link bank and non-banks • Mediation and design of cross-border and domestic cooperative arrangements that broaden oversight and improve regulatory coordination • Development of intervention and resolution frameworks for distressed institutions • Assistance in developing mechanisms that catalyze interaction between regulators and the institutions they supervise • Support in the development of SROs; assistance in integrating SROs into formal regulatory operations • Legal reform, including strengthening administrative agencies, developing legal standards for judicial review of supervisory decisions, alternative dispute resolution

	Technical Area	Indicative Donor Interventions Driven by Trends
Information Disclosure and Governance	Banking and Non-Banking	• Support for the development and implementation risk management systems and procedures in response the proposed new Basle guidelines • Assistance in meeting EU integration requirements (CEE countries) • Support growth in non-bank subsidiaries such as leasing and insurance companies
	WTO Accession/Trade	• Build the institutional capacity to supervise and regulate a liberalized financial sector in line with international standards
	Accounting, Auditing, and Disclosure	• Continue efforts to adopt international accounting and auditing standards by: strengthening the accounting and auditing profession; development of national policies on auditor independence; development of sustainable SROs, assisting enterprises and institutions in converting their accounts to IAS, and harmonizing local accounting standards with global standards • Support for the development of laws and regulations for better disclosure; assist in the establishment of enforcement procedures and evaluative frameworks to ensure compliance with disclosure standards • Support development of credit bureaus
	Market Discipline	• Develop mechanisms that increase the role of market discipline in the operation of financial markets • Develop systems and tools that collect, aggregate, and disclose information on intermediaries, enterprises, financial products and markets (e.g. credit rating agencies, shared credit systems, etc.)
	Corporate Governance	• Assist countries to build legal framework and institutions to comply with the OECD principles of corporate governance • Increase measures for improved public sector governance, in particular of state-owned banks and asset management companies • Establishment of mechanisms to strengthen shareholder activism and communication of shareholder rights • Support in the design of governance structures for public institutions and agencies
Electronic Finance	Regulation and Supervision	• Assist in establishing new central policies on the regulation, extension of assurance, payment systems access of e-finance operations • Assist in evaluating the macro impact of new operations and exposure (e.g. on lender of last resort policies, commercial organization, and market structure) • Support revision of the legal framework for protection of consumers and investors • Support for the strategic evaluation of e-finance opportunities • Development of new institutions or mechanisms that leverage e-finance to increase access to financial services in under-served areas
Safety Net Reform	General	• Country assessments of safety net extension from the point of view of: suitability, design, efficiency, breadth of coverage, regulation and governance
	Pension reform	• Support for the overall development of pillar private pension schemes (policy, regulation, governance, financial management, advocacy and outreach, and capacity building) • Support for the reform and strengthening of state pension operations Assist in the set-up, organization, function and design of a pension supervisory agency • Develop pension regulations (licensing criteria for pension fund management companies, advertising guidelines, asset segregation and minimum capital/reserve requirements, investment rules, disclosure and reporting requirements) • Assist in upgrading technology for data collection and analysis to support the pension supervisory agency, pension funds and individual pensioners

	Technical Area	Indicative Donor Interventions Driven by Trends
	Deposit Protection	• Assessment of the suitability of depositor protection arrangements. • Support for the best practice design and development of deposit protection schemes • Assistance in the design and implementation of public consultation studies • Development of risk-based pricing approaches • TA for: improving the coordination between regulators and deposit insurance agencies; developing pricing mechanisms, reforming existing systems
	Investor Protection	• Assistance in the development and regulation of investor protection funds • Assistance in the strengthening of capital markets regulation for more precise protection of investors
New Financial Products	Derivatives and Securitization	• TA for the development and application of new product-market deepening technology; assistance in using this technology to facilitate financial intermediation where structural barriers that stand in the way of normal market development • TA on the public policies and regulation governing new technologies/products Assistance in the development of risk management policies and procedures for new products • Assistance in the development of risk management policies and procedures for new products • TA for the development of an enabling environment for special purpose vehicles, trusts, and other contractual vehicles - legal structures that facilitate risk-fencing of risk, the separation of ownership interest from beneficial interest, or secure capture of cash flow/collateral for pass thru securities • Market education, outreach and policy assistance on new technologies
	Credit Products	• Support for the development of credit products by: product design, training, infrastructure development, rating systems, etc • TA for the development of mortgage markets • TA for the development of corporate bond markets
	SME Finance	• Assistance to banks in developing strategies and service offerings under *SME banking.* (This goes beyond SME finance to include whole business strategies leveraging distribution channels, deposit products, and non-credit services) • Assistance to NBFIs and/or MFIs in providing SME-specific products

II.C. OPTIONS FOR OFFICE OF ECONOMIC GROWTH

II.C.1 Objectives

During the current USAID reorganization, the Office of Emerging Markets was dissolved and the Office of Economic Growth (EGAT/EG), a single office within the EGAT Bureau, will assume responsibility for providing field support and technical leadership in financial sector development. As implied earlier, we support the concentration of USAID/Washington's financial sector staff, rather than fragmenting them throughout the Agency, in order to allow them to accumulate the information and experience required to support the field. Yet, the reorganization has resulted in the overall reduction of Washington-based financial sector specialists. Accordingly, we would recommend that EGAT/EG ensure that it is staffed with a sufficient number of specialists to develop core technical competencies, in those areas identified in the section on key developments above[25].

The technical strengths of EGAT/EG's staff must also be consistent with the work to be done; that is EGAT/EG's technical leadership role must exist within a decentralized Agency. USAID continues to be a bottom-up operation with most of the decision-making and budgeting controlled in the Missions, with Washington offices providing support. Nonetheless, EGAT/EG has an important role to play through suggestion and recommendation of the strategic direction for the Agency's financial sector activities.

There are two main objectives of the Office of Economic Growth: field support to Missions for project selection, design, and project implementation; and technical leadership. These are described below.

1. **Field Support:** At the country level, EGAT/EG should advocate that Missions use financial sector assessments, such as output from the joint IMF/World Bank Financial Sector Assessment Program (FSAP) or from a structured country classification exercise (topology), to select which technical assistance projects to support. EGAT/EG should assist Missions in project design, through its own resources, and by facilitating access to contractor and USG resources through its global mechanisms[26]. EGAT/EG should be the driver of this process by ensuring that Missions have the information on current status of global markets and access to information on their domestic financial sector, including other donor activities. If there

[25] *This final draft of this paper was presented in early December, 2002. By January, 2003, transfers from other bureaus into the EGAT Office of Economic Growth as part of the reorganization were completed and the number of staff dedicated to the financial sector specialists is expected to be five. We also understand that the 2003 budget is expected to be in the range of $1.5 million.*

[26] *In recent years, the trend has been away from providing core funds as part of the IQCs. A similar mechanism for providing central funding for design should be considered.*

were a significant event effecting the global or the partner country's financial sector, EGAT/EGAT/EG might take the responsibility to join with the Mission in conducting a new country strategy or revising the objectives of a financial sector activity.

Furthermore, EGAT/EG could take a more active role in ensuring that the projects chosen by the field Missions and Regional Bureaus are well implemented. Reaffirming this role will require continuation of existing global mechanisms[27]; improving and maintaining an information database and website; requesting CDIE to undertake evaluations; better, more proactive interaction between EGAT/EGAT/EG, other offices, the Missions, and other USG agencies; and conducting conferences on lessons learned.

2. **Technical leadership in new and existing programs:** The Office of Economic Growth should promote excellence in ongoing field programs and technical assistance areas that are new for USAID and that address key issues in financial sector development. The office should consolidate USAID/Washington's financial sector resources. These staff would undertake eminence activities that include research, knowledge management, and training. Implementation of this role might include issuing new umbrella contracts, drafting guidance for scopes of work for the field, undertaking targeted studies, and setting guidelines for what might be included in design of new financial sector development projects, among others.

Much of the infrastructure to meet these objectives is in place, but that does not cover all that is needed. EGAT/EG designed its cooperative agreements, contracts, and interagency agreements in ways that facilitate rapid access to professional technicians by Missions. EGAT/EG has staff well experienced in maintaining the contracts and agreements, ensuring continued availability of professionals to the Missions. They may use contractors under the SEGIR mechanisms and/or the US government and other specialists who can be accessed through the Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Financial Services Volunteer Corps agreements. During the past few years, EGAT/EG staff has been principally occupied with assuring compliance of these arrangements with the provisions imposed by the contracts. As a result, EGAT/EG staff has had minimal time to participate in designing and/or overseeing the implementation of individual scopes of work; understaffing has kept them from making the quality contributions they might have made.

During recent years, EGAT/EG has provided limited technical leadership for new initiatives. Resource cutbacks during the reorganization have left the Agency with less capacity among financial sector specialists in Washington. A

[27] *This includes, most importantly, the maintenance and recompetition of the SEGIR contracts.*

question now appears to be whether EGAT/EG can obtain staff that it will require to provide technical leadership. An objective going forward should be to provide EGAT/EG with additional financial sector specialized staff, some of whom may join with pre-defined responsibilities in the financial sub-sectors.

II.C.2 A Center For Financial Sector Reform: Potential Global Initiatives

The most compelling reason for enlarging EGAT/EG's staff size is the accumulating body of evidence showing that there are greater opportunities than ever for bilateral donors to provide technical assistance in the financial sector. USAID leadership seems to have accepted the idea that greater financial sector efficiency leads to more rapid output growth and poverty reduction. Through the reorganization, EGAT/EGAT/EG has already become larger with more staff working on financial sector issues. It is also probable that, in line with the concentration of staff, the level of annual program funds will increase considerably. If a critical mass is reached (e.g., more than 5 financial sector staff including net new resources in Washington), then it might then be useful to establish an independent center for the financial sector work. This would create an identity for USAID's financial sector programs. A coherent financial sector policy for all USAID activities could be made. The financial sector center's professionals would become increasingly more available as a welcome source of leadership, information, and advice to the staff in Missions and other USAID/Washington offices than the workload currently within EGAT/EG will now permit.

Size will also determine the level of depth to which the Office of Economic Growth can fulfill its role to serve as a central point within USAID for information and access to resources on financial sector development during the next decade. In addition to leadership in new initiatives, EGAT/EG would have cross-country and cross-regional perspectives. Key issues that have emerged from the crises and technological changes that financial markets have undergone will continue to influence the sector's development for the next decade. EG's role in keeping abreast of these issues, dependent upon an increase of staff and program funds, can improve USAID's fundamental processes of project selection and implementation and ensure development impact of the financial sector reforms USAID Missions support. A thorough understanding of global and national level financial environments will assist the organization to guide Missions in defining the most effective types and levels of assistance.

Most importantly, EGAT/EG might consider initiating global programs which are consistent with its technical leadership mandate. EGAT/EG might work with Missions to implement pilot projects that address country-specific issues related to the key financial sector trends listed earlier. The criteria for global projects are those which would likely represent new approaches for USAID,

would likely require specialized expertise that might not be available within a given Mission, and could require some research and conceptual work to be performed in advance of a project to identify common problems across countries and develop tools to be used in solving them. EGAT/EG is particularly well placed to launch such pilot projects because it can take greater risks than Missions - assuming its mandate explicitly includes innovation and experimentation with new project designs.

In considering the list of global trends and the possible interventions, above, we suggest below some projects which meet these criteria and which EGAT/EG might undertake that would be meaningful to many USAID partner countries over the next decade. It should be noted that many of these are complex and perhaps better suited to more sophisticated financial markets. EGAT/EG may also consider interventions in building the basic foundation for a financial system in countries in which USAID is just initiating non-humanitarian assistance (e.g., Afghanistan):

- **Financial regulation and supervision.** EGAT/EG, by conducting evaluations, might undertake an analysis of USAID's banking supervision projects to date, identifying what has worked and what has not. Using this data and projecting the future needs for regulation and supervision, EGAT/EG could identify those areas which require additional assistance. Based upon this analysis of gaps, EGAT/EG could suggest to Missions the scope and content of second and third generation projects, such as consolidated regulation and supervision, surveillance and enforcement.
- **Compliance with international supervisory standards.** As described above, there is a need for extensive training and internships to upgrade supervisory capacity to meet international standards such as the Basle Core Principles or Basle II requirements, which can be done on a broad scale rather than by individual countries. EGAT/EG could employ implementers to design and deliver this training, sharing the costs of participation with Missions and with beneficiaries.
- **Rating agency/service development.** Under the new Basle capital adequacy framework, there is likely to be a significant increase in the demand for rating and risk management/ measurement services, providing an additional target of opportunity for USAID work. As this is a relatively untested area (although the E&E bureau has done at least one such project in Hungary), EGAT/EG might initiate a pilot effort in specific countries. There may even be scope for GDA involvement, teaming with Standard & Poors, Moody's, Fitch, or other US-based rating services interested in investing in developing countries.

- **Regionalization of securities markets.** We propose EGAT/EG undertake an initiative to determine how to harmonize or regionalize regulation, supervision, technology, and operations of capital markets. A technical assistance gap analysis or analysis of the pre-conditions for harmonization could then be used to guide Mission development of statements of work.
- **Prevention and enforcement of money laundering, terrorist financing, and financial crimes** are coming to the forefront and most Missions have not integrated these issues into financial sector programs. In parallel with the new World Bank initiative and those of the US Government, in collaboration with interagency partners, EGAT/EG could lead the Agency in tackling these issues.
- **Expanding markets through e-finance:** Again, this is an area in which EGAT/EG could take a technical leadership role in analyzing current research on e-finance, identifying potential interventions and then, assisting Missions to design programs through which they could assist financial institutions to introduce technologies that lower operating costs and that make it possible to provide financial services more widely.
- **Expanding access to finance for SMEs and for the poor:** USAID has funded several large SME finance activities, the impact of which is still unknown. It is now critical for EGAT/EG to evaluate and synthesize the successes and failures of these SME projects for future project design - which could incorporate measures to increase local capacity to provide technical assistance as well as financing to micro- and small businesses. Also, USAID's commitment to microfinance indicates a commitment to facilitate access to finance for the poor. Opportunities aside from microfinance to extend finance to the poor through conventional institutions merit further study.
- **New financial instruments development,** which results in better diversification of products and improved financial intermediation, is another innovative area for USAID. Some ongoing projects (India FIRE, Jordan AMIR, others in E&E) have included financial instrument development, but there is little yet understood about the success of these interventions in bringing new products to market. Not only might EGAT/EG commission evaluations to support future project design, but it might also continue training efforts (such as upcoming debt and mortgage market seminars funded by the E&E bureau) across regions.

II.C.3 Four Scenarios

In the pages that follow, we review EGAT/EG's options by analyzing increasing levels of staff and program resources. This analysis will help EGAT/EGAT/EG management to understand the technical difficulties in the pursuit of a financial sector reform "center of excellence" and the resources required. In our analysis, we treat those tasks which might at first appear to be administrative -- improving information flows, project evaluation, and liaison with other groups working in the financial area - as important as research and implementing new programs. The recommended tasks under each option will contribute substantially to fulfilling the Agency's work in the financial area and attaining EGAT/EG's objectives. Some tasks are presented in a base case, requiring no increase in the current level of resource, others would be expensive to implement and could not be undertaken by EGAT/EG without additional resources. The four scenarios are as follows:

- **Scenario A - Base Case Mission Support:** Two full-time equivalent (FTE) staff who are financial sector generalists and $500,000 of annual program funds (assumes a small increase, if at all, from the current level of resources)
- **Scenario B - Better Mission Support through Evaluations and Assessments:** Two FTEs who are financial sector generalists and $2,000,000 of annual program funds (assumes no additional staff, but a significant increase in program funds)
- **Scenario C - Improved Technical Leadership through Increased Technical Staff:** Four FTEs, including financial sector generalists subsector specialists, $2,000,000 of annual program funds (assumes both additional staff and a significant increase in program funds from Scenario A)
- **Scenario D - Dedicated Center for Financial Sector Reform providing Mission Support and Technical Leadership through Global Programs:** Six FTEs, including generalists and sub sector specialists and $5,000,000 of annual program funds (assumes a dedicated financial sector development department and sufficient funds to run multi-year, global projects). This scenario would allow for an increasing level of complexity with which financial sector development issues, listed in the section on global programs above, are addressed.

We keep our discussion of the Scenarios illustrative. We provide some recommendations for tasks in the Tables in Attachment 1. The next step is for EGAT/EG to define for itself what level of resource it may pursue and, accordingly, prepare a more definitive set of tasks. It should be noted that during the course of our work, we did not analyze EG's current activities at this level of detail. Consequently, the Scenarios are presented as a tool for EGAT/EG to use and adjust, rather then a set of well-defined work plans. Each task must in turn,

be analyzed according to level of difficulty in implementation. For the purposes of this report, we have classified tasks simply into the following categories: those with a high degree of difficulty to implement that will likely require agreement from and collaboration with organizations outside the Agency; those with medium difficulty requiring intra-agency collaboration among offices; and those with low difficulty tasks that could be accomplished with current and planned EG's resources. In the Tables, we offer a projection on the level of resources that might be required.

Scenario A: Base Case - Mission Support

Scenario A is the base case scenario. In this scenario, we assume there will be only two people assigned to a financial sector unit within EGAT/EG. This includes the SEGIR FS component manager and one additional person. We assume the amount of funds that the office programs will remain the same as in fiscal year 2002, $500,000 per year.

Field Support

Of the Office's two objectives, with this level of resources, EGAT/EG will focus nearly exclusively on field support. In particular, they will support Missions by drafting, negotiating, and managing the three global mechanisms: the SEGIR global contracting vehicles, cooperative agreements (CAs), such as that with FSVC, and interagency agreements (IAAs). This is largely an administrative task, in which the SEGIR FS Component Manager will review scopes of work for technical merit, without adequate time for more comprehensive consultation. Based upon the team's findings, this is most valued work of EGAT/EG, and program resources should go toward improvement of this function. We found consensus among those interviewed -- USAID/Washington staff, contractors, and partner USG Agencies - that the SEGIR contracts are particularly effective mechanisms for delivery of technical assistance.

Currently, technical resources to assist Missions in project design are the SEGIR contractors, volunteers, or other US Agency personnel from, for example, the US Securities and Exchange Commission. EGAT/EG does not have the staff to provide much direct support to Missions in either project selection or project design.

Even with modest funds, however, under this scenario, EGAT/EG should use the majority of these program funds to undertake the research and planning needed to develop the methodology for country classification described above and to link the classification to appropriate design and sequencing of technical assistance projects. Most Missions should be able to determine into which of the proposed categories their country falls. Resources dedicated to implement the country classification process described above must be available from

Missions or the Regional Bureaus and ongoing validation and research must come from contractors. EGAT/EG will not have the personnel to dedicate to the topology, only to manage the contractor's efforts.

Knowledge Management

The remainder of EG's resources should be used to expand its knowledge management role. For example, as part of knowledge management, staff should update and maintain the database constructed as a part of this study, which lists USAID financial sector projects from 1988 to 2001. EGAT/EG may use program funds for this work and as well as for enhancement of their current website. EGAT/EG should continue its effort to collect and post statements of work in financial services, development experience documents, and progress reports. EGAT/EG should ensure those reports are submitted to CDIE repository. Furthermore, a dedicated knowledge manager might be hired.

Within the current level of resources, other improvements could be made. One area is in intra-agency communications. To date, EGAT/EG has used the results of this project for these purposes, through the team members' presentations. Going forward, EG's Office Director might schedule regular, unstructured luncheons with the heads of other USAID offices with large financial sector reform activities. EGAT/EG might arrange occasional retreats for all USAID/Washington and other US Agency staff working on financial sector reform. Such retreats (perhaps half-day to maximize participation) would give practitioners opportunities to make semi-formal presentations about their work and would give these diverse parties opportunities to learn who is doing what and how.

Scenario B: Better Mission Support through Assessments and Evaluations

Under this scenario, we assume that the EGAT/EG continues with only 2 people, but has a significant increase of program funds to $2 million per year. In addition to the areas in Scenario A, above, the incremental increase of $1.5 million in program funds will be used, for the most part, for financial sector assessments and for evaluations.

Assessments and Evaluation

With this level of resources, EGAT/EG will support the Agency by analyzing lessons learned in financial development and incorporating such practices into project design. USAID Missions could benefit from EGAT/EG core funding for conducting assessments - and by using the public documents produced as outputs from the FSAP/ROSC for project selection and design, made available by EGAT/EG[28]. Moreover, EGAT/EG may take advantage of these in-depth

[28] *OEM does not have the qualified personnel nor do USAID Missions have resources to undertake the level of diagnostic work done in an FSAP at a cost of $600,000 per country.*

studies to identify the key areas requiring technical support. In addition to the designing the topology (described in Scenario A), EGAT/EG could initiate a regular exercise to review the mission plans for financial sector TA against either the needs identified as a result of an FSAP or the topology.

As described above, USAID's most pressing need respecting financial sector reform, may be to find out what the results have been of past financial sector reform initiatives. EGAT/EG should continue its effort to collect and post relevant materials in financial services. However, with additional resources we propose that EGAT/EG design an evaluation program and begin to commission evaluations to be undertaken by CDIE and/or a contractor with the goal of developing material on lessons learned in those areas of USAID involvement.

Technical Leadership

A thorough understanding of global and national level financial environments will assist EGAT/EG to guide Missions in defining the most effective types and levels of assistance. It will also allow EGAT/EG to articulate a coherent policy regarding financial sector activities both within USAID and to its clients, partners, and implementers as well as to those outside the agency. EGAT/EG may do this in several ways:

1. Funding global programs, funding cross-border or regional activities
2. Providing knowledge management, through making statements of work, reports, contractor performance reports, as well as financial sector assessments and other relevant technical documents available on their website, and
3. Conducting research resulting in model statements of work, development of tools, and/or as advance preparation for pilot projects
4. Training staff through participation in international conferences and through modules for Mission staff in financial sector issues

However, with only 2 people, there will be insufficient EGAT/EG staff time to draft scopes of work or to manage actively new activities (i.e., serve as CTOs), other than the topology exercise. EGAT/EG will have to rely heavily on activities that are not as management intensive. Those probably include existing cooperative agreements only. If, on the other hand, core funding is used for SEGIR contractors, responsibility for management may have to be delegated to a CTO in another bureau or office.

EGAT/EG will have to balance its own resource constraints with the relative strengths of each group - contractors, cooperative agreement holders, and USG agencies -- taking into account the associated pros and cons. For example, reliance on USG agencies may result in a situation where only US financial markets approaches are considered, when a more global view might result in a

better project design. The business perspectives of market operations expertise or practicalities of implementation may also be missed. On the other hand, USAID might avoid the possibility that consultants may design a project that they are best suited to implement rather than one which addresses all the needs of the country, if only contractors are used.

In addition, another opportunity for EGAT/EG is to assume from the Regional Bureaus the responsibility for responding to Embassy or Mission requests specifically related to financial sector development. The result of decreased funding to the Europe and Eurasia region with the cut in SEED funding and the USAID reorganization is that fewer personnel resources available in E&E to manage regional activities. Using its global mechanisms (SEGIR, CAs, and IAAs), EGAT/EG might still fund central or regional activities with the objective of supplementing Mission funds. It may also fund regional activities, such as invitational travel for training seminars, workshops, or internships for development of skills among regulators and financial market participants and for which funds are no longer available.

Above, we list the potential areas for global programs. These should be developed further by EGAT/EG into an agenda for technical assistance or research. To repeat, the technical areas to consider are:

- Financial regulation and supervision
- Compliance with international supervisory standards
- Rating agency/service development
- Expanding access to financial services through e-finance
- SME finance and finance for the poor
- Regionalization of securities markets
- Prevention and enforcement of money-laundering, terrorist financing and financial crimes
- New financial instruments development

Training

There will be a need for more training of Mission staff in financial sector issues due to the limited headquarters financial sector staff. EGAT/EG has already asked a contractor to design training for Economic Growth staff, this should include additional modules on specific financial sector issues to complement the overall Economic Growth curriculum.

Scenario C: Improved Technical Leadership Through Increased Technical Staff

Under this scenario, we assume that EGAT/EG will increase its staff by two to a total of four people and the level of program funds will be $2,000,000. Given current circumstances, it is likely that this will be the increase in staff as a result of the reorganization, although there are no net new financial sector specialists in Washington headquarters as a whole. It is envisioned that EGAT/EG will have more active involvement in financial sector assessments as EGAT/EG staff can go on temporary duty assignments (TDYs) to conduct or participate in assessments upon Mission requests. The EGAT/EG team will also be able to go further than they do currently in providing technical review and comment on Mission SOWs.

Assessments

With more staff, EGAT/EG could expand its role in financial sector assessments to include direct hire staff to conduct and participate in project selection activities. The ability to hire direct staff rather than use contract or other USG agency staff makes it possible to provide a unified USAID financial sector development perspective from the center to project design and contributes to continuity between and among countries. With direct hire staff, EGAT/EG should be able to review task orders and project activities proposed by Missions requesting support for projects and then compare them to the priority lists developed through the topology and assessment exercises conducted under A and B above. Additional tasks that could be undertaken with additional staff include the drafting scopes of work for USAID Missions, based in part, upon fieldwork and the evaluative work done by contractors or CDIE. Staff members could also design scopes of work for technical assistance in areas that individual Missions might not wish to fund entirely, but may wish to share costs with EGAT/EG.

Under this Scenario however, lack of specific expertise in financial sub-sectors, might still make it difficult for highly complex programs to be adequately assessed or designed. The need for highly specialized resources (e.g., electronic payments systems experts, actuaries) would be met by procurement from contractors, CA holders (volunteers), or USG agencies.

Global Initiatives

Although the program funds remain the same and our suggested list remains the same, with more people, EGAT/EG might spend the $2 million per year differently. Most importantly, the significant difference between this scenario and Scenario B is that the range of global mechanisms which EGAT/EG might use is broader. This statement is based upon the understanding the contracting or use of IAAs is more labor intensive, requiring active CTOs.

The increase in staff will partially overcome constraint of CTO limitations to draft statements of work and actively negotiate and manage global projects. Accordingly, there will be scope for more active projects such as pilot programs in e-finance or regional capital market development. These might include regionalization or cross-border financial institutions or some of the new TA topics described above. Given the difficulty of negotiating IAAs, it would probably only be possible to, for example, agree upon an IAA with the Department of Justice for addressing financial crimes and Financial Action Task Force (FATF) compliance with more staff.

Scenario D: Dedicated Center for Financial Sector Reform Providing Mission Support and Technical Leadership

In Scenario D, two people are added in the EGAT/EG office for a total of six staff members, requiring new outside hires. We assume that the six are able to pursue sub-sector specialties in, among other topics, for example: banking, pensions and insurance, financial sector regulation, SME finance, accounting reform, and financial crimes. We also assume that these are incremental resources to the Agency as a whole, not just transfers from the Regional Bureaus. Each would manage his or her portfolio as, in this Scenario, the amount of program funds jumps to $5,000,000.

While at first glance, this scenario may appear contrary to Administrator Natsios' vision of a Mission-driven organization and out of limits, there are a number of factors which have prompted its consideration in this review. Financial sector development is a global phenomenon. IFIs with levels of funding and influence similar to that of USAID (e.g., the regional development banks) already have dedicated financial sector offices. At this size, Financial Sector Development could become its own office, a "center of excellence in financial sector reform." In particular, the Center (a term we will use for this scenario) could assume a greater implementation role as well as undertake more extensive research. This may also allow USAID to take a more prominent role vis-à-vis other USG agencies or other donors by gaining additional resources and improving its internal programming significantly[29].

FIRST Initiative

Since Tasks 1 and 2 of this Financial Sector Review and Strategy project were completed in January 2002, the World Bank and IMF have announced the coordination mechanism, entitled the Financial Sector Reform and Strengthening (FIRST) Initiative. The FIRST Initiative is a multi-donor project, which states

[29] *For example, we understand that, as part of multilateral negotiations on trade in financial services, the US Treasury is seeking to increase technical assistance as a lever to encourage market access. USAID should be part of this effort directly, through interagency coordination and through the IFIs.*

its aim as developing robust and diverse financial sectors in developing countries. In particular, FIRST is supposed to provide the development response to the findings of the FSAP/ROSC process. To-date, $45 million has been raised from bilateral donors to provide technical assistance grants to low and middle income countries for short and medium-term capacity building and policy development and will fund the provision of technical assistance to developing and transition countries in the areas of financial sector regulation, supervision and development.

Whether USAID chooses to join the FIRST initiative or not by contributing to the pool of funds, from the work in Tasks 1 through 4, we conclude that the FSAP/ROSC process is providing the best available financial sector assessment data currently available, due to the comprehensive nature of the reviews. At this level of resource, EGAT/EG could get directly involved in the FSAP/ROSC process -- through providing some grant funding and/or participating in the coordinating structure. This level of resource would allow EGAT/EG to at least have a dedicated person to collect information in a similar manner to that being done for FIRST, analyze it, and provide it to missions for their programming. This staff member could also be dedicated to the topology research and validation. With additional program funds, EGAT/EG will have the scope to provide grants or trust funds to international organizations to meet specific FS objectives, in particular around tallying and coordinating donor programs.

Financial Crisis Mitigation

As a result of the research and conferences conducted under Scenarios B and C, there might be scope for multi-year, multi-disciplinary regional implementation efforts. USAID could join other USG organizations and/or international organizations for activities related to financial crisis prevention, mitigation and resolution. EGAT/EG may even contract for a financial crisis rapid response team, to complement resources from the US Treasury. EGAT/EG may issue a new FS-focused research or project evaluation IQC.

Through the Center, USAID might develop the capacity to get involved in addressing financial sector crises. The Center could issue a contracting mechanism for crisis assistance, which would join IMF, World Bank, US Treasury, and regional development bank teams in crisis resolution. The Center might encourage financial crisis contingency planning in USAID-assisted countries, which is currently limited. In this, the Center would have the advantage of bringing to bear all its global mechanisms and therefore access to a wide range of governmental and private sector skills to the development of a solution.

Knowledge Management and Research

Lastly, under this scenario, we also propose that the Center broaden its research agenda. This scenario assumes that with more resources, there would more "thinking" time available in addition to the heavy administrative and contract management effort required under Scenarios A through C. This may allow EGAT/EG to expand its technical eminence and publish occasional papers on topics such as sequencing FS reforms or addressing the special circumstances of small financial systems. The research outputs that it could produce include: scholarly papers, regular evaluations and lessons learned articles, a regular newsletter, and seminars and workshops.

There could be occasional staff retreats on FS lessons learned or regular e-group discussions on FS topics. If done by direct hire staff, rather than contractors, there is greater likelihood of improving project selection and implementation, due to access to the Mission planning and procurement processes this allows.

USAID might also have additional program funds to provide to international organizations to encourage them to take on some additional responsibilities. These could range from introduction of new standards and codes by the IMF/World Bank, in, for example, housing finance or pensions, or collection and dissemination on what financial sector work is being undertaken by all the donors by an organization such as FSF.

II.C.4 Conclusion

USAID has implemented about 761 financial sector development activities since 1988. These were done absent of any Agency-wide financial sector strategy, yet on balance, probably met Agency goals. Looking ahead, a financial sector strategy will be critical to making improvements in project impact and sustainability. Even more importantly, USAID's mandate, resources, structure, and other key factors such as country conditions and other donors' activities are likely have greater influence on what projects are undertaken, than a formal strategy based upon specific types of financial sector technical assistance.

Moreover, how expansive EG's role will be going forward and what level of the activities it may undertake, depends on its resources. Scenario C, it would seem, would be consistent with the objectives of the USAID reorganization to improve support to the Missions. However, in considering Scenario D, management might also consider additional resources beyond having added staff and program funds in EG, while cutting technical expertise in the financial sector in the regional bureaus. With a net decrease in financial sector expertise, USAID may have limited its opportunity to solidify the accomplishments made to date.

The statement of work calls for a Forum to be held as a next step to this paper. Through the Forum, a relatively narrow USAID audience will contemplate the findings of the strategy work done to date and be allowed an opportunity to analyze and challenge the options. We propose that the topic for discussion at the Forum be:

- Key issues and trends in financial sector reform and what those means for USAID Missions as well as global programs
- Country topology
- Options for EGAT/EG

After the Forum, it will be up to EGAT/EGAT/EG management to make use of the recommendations in the paper and to move forward to secure the level of resources required to make a central financial sector unit viable and productive for USAID. They must consider several additional questions: What is the current donor, political and financial environment demanding of USAID - what are the internal and external pressures that might be forcing the organization to move in different directions? Will it do so on an ad hoc basis or will it go forward strategically - what is the field saying about the changes? In addition, to make those choices, management will have to think about the following factors:

- Expanded use of all three global mechanisms, SEGIR, the Cooperative Agreements and the IAAs and the effort within the office to draft, negotiate and manage those
- Possibilities for inter-agency cooperation, encouraged by the US stance vis-à-vis multilateral negotiations for increased trade in services
- Extent to which war on terrorism will continue to dominate US foreign policy

We look forward to discussing these questions with our colleagues in USAID and the development consulting community at the upcoming Forum[30].

[30] *Proceedings of the Forum held December 12-13, 2002 are provided in the Task 6 Report.*

ACKNOWLEDGEMENTS

The authors wish to thank those who generously gave their time in relating their insight and experience in financial sector development during our interviews. In particular, we wish to acknowledge former colleagues from USAID, the International Monetary Fund, and the World Bank who made themselves and their work accessible to us. Above all, we thank our CTO, John Crihfield, for his painstaking reviews of our many drafts as well as Skip Kissinger, the SEGIR Manager, and Steve Hadley, the Director of the Office of Economic Growth for their guidance during this process.

The dramatic events of the late 1990s brought the issue of financial sector policy in developing countries to the forefront. Much of the international community's policy focuses on financial sector reform including strengthening the prudential regulations and supervision of the financial system along with ensuring that finance can make its most important contribution to economic prosperity through market-driven allocation of investable resources.

Caprio et al., 2002

EDITOR'S NOTE

On December 11 and 12, 2002, a USAID Financial Sector Review Forum was held. The contents of this report was distributed to many of the participants in advance and, on the 12th, three panels were held -- comprised of representatives from USAID implementers, other donor agencies, and from USAID. Each set of panelists commented on the contents of this paper. It has been revised to reflect some of those comments. Those who wished to submit written comments did so and those are included in Appendix 2.

Furthermore, it should also be noted that progress in the formation of a financial sector team in the Office of Economic Growth has been significant since this work began in September, 2001 and since delivery of the draft of this paper in early December, 2002. There are now five specialists assigned to EGAT/EG/EDFS who will work on the financial sector under the direction of the Chief, Enterprise Development and Financial Sector Division. Those individuals, along with peers from the regional bureaus, have formed a working group for the consideration and implementation of many of the recommendations provided herein.

Appendix 1: Table of Strategic Options For Role of EGAT's Office of Economic Growth

SCENARIO A: *Staff Resources:* 1 to 2 Dedicated FS Generalists
Budget: $500,000 per year

Objective	Topic	Recommended Tasks	Implementation	
			Level of Difficulty	Resource Requirements
Field Support: Project Selection and Design Assistance	Financial Sector Assessments	• Develop topology (system for country financial sector classification) • Ongoing validation and support of topology	Medium	Dedicated CTO. Contractor cost: $200,000 year 1, then $50,000/yr.
Field Support: Project Implementation Guidance	Global Contracting Vehicles	• Contract and administer SEGIRs: rebid as necessary • Review and approve SOWs • Collect SEGIR SOWs and post on SEGIR website • Collect development experience documents, post on SEGIR website, and ensure they are submitted to CDIE repository • Review quarterly or semi-annual progress reports • Host annual review of SEGIR consortia (limited presentations)	Low - Examples already exist, wealth of information on what works, OP and GC understand mechanisms	Component Manager to draft SEGIR FS RFP; negotiate and manage resulting contract.
	Cooperative Agreements	• Administer CA with FSVC • Develop and manage workplan for $1 million grant to FSVC • Review and approve Activity Action Plans	Medium	FSVC: $100,000Dedicated CTO
	Inter-Agency Agreements	• Administer IAA with SEC, and, possibly, with FDIC and Treasury· • Review and approve work statements	Low	IAA funding: $100,000Dedicated CTO
Technical Leadership	Knowledge Management	• Organize Economic Growth Sector Council and similar intra-Agency meetings and seminars	Low	Generalist's time
	Research	• Issue contract for study/validation of key FS development trends, e.g., in year 1 additional research on multilateral negotiations for increased market access in financial services, one study/year	Medium	CTO$100,000 per year
	Training	• Attend relevant FS training/conferences held by World Bank and others • Support FS course as part of Economic Growth Officers' training	Medium -- possibly heavy time commitment	Access to information on training/ conferences offered; admin support to manage logistics

SCENARIO B: Staff Resources: 2 Dedicated FS Generalists
Budget: $2,000,000 per year ($500,000 from A plus $1,500,000 in new funding)

Objective	Topic	Recommended Tasks	Implementation	
			Level of Difficulty	Resource Requirements
Field Support: Project Selection and Design Assistance	Financial Sector Assessments	• Issue contract to design tool for use of FSAP/ROSC to support Mission programming as enhancement to topology	Low to Medium	One time cost: $50,000
Field Support: Project Implementation Guidance	Project Evaluations	• Conduct approx. two cross-country evaluations per year of SEGIR task orders by contractor and/or CDIE on topics such as: • Lessons learned in USAID's SME finance projects, and design of sustainable SME financial institutions • Lessons learned in Pension Reform, and implications for expansion of USAID's efforts (e.g., moving to Pillars 2 and 3)	Medium	$50,000 per evaluation; total $100,000
	Global Contracting Vehicles	• Upgrade SEGIR Annual Review into Annual Lessons Learned Workshop (review of successful practices across projects)	Medium	Cooperation of SEGIR Contract Holders
		• Fund SMALL central/regional task orders under SEGIR FS IQC with the intention of assisting Missions in project assessments/design, 2 to 3 per year	Medium	$75,000 per task order; total $225,000 per year
	Cooperative Agreements	• Fund specific regional and/or global FS activities	Medium	$500,000 per yeaer
		• Fund annual work plans for central/regional activities	Low to Medium	$100,000 per year
Technical Leadership	Inter-Agency Agreements	• Fund regional participant training and/or workshops which would not be funded by Missions	Medium	$5,000 per participant, total $25,000 per year
	Knowledge Management	• Enhance website (post SOWs, links to other IFIs)· Contract for maintenance of database of USAID FS development experience • Post/make interactive FS module for Economic Growth Officers	Low	Webmaster/Contractor: $100,000; ongoing cost might be $2,000 - $5,000 per month
	Research	• Develop a research agenda • Issue contract for studies of two timely FS development topics per year as per list	Medium	$200,000 per study; total $400,000support to manage

SCENARIO C: Staff Resources: 4 Dedicated FS Generalists
Budget: $2,000,000 per year ($500,000 from A plus $1,500,000 in new funding)

Objective	Topic	Recommended Tasks (In addition to Scenarios A and B)	Implementation	
			Level of Difficulty	Resource Requirements
Field Support: Project Selection and Design Assistance	Financial Sector Assessments	• Send EGAT/EG staff to participate in assessments, 2 per year for 2 staff members	Medium to High	$15,000 total
		• Support EGAT/EG staff TDYs to conduct/participate in financial sector assessments upon Mission request	Low	At Mission expense
		• Support design and implementation of Mission SOWs	Low	At Mission expense
	Project Evaluations	• Support EGAT/EG staff TDYs to conduct/participate in evaluations of FS projects, 2 per year	Low	$10,000 total in travel expenses
	Donor Coordination	• Construct and maintain a web-based resource for Missions with links to international organizations' financial sector resources	Low	Part of website enhancement
Field Support: Project Implementation Guidance	Global Contracting Vehicles	• Implement TOs that individual Missions would not initiate, e.g., • Pilot programs in regionalization, • Cross-border financial institutions • Credit rating	Medium	$100,000 to $500,000 per task order Need CTO
		• Draft sample SOWs and tools for circulation to Missions, based upon "lessons learned" or from research	Low	$75,000 per task order; total $225,000 per year
		• Support EGAT/EG staff TDYs to assist in Mission SOW development	Low to Medium	Staff maybe should include sub-sector Specialists
		• Post annual reports on accomplishments for each TO on website	Medium	
	Cooperative Agreements	• Reallocate to Global Vehicles and IAAs		*Replace $600,000 to $800,000 per year with task orders*
	Inter-Agency Agreements	• Issue new IAAs with Dept. of Justice (for purposes of assisting countries with FATF compliance), or Dept. Of Labor (Pensions), or OCC & FED (bank supervision)	Medium to High	$100,000 per year
Technical Leadership	Knowledge Management	• Hold occasional ½ day staff retreats on FS lessons learned	Low	
	Research	• Publish occasional research papers	Medium	
	Training	• Develop additional FS specific training modules as part of overall Economic Growth training for private sector officers	Medium	

APPENDIX 2: COMMENTS OF SEGIR-FS CONTRACTORS ON TASK 5 REPORT

CHEMONICS INTERNATIONAL COMMENTS ON THE FINANCIAL SECTOR REVIEW TASK 5 DRAFT REPORT

1. The importance of small and medium enterprise (SME) Finance

pg. vi. I don't agree that SME finance is not intrinsic to the stability or performance of the financial sector. According to World Bank statistics, 50% of US GDP and 60% of EU GDP comes from the small and medium enterprise sector. While the percentage is less in the developing countries in which we work, one can argue that it is the sector that has been most neglected by the formal financial system and that SMEs offer the greatest potential to create economic growth and generate employment in these countries.

While the FS IQC has been effective in improving regulatory frameworks, we must beware of over-regulation as it can hinder economic growth where it begins. In the future, when we have teams work on regulation and supervision, we need to have consultants from both sides of the equation - those that understand the needs of the traditional banking sector and those that understand micro and SME finance.

p.x I don't agree with the term "SME banking," as that implies that only banks can do SME lending, when in fact many NBFIs and MFIs have been very successful SME financiers. SME Finance is the better term and does include savings mobilization.

2. Globalization and e-finance

I love the focus on globalization and feel that is very important for the future of financial services. I also thought that the discussion on e-finance was great, but I would have liked to see more concrete examples of what you mean.

3. Role of Credit Bureaus

p.ix Under Information Disclosure and Governance, the role of credit bureaus should be included as a technical area. Credit bureaus are another way to supplement and strengthen the regulatory framework, and can be created relatively cost effectively by building off the information the central bank already collects from regulated financial institutions.

4. New Product Development

p. xiii The discussion on new product development is good, but we need to make sure new product development is market driven. We need to help financial institutions across the financial services spectrum to understand the diverse needs of their clients by segmenting the market and creating products that address the specific needs of each target market and segment. New product development should focus on the creation of savings vehicles as well as other non-loan products and services, i.e. leasing, etc.

5. Public Relations and Advocacy

I agree with the need for a greater emphasis on public relations and advocacy in projects to help sell our local partners and stakeholders on the project's vision. To do this, USAID missions need to allow for adequate time to build relationships and sell concepts before

pushing for immediate results. Many cultures are turned off by the American emphasis on productivity at the expense of relationship building.

6. Financial Sector Assessments

I think the idea of supporting the World Bank's and IMF's formal financial sector assessments is excellent. We need to think strategically how we will work to gain access to the information from the countries studied. Perhaps the best approach is to get involved in the pre-assessment preparation work, as then we will have already established relationships with the stakeholders and they will be more likely to share the information, which can feed into project design.

7. Need for Evaluations

We agree that there is need for more evaluations to ensure that the work done by contractors in USAID's name is effective. However, this need could partly addressed by making sure that proper monitoring and evaluation systems are set up at the start of a project. We have found that there is a fair amount of disagreement about how to measure success in financial services projects and as a result, indicators and targets can shift a lot over the life of a project. Perhaps we could work together to build consensus on what is most important to measure and how.

DAI COMMENTS ON THE FINANCIAL SECTOR REVIEW TASK 5 DRAFT REPORT

DAI commends Deloitte Touche Tohmatsu Emerging Markets, Ltd. for delivering an in-depth and well executed report for the Office of Economic Growth's Financial Sector Review and Strategy. The report's authors conducted a comprehensive financial sector review and proposed sound strategy, and we are pleased to have the opportunity to comment on the Task 5 Options Draft Report. We offer our observations in areas that we believe can be strengthened, most of which relate to item ten of the authors' Top Ten Suggestions for USAID/OEG:

> *"10. Strenghten the links between financial sector development and poverty alleviation"* (p. vi)

We believe this suggestion is an important one, and that it requires elaboration beyond what is presented in the draft report. The report makes a clear case that a strong financial sector is a fundamental element of economic growth and poverty reduction, but unfortunately, avoids the subject of micro- and SME finance:

> *"…while micro- and SME finance are obviously important, they are not discussed here because donor projects in theses fields are typically more concerned with extending the reach of financial services rather than improving the intrinsic stability or performance of the financial sector." (p. vi)*

Page 10 of the report further states regarding microfinance:

> *"…these programs typically lie outside the financial core, utilize different intermediaries, and have staff not biased by crisis conditions."*

Many of the world's most successful providers of micro- and SME finance are regulated financial institutions that form an important part of their country's financial core. Furthermore, regulated institutions that are part of the formal financial sector have proven most capable of expanding their outreach to massive numbers of poor people, microenterprises and SMEs.

Therefore we firmly believe that in order to strengthen the link between financial sector development and poverty alleviation, financial sector development initiatives should take into account the need to expand access to formal financial services. Along these lines, we offer comments in four sections below: Micro- and SME Finance as Part of the Financial Sector, Institution-building and Financial Sector Development, Expansion of Financing, and Regulation and Supervision.

MICRO- AND SME-FINANCE AS PART OF THE FINANCIAL SECTOR

Micro- and SME finance should be considered intrinsic to financial sector development. Inadequate access to financial services among microenterprises and SMEs constrains economic development and growth, as entire communities of entrepreneurs are

disenfranchised. Microfinance products are becoming an important part of formal financial sectors in the economies in which USAID works, as demonstrated by:

- Additional mobilization of savings from individuals who otherwise keep funds in their households. It is critical to financial sector growth as well as the overall economy to move these funds into the formal financial sector. The expanded liquidity also brings diversification of clients and products, reducing institutional risk and providing the base for consumer, institutional, and intra-bank product development.

- Creation of sector and institutional stability by providing saving and loan products, due to the vast size and funds flow in underbanked populations.

- Generation of economic growth from the expansion of small businesses, due to access to financial services (credit and deposit accounts at minimum). Institutions offering these services must be able to operate in a financial sector that supports them through proper laws and regulations: full participation as sanctioned financial intermediaries.

Increased outreach is an important goal of most microfinance projects, but to imply that USAID's recent microfinance interventions are independent of the financial sector runs contrary to the design and implementation of a number of important microfinance projects. Far from treating microfinance projects simply as outreach programs, the DAI approach to microfinance, developed in collaboration with USAID, is to ensure that financial services to the poor become an integral part of the overall financial sector, expanding outreach to the underserved while tapping their surprisingly large financial resources and meeting their financial needs.

We believe that in order to ensure that microenterprises and SMEs have ongoing access to services, it is necessary to promote:

- Sustainability/profitability of institutions and product lines targeting this market segment
- A facilitative legal and regulatory environment;
- Availability and use of high quality of information through credit bureaus and IT infrastructure, and;
- Improvement in the quality of support services (auditors, marketing specialists, training providers, etc.) that MFIs have at their disposal.

Financial services for the poor must be considered part of the financial sector if they are to be sustainable—through this approach the poor are explicitly included in the formal financial sector, offered services, and are treated as paying clients, as opposed to outreach project beneficiaries.

> *"people's livelihoods – particularly those of the poor – largely depend on a strong financial sector"* (p. 3)

Overall financial sector stability is fundamentally important: it is a necessary condition for large-scale poverty reduction. Nevertheless, it is not a sufficient condition for poverty reduction. The poor are likely to get indirect benefits from financial sector stability, but they also can benefit substantially from ongoing financial services. A client's comments from an impact assessment of the USAID-funded FOMIR Microfinance project in El Salvador, which has a relatively strong financial sector, helps illustrate this point:

> *With my loan, I purchased hair care supplies and more equipment. Prior to the loan I did all the work myself. Now with more equipment and an improved shop, I have enough customers to employ three people in my shop.*
> – Beauty Salon Owner in Ahuachapan, El Salvador[1]

This testimony is representative of the sentiment among other clients interviewed for this and other microfinance impact assessments. If we are to speak of poverty reduction, we should not lose track of the people we are attempting to assist. We must understand that financial sector stability is important, but so is widespread access to financial services.

The general country classification system that the authors present suggests classification of countries based on vulnerability to crisis, commitment to reform, and size of the financial sector. We believe it important to include an aspect of access to services as an additional means of classification. Using the authors' definition of what constitutes a strong financial sector, it may be possible for a large financial sector in a reform-minded country to maintain a high level of performing assets and be relatively invulnerable to systemic shocks while also providing only a small fraction of the finance that microenterprises and SMEs require. We believe that a strong financial sector includes institutions, whether they are banks, finance companies, credit unions, or microfinance institutions, that are capable of serving microenterprises and SMEs, and that an element of access to financial services could also be used in a classification system.

As USAID moves into countries such as Angola, Paraguay, Laos, Cambodia, Afghanistan, and other states that have little financial sector infrastructure and capacity, the financial sector strategy must be sequenced properly and not focus on assistance that is beyond the country's ability. As nearly half of USAID's financial sector assistance has been directed to the transition economies of the former Soviet Union and newly industrialized states, the lessons learned may not be directly relevant to other contexts in which USAID will be operating.

To foster a dialogue on expansion of financial services to be programmed in next-generation SEGIRs, we present several financial sector options that should be considered in defining the Office of Economic Growth's financial sector strategy. The turn-around management and privatization of state-owned micro and agricultural financial institutions, the expansion of financing through provision of guarantees (through the Development Credit Authority) to financial institutions and small and medium sized

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[1] Miller, Hillary and Galdamez, Ernesto. Client Impact Assessment. DAI's Rural Microfinance Strengthening (FOMIR) Project, USAID. El Salvador.

institutions, and effective regulation and supervision of institutions servicing micro, small, and medium sized enterprises will be discussed below.

FINANCIAL INSTITUTION-BUILDING IN FINANCIAL SECTOR DEVELOPMENT

In 1999, Ag Bank of Mongolia was in receivership after having been re-nationalized following a failed attempt at privatization. The government, however, was keenly aware of Ag Bank's importance to Mongolia's rural residents and the overall financial sector. Though Ag Bank was one of the smaller financial institutions in Mongolia by asset size, it offered nearly 275 points of service and was the only financial institution serving a large percentage of Mongolia's rural population. Ag Bank was the only bank able to transfer money, make payments (including pensions and salaries), and provide deposit services throughout Mongolia's vast territory. While business arguments suggested that the bank be closed, Ag Bank was a central player in Mongolia's financial sector.

The Government of Mongolia, with funding assistance from USAID, contracted DAI to manage the institution under a turnaround contract protected from political interference. As it was critical for the institution to remain open, the Bank developed products and services tailored to market needs. It found its best opportunity for expansion, stability, and growth through serving the Micro/SME sector.

New products were designed, piloted, and rolled out through a branch network. New Ag Bank lending products include microenterprise loans, SME loans, crop and herder credits, as well as pension advances and consumer lending. Ag Bank's branch network was found to be a strength, not a weakness. It provided unique access to Micro/Small markets with a high demand for financial services.

Ag Bank was able to provide products to a larger Micro/SME market while also increasing profitability to ensure institutional stability. This stability was crucial for the financial sector as a whole, as Ag Bank maintained its dominance as the main payment agency for the government. It now provides the largest number of loans in the country.

The lower income segment has often been ignored as banks tend to go after larger customers, often thought to hold the biggest profit opportunities. However, the Ag Bank created products to encourage the Micro/SME segment to save money, borrow and benefit from other products and services such as transfers. While the amounts may be small, with economies of scale, the Ag Bank discovered that it could serve this segment profitably and effectively.

The results from these new products and other restructuring initiatives have been impressive. Ag Bank has expanded its outreach to more than 350 locations. As of the end of November 2002, Ag Bank had disbursed over 370,000 loans, opened over 200,000 new current accounts, and increased savings deposits 400%. Bank assets have grown 500%. The level of loans in arrears has remained consistently less than 1% due to expansive yet prudent lending practices. The Bank began making a profit in January 2001, only six months into the turnaround, and the profits have grown monthly. The

current Return on Assets (ROA) and Return on Equity (ROE) exceed industry and country standards.

From a troubled beginning, Ag Bank is emerging as an example for similar institutions in other economies. By leveraging existing institutional strengths and creating products that meet market needs, the bank is profitably providing rural Mongolians with products that support growth in incomes and economic opportunities. The underserved market in Mongolia was the Micro/SME market and by focusing on this sector the institution flourished.

Financial sector development in Mongolia received an enormous boost from Ag Bank's privatization efforts. All bidders have been qualified and have performed their due diligence efforts, and the bank is on track to be privatized within the first half of 2003 at a multiple many times earnings. Investment has been attracted from outside, and Mongolia bank equity now has a market valuation standard. Without developing and implementing products for the Micro/SME sector, the institution would not have survived, let alone be attractive to financial sector investors.

EXPANSION OF FINANCING

When reviewing the types of projects proposed on pages 43 and 44 of the Financial Sector Review and Strategy (Task 5), those projects being designed under *Expanding Access to Finance for SMEs* and *New Financial Instruments Development* should consider incorporating leverage, using USAID's Development Credit Authority (DCA). DCA is a highly flexible mechanism used to leverage commercial funding sources and address market imperfections. DCA offers a 50 percent guarantee to lenders to partially underwrite the lender's venture into new types of lending: since DCA covers some of the lender's potential losses, the lender can learn how to lend to a new type of client or in a new industry with reduced risk.

SME Lending. The most common use to date of the DCA guarantee has been for a loan portfolio guarantee for banks interested in developing small- or medium-enterprise (SME) lending. A perceived limitation in lending to SMEs has been that to be safe, loans must be secured by collateral often unrelated to the business. By offering a loan portfolio guarantee, which authorizes the bank to decide which of its loans meeting basic criteria they would like to place under guarantee coverage, USAID has encouraged banks to try cash flow based lending, using the guarantee to substitute for heavy collateral requirements.

Microfinance. To enhance USAID microfinance activities, DCA loan portfolio guarantees have also been established with MFIs to encourage NGO microfinance institutions to expand their outreach and diversify their products and services. Additionally, a microfinance institution that needs funds for on-lending could source a DCA-guaranteed loan from a commercial bank or other intermediary financial institution.

Deposit Mobilization. If there is a limited amount of deposits in the commercial banking system, DCA might be used to guarantee bonds or certificates of deposit issued by the bank, to garner funds for on-lending. Since the bonds or certificates of deposit could have several month or even several year maturities, the guarantee would provide the institution with a source of funds for longer term loans. Longer term funding for banks and non-bank lenders will strengthen the overall financial system.

New Financial Instruments. In addition to encouraging lenders to innovate and test new credit and savings products and services, DCA can also be used to support the development of other financial instruments and markets, including: municipal finance; primary and secondary mortgage markets; pension funds; commercial paper and bond markets.

Partners for DCA and Relation to the Global Development Alliance. Partners for DCA guarantees can be any type of lender, including but not limited to: commercial banks; non-bank financial institutions such as credit unions or NGO microfinance lenders; leasing companies; supply creditors; and bond holders. While the lender is the party covered by the actual guarantee, partnerships have been formed through DCA deals with agricultural cooperatives, private housing developers, municipalities and community governments, utility providers, private guarantee organizations, and the local business community. All DCA deals are in essence Global Development Alliance projects if seen more broadly as a partnership facilitation mechanism, rather than simply as a financing tool.

REGULATION AND SUPERVISION

DAI is currently implementing two long-term microfinance projects that are funded through SEGIR-FS task orders (in Bolivia and in Ecuador). We are demonstrating to commercial banks that Micro/SME financial products and services can be profitable, and are assisting successful microfinance institutions and credit unions to professionalize their services and become regulated, sustainable institutions: fully participatory financial intermediaries, adding depth to the provision of formal sector services. DAI also works with regulators and ancillary service providers (such as credit bureaus, auditors, and local training providers) to build MFIs.

The case of Ecuador illustrates our industry approach to the development of financial services, and how microfinance fits into the formal financial sector. The financial crisis in Ecuador at the end of the 1990s led to the disappearance of nearly half of Ecuador's financial institutions. Many small-scale depositors found a safe haven in the country's largest credit unions, which has since led to rapid growth among the strongest credit unions over the past two years. All of Ecuador's strongest credit unions are now either regulated financial institutions, or in the process of becoming regulated. Credit unions form a fundamentally important part of the financial sector, especially for the poor, who are most susceptible to financial shocks. Credit union liquidity has provided ample cushion for temporary financial sector shocks experienced by traditional banks.

The SALTO project, a SEGIR-FS task order with USAID/Quito, works with credit unions, banks, and microfinance institutions that are either regulated entities, or that have made a commitment to become regulated. We have worked with the Superintendency of Banks and Insurance of Ecuador to develop the country's first risk-based framework for the supervision of microfinance and consumer credit products, and are developing practical supervision manuals. The regulations were developed based on international lessons learned, especially in Bolivia and elsewhere in Latin America on how to regulate microfinance and consumer credit, with the recognition that multiple types of institutions, including banks, serve a broad range of potential banking customers.

We are also working with the superintendency to build a legal framework that enables effective credit information-sharing to serve banks, credit unions, microfinance institutions, and non-financial service providers, while also respecting the privacy rights of clients. The goal of this initiative is to create an environment that is attractive to private investors interested in building a solid credit bureau that will benefit the entire financial sector, not just the microfinance providers.

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January 23, 2003

Mr. John Crihfield
Econ. Financial Advisor
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Washington, D.C. 20523

Dear Mr. Crihfield:

Barents Group of BearingPoint, Inc., is pleased to submit the following comments on the Preliminary Draft Discussion Paper concerning the United States Agency for International Development (USAID) Financial Sector Review and Strategy prepared by Deloitte Touche Tohmatsu.

The paper is obviously very well researched and reflects thoughtful consideration of the issues facing USAID as it evaluates its role in providing assistance in the financial development sphere, and formulates its plans for the coming years. Our comments and suggestions are based on our review of the paper and our first-hand experience in implementing numerous USAID financial sector assistance projects over many years. The comments are divided into two sections: the first concerns substantive areas in which we believe USAID assistance would be beneficial. The second concerns institutional issues, such as USAID structure and project design. All of the comments are intended to provide constructive feedback so that USAID can enhance its existing financial sector assistance programs and design future programs in a way that will be most likely to maximize USAID's effectiveness in light of American foreign policy priorities and the realities of financial sector development in each country.

A. Subject areas

Corporate governance and risk management

We wholeheartedly support the paper's emphasis on corporate governance and risk management. These topics are especially critical in the rapid-changing world of financial sector supervision, which has evolved from a compliance function to a judgment function. Increasingly, financial sector supervisors must understand and evaluate the non-quantifiable risks to which banks and other financial institutions are exposed, rather than simply monitoring for compliance with numerical calculations and ratios. Unfortunately, in many countries where USAID has projects, a checklist mentality toward supervision is still prevalent (although this is changing as a result of the efforts of USAID and others). The tendency to over-regulate and under-supervise has not been completely eradicated. USAID should vigorously continue to pursue progress toward a risk-based supervisory approach.

The necessity and depth of this type of assistance will differ from country to country, generally in relation to the degree of foreign participation in the financial sector. The less foreign participation, the more need for proper risk management training.

In this area, as in many others, a strong legislative base is necessary in order to ensure the development and implementation of sound corporate governance and risk management systems. In the banking sector, for example, flexible legal standards that allow the supervisor to assess the fitness and properness of proposed bank owners and managers (as opposed to simply verifying lack of criminal convictions and a certain level of education and work experience), and to critically analyze and evaluate the suitability of banks' internal controls and risk management techniques are necessary. However, bank supervisors cannot force proper risk management solely through legislative standards and regulations. Legal standards are a necessary, but not sufficient, component of sound corporate governance. Thus, USAID should consider developing bank-training centers that offer a banker's program certification or a type of banking degree, rather than a random set of courses. Risk management is one area where bank twinning programs, internships and programs such as those undertaken by the Financial Services Volunteer Corps, are particularly useful.

Consolidated supervision

Consolidated supervision and the formation of a unified regulator are also areas that we are happy to see included in the paper. As banks are increasingly affiliated with other companies (both financial and non-financial), bank supervisors must be able to determine the risks to which banks are exposed through such affiliations. USAID should continue to promote efforts to develop consolidated supervision as a supervisory risk management tool, stressing the need of the financial sector supervisor to have two critical powers:

- the power to obtain reliable information about all entities that are affiliated with banks through common ownership or an equivalent degree of influence; and
- the power to take, or cause other financial sector supervisors to take, effective corrective actions when the activities or financial condition of such affiliated entities may pose an unacceptable level of risk to a bank.

Consolidated supervision in the developing world is much more complicated than in the west. "Downstream" consolidation is usually not a large problem, for two reasons. First, banking laws generally limit the types of equity investments a bank may have. Second, many supervisors are moving toward consolidated accounting practices in accordance with International Accounting Standards, which tend to focus on a given entity and its subsidiaries. However, "upstream" consolidated supervision is enormously complex, since in most developing countries any individual or company is usually allowed to own a bank, and the ultimate controlling parties often do not want to be disclosed. Yet, it is vital that the bank supervisor have the legal authority, and the practical ability, to determine who is ultimately in control of each bank, in order to effectively assess the risks to which the bank is exposed as a result of such control and affiliate relationships.

Consolidated supervision is a difficult concept for supervisors in many transition countries to accept, as the local legislators and financial sector practitioners often view it as an unnecessary "power-grab" by the bank supervisor. This is an erroneous perception, and is probably due, in large part, to the fact that in most countries that retain the functional approach, the bank supervisor typically has a preferred status in terms of supervisory policy development and legal authority. This in turn is a reflection of the traditional view that as depository institutions and the principal components of the payment system, banks are "special," and that many financial conglomerates contain a significant banking entity. Consequently, banking entities are protected from contagion from other component entities of their conglomerates that may lead to a systemic crisis.

Another marketing aspect of consolidated supervision is its potential benefits to increase small and medium-sized business lending. By reducing the prospects for connected lending and other transactions between banks and their affiliated entities, more banks may be forced to start lending to the real sector of the economy. USAID should therefore promote programs that emphasize consolidated supervision by focusing on its benefits to countries seeking to enter the global financial marketplace, depositor protection through transparency, and risk management.

Although consolidated supervision and the concept of the unified regulator are two separate issues, they are closely related. To facilitate consolidated supervision, a number of countries are moving toward the concept of the unified approach to supervision, under which all financial sector supervision is housed in one agency. Most countries still maintain functional regulators (i.e., separate supervisors for the banking, securities, and insurance industries), with a renewed spirit toward cooperation and information sharing amongst the regulatory bodies. Some countries have adopted a hybrid approach, which retains the functional approach generally but also uses an umbrella oversight committee for purposes of facilitating inter-agency coordination.

While we do not advocate one approach over the other, we recognize that in a transition economy, the unified approach makes sense from the point of view of economies of scale and the conservation and maximum efficient use of scarce supervisory resources. Both approaches have advantages and disadvantages. Whether a country adopts a unified approach or a functional approach depends in large part on local conditions and capabilities. But the fundamental elements of consolidated supervision should be included in the legislative and supervisory framework of any country that wishes to implement effective financial sector supervision. This is the case regardless of whether a country elects to utilize a unified approach or a functional approach.

Non-Bank Financial Institutions (NBFIs)

USAID has recognized the importance of the non-bank financial institution sector (insurance, mandatory and voluntary pension systems, capital markets, credit insurance etc.) in the overall financial sector and as an engine to promote economic growth and protect individuals. In most developed countries, for example, insurance companies and pension funds serve as a major source of capital investment, second only to banks. USAID has committed significant resources, with mixed results, to promoting the development of capital markets. Somewhat fewer resources have been devoted to other NBFIs, but results in insurance regulation and supervision, and pension reform, have often been quite tangible (for example, improved insurance supervision in Egypt has lead to attracting foreign companies, the developing new products and services for individuals and businesses and more competitive pricing of insurance products).

As vehicles that can mitigate risk, promote national savings and help use market forces to promote higher standards of corporate governance, we believe USAID should continue to support reforms in NBFIs. Programs can help 1) improve the legal and regulatory framework; 2) promote the movement to risk-based supervision; 3) build capacity in actuarial science, investment management, financial reporting and examination and information systems; 4) address long term budget deficit issues through effective pension reforms; 5) increase consumer protection and NBFI transparency; and 6) encourage integrated supervision approaches, when appropriate. Sometimes support for USAID resources for this area are questioned because it is argued that short-term results are hard to demonstrate. It has been our experience that technical assistance to the NBFI sector brings both demonstrable short-term and long-term benefits.

Legal assistance

The message that there needs to be continuing emphasis on legislative improvement and enforcement efforts is quite clear from the paper (though it might be helpful to include an explicit section, as the authors did with accounting reform). Indeed, this area of assistance has not always received the attention that it needs in the bank supervision area. USAID should continue to support efforts to improve the legislative standards for financial sector supervision by bringing those standards into closer harmony with the international standards exemplified by the principles of the Basle Committee and related organizations.

To achieve this goal, USAID should consider increasing the amount of legal assistance on most financial sector reform projects. Resident or quasi-resident legal advisors are an excellent idea. USAID should encourage efforts to have legal advisors work directly with the legal staffs of the financial sector supervisors to assist in drafting legislation, as well as to assist in explaining and promoting the improved legislation to parliamentarians and cabinet officials.

Along with continued support specifically for improved financial sector legislation, we strongly recommend that legal reform efforts include general administrative law reform. In many transition economies (particularly CIS countries), the concept of "administrative law" is very different than is understood in western countries. In a holdover from the Communist era, the term usually refers to a series of legal principles under an administrative violations code, which imposes sanctions for various lower level infractions which are less serious than those found in the criminal code.

USAID should support efforts to improve the accountability of administrative agencies, including financial sector supervisors, and in particular, legal standards for judicial review of administrative/supervisory decisions. More specifically, there needs to be increased emphasis on judicial training and awareness of the regulatory process, the purposes of financial sector supervision, and the role of the courts in the process. The concepts of limited judicial review, based on the administrative record, and of judicial deference to the expertise of the financial supervisor, need to be strongly emphasized. USAID should vigorously support legislative drafting efforts to adopt judicial review standards analogous to those employed in the United States and the European Union countries, which embody these concepts.

These judicial review standards are especially important if risk-based supervision is to be pursued. The risk-based approach is more judgmental than mechanical, more art than exact science. Thus, the legislative standards need to be sufficiently flexible (allowing the supervisor to determine, for example, whether a bank's risk management systems/internal controls are adequate, or whether a bank's practices are "unsafe/unsound"). The courts, in turn, need to understand that they should presume the correctness of the supervisor's judgment and assessment of a given set of facts under these flexible standards, and that they should reverse a supervisory decision only in the uncommon case where it can be shown that the supervisor's decision lacked a rational basis (analogous to the arbitrary and capricious standard in the U.S.). No matter how much risk analysis training is provided to examiners and financial sector supervisors, their efforts will be hampered if their decisions are second-guessed and reversed by the courts. There is a much greater likelihood of this happening if the courts apply a "de novo" standard of review without reference to an administrative record.

This has been a problematic issue on many of our projects over the past few years (e.g., Serbia, Kyrgyzstan and Armenia, among others) and one that we are continuing to try to address. There are of course many efforts underway in the commercial law area, and these projects can provide some valuable insights. But relying on these projects alone will not get USAID to where it needs to be in terms of enhancing the effectiveness of the

supervisory authorities. Commercial law, by definition, tends to emphasize contractual and property rights as between private parties, rather than the authority of public bodies such as financial sector supervisors. From the point of view of financial sector reform, the latter category is much more relevant.

A cautionary note is necessary. While courts should show great deference to the expertise of the supervisor, supervisors need to earn the right of judicial deference. Many times, the supervisor has not made a strong case for enforcement initiatives because they either lack the knowledge or patience to properly assemble a legal case, or merely because they believe that judges should, in essence, take their submissions on faith. This is particularly true in the area of efforts to curb money laundering. The only truly effective measure of enforcement in most developing countries is a strong (feared or respected) director of supervision or central bank chairman. Thus, administrative law reform also needs to focus on the development of procedures at the agency level designed to afford due process to regulated entities. The supervisors will need to be trained in the concept of the administrative record with a view toward providing the reviewing court with a clear roadmap of the connection between the facts and a given supervisory action.

Cooperation with external audit companies

It would be helpful to include more emphasis on cooperation with external audit companies, particularly in small countries where forming a strong supervision function with varied skill sets is more difficult. In many cases, the supervisory staffs do not yet have the experience to deal with risk management issues or with the complexity of products and services that commercial banks are now offering or preparing to offer. The banking industry is advancing at a much faster rate than bank supervisors.

USAID should support efforts to enhance external auditors' ability to check compliance with these various prudential normatives, as well as a review of financial risk, particularly credit risk, liquidity risk, foreign exchange risk, interest rate risk, price risk, and operational risk.

E-finance

We favor the inclusion of e-finance in the areas of development and assistance. However, USAID should be careful not to place too great an emphasis on the supply side of e-Finance applications at the expense of ensuring that the demand and capacity on the consumption side is also in place. Too often in the past, e-Finance initiatives (and this has been true of some e-Government and e-Commerce initiatives also) have placed too much emphasis on the front office side - the creation of a sophisticated website. However when planning and funding such initiatives it is equally - if not more- important to pay attention to issues such as market or user awareness, capacity and skill building, as well as ensuring that the targeted users can gain access to the service at a reasonable cost.

We have also learned from past experience that there can be a tendency to pay inadequate attention to adjusting the institutions' ICT infrastructure, policies and procedures to properly support the new e-Finance undertakings. Issues such as firewalls, information

security, back-office integration and customer privacy must be part of any e-finance discussion. Also, some have questioned the overall effectiveness of e-finance in helping small businesses and the poor. Donor programs, they point out, have been effective in helping urban communities, but much less effective in assisting rural communities due to the typically low developing country personal computer/per capita ratio. In the future, e-finance initiatives will need to find ways to have the same positive effects in more rural communities (that often need the most financing assistance) as they have enjoyed in urban communities to date. To achieve this, consideration must be given to funding innovative ways of providing cost-effective access at the community level not just at the individual business or citizen level. For example, culturally-appropriate community access points, shared-purpose automated access devices, and truly mobile solutions will all play critical roles in rural e-financing, as in micro-financing in general, in the future.

Human Resource Development

An item that was not specifically mentioned in the paper is human resource development at government institutions. USAID has not had any projects (that we are aware of) specifically aimed at addressing overall human resource development beyond delivery of core courses and limited assistance on accreditation programs. Yet, the development of a highly qualified cadre of public service personnel is critical to a country's development. This is especially true in the case of financial sector supervision, which is a highly specialized public function requiring detailed knowledge in the fields of accounting, financial analysis, collateral valuation and business risk management.

For example, in some supervisory organizations staff are hired for the methodology (regulatory policy) unit directly from college (or from the secretarial pool) without ever having been on a bank inspection and with no financial education or background. Yet, they are expected to develop a bank supervision policy. USAID programs could further assist financial sector supervisors and other government authorities in developing career paths for the agency's employees, and training programs that match those career paths.

Educational and training programs

In general, training and educational programs should be heavily emphasized. This is a major component of the transfer of knowledge. Both formal classroom programs and on-the-job training should be included.

We especially favor the idea of an educated media. This concept is discussed somewhat indirectly in the paper, but should be discussed directly. An educated media could have great impact and benefits in each of our countries. The media needs to know how to interpret and present financial results that in turn would allow better market participation and market-based supervision. Often, the media in developing countries report a bank's total assets and total profit, without reference to trends, quality or other concerns. This leads to the mentality that bigger is better.

We also believe that reforms and institutional change in the financial sector must be effectively communicated to the public and the various stakeholders in the financial arena. Effective communications is essential not only for informing the public and other stakeholders, but for motivating appropriate behavior changes in the population. A primary stated goal of financial sector reform is to improve the strength and transparency of the financial sector that leads to increased consumer confidence and protection so that financial institutions are used to help power economic growth. This will only happen if they see the reforms as having a real benefit to them -- and effective communications and social marketing programs are a key element in building trust and showing the benefits of reform to the public and other stakeholders.

Real estate valuation/appraisals

USAID should devote more assistance to real estate valuations and appraisals. This is critical to development of the mortgage market. One key element to promoting capacity would be for USAID to work with counterparts to help them foster the establishment of a professional body of real-estate assessors.

Credit bureaus.

We would favor increased emphasis on assistance for the creation of credit bureaus. Admittedly, a credit bureau is very difficult to start in most developing countries, as banks have a tendency to perceive credit bureaus as competitive and thus, are resistant to sharing information on borrowers and lenders. In order to overcome these obstacles, we would recommend the creation of a task force made up of potential beneficiaries who could attempt to persuade banks and government agencies that credit bureaus provide immense benefit to the consumer and SME credit markets development

B. USAID Institutional factors

USAID Structure

While a decentralized and "empowered" organization such as USAID has benefits of custom designed products and services for each country or region, it displays of the weaknesses that were highlighted in this paper. USAID should take steps to improve its leveraging of its intellectual capital. Ironically, after a large downsizing effort at USAID Headquarters in Washington, full implementation of the concepts outlined in the paper would greatly expand the staff size again. We believe a re-expansion of the headquarters office would be well justified as USAID may have gone from one extreme to the other in its re-engineering efforts.

Center for Financial Sector Reform

We believe that the idea of creating a Center for Financial Sector Reform has considerable merit. This Center could act as an internal consulting arm of USAID. Of course, USAID will need to effectively manage the relationship between the Missions

and the Headquarters Office to make this effort a success. One of the most critical operations of the Center should be to better organize a centralized database and set minimum standards for collection of data from projects. This Center should also form an evaluation team that would visit the projects and the project counterparts on a periodic (but not frequent) basis, similar to a peer review process. This concept may not be well received by the Missions, and too frequent visits could damage the existing relationship between the Missions and headquarters. We also favor the idea of promoting global and regional concepts (conferences, workshops, etc.) through this Center. The Center could work closely with the Basle subcommittees for this effort. Finally, we believe that the Center should employ subject experts to assist the Missions' country experts. Subject experts would help USAID move toward a more strategic thinking pattern with a "big picture" view, in recognition that many aspects of financial sector reform can only be achieved gradually.

Design Requirements and Technical Expertise

We strongly support the leveraging of FSAP reviews to design and evaluate USAID projects. For example, the IMF's review of Basle Core Principles at the onset of some of our projects (e.g., Kazakhstan) has been a valuable resource in designing our assistance to the financial sector regulators. The independence of this review must be emphasized. The project implementers are generally not as effective in evaluating Core Principles compliance, as the inherent conflict to please the counterpart is often too strong. If World Bank / IMF funding for this effort is problematic, USAID might consider designing a task order to create an independent FSAP review team or budgeting for independent FSAP reviews on its projects.

Overall, the techniques of project design and evaluation are in need of updating and improvement. USAID projects are generally well designed to the degree that a corresponding CTO is an expert in the particular field. However, as the Missions are organized by country and the expertise of the CTO is often too widespread to be effective. As stated above, the subject experts from the Center could be used in project development and design. Finally, we would recommend that USAID involve the various central banks or other implementing agencies in a review of what projects have worked or not worked. Assistance is often designed with little or no discussion with the counterparts.

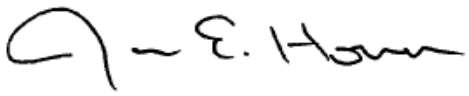
We would also recommend that USAID reconsider its requirement that consultants be qualified for "Level 1" status only upon the completion of 5 years actual overseas work. While the desire to recruit highly experienced consultants is understandable, this policy has the effect of discouraging many well-qualified experts from accepting USAID assignments. There are a number of individuals with long careers in the financial sector in the United States, who could provide valuable insights and assistance on USAID projects. The 5-year requirement often acts as an impediment to their willingness to do so.

Country classification system

We believe that the idea of a country classification system ("topology") has merit. However, more attention to the details is necessary. Defining a "reforming" country as opposed to a "non-reforming" country will be difficult and will be subject to a large degree of interpretation. We also assume the term "reforming" is in relation to financial sector issues only. For example, the market transition side of USAID would clearly say that Kazakhstan is reforming, while the democratic transition side would say that it is racing quickly in the opposite direction. Both views are correct. A potential solution would be for USAID to explore certain links to Standard and Poor's or Moody's sovereign ratings for countries, rather than trying to configure a new complicated matrix. Also, we do not believe that the absolute size of a country's financial sector should be the gauge of assistance. A preferable gauge would be the ratio of financial assets (banking, insurance and pensions) to GDP. That would be a better measure of financial depth than an absolute number of greater or lesser than a given amount.

We hope that the above comments and suggestions will provide USAID with some useful material as it goes about the critical task of planning its future undertakings. We would be happy to discuss any of these issues in more detail, if you desire. Please feel free to contact me if you would like additional information or have further questions. I can be reached via telephone at (703) 747-3248 or via e-mail at Jhorner@bearingpoint.net.

Very truly yours,



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