United States Agency
for
International Development

Financial Sector Strategy

USAID/EGAT

COMMENTS AND QUESTIONS SHOULD BE DIRECTED TO
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Executive Summary

The Pillar Bureau for Economic Growth, Agriculture and Trade (EGAT) presents a financial sector strategy to strengthen the effectiveness of USAID's financial sector development programs around the world.

Resilient, well-regulated financial systems are essential for macroeconomic and financial stability in a world of increased capital flows. Financial sector reform leads to reduced risk and increased financial intermediation. Financial sector deepening creates a wider range of financial products and services that serve a larger share of the population and are offered by diverse, healthy financial institutions. Financial sector development, leads to increased investment, economic growth, and welfare.

Financial services are the lubricant of any economy and touch every aspect of USAID's mission. For example:

- **Trade** requires that goods be paid for, and that the inputs, production and distribution costs be financed.
- **Agriculture** requires the financing of inputs during the growing cycle, and the processing and distribution costs between harvest and sale to the consumer.
- **Enterprise Development**, whether micro, small, medium or large, is dependent on leveraging own funds.
- **Water** and other natural resource management requires deferring the cost through financing to match the revenue stream.
- **Education** requires funding school buildings. The cash required to pay teachers and for supplies moves though the financial system.
- **Urban Development** depends on financing of everything from mortgages for housing stock to home improvements to infrastructure.
- **Remittances** account for a major portion of many country's cash inflows.
- **Safety Nets** depend on personal savings as the general public's main social safety net, and pension systems can help people avoid poverty in old age.
- **Household finance** provides families with access to financial services to help build income and assets, smooth consumption in hard times, and invest in their own human capital.

These are just samples of the importance of financial services – the financial sector is pervasive throughout every economy. Accessibility, the range of services available, transaction costs, the speed of execution and public confidence in the safety of their funds directly impact each country's economic efficiency, the wellbeing of its citizens, and social stability.

This financial sector strategy is based upon a review of USAID's work in this sector since 1988, and draws on best practices and lessons-learned in other donor-assisted financial markets interventions over the last fifteen years. It also draws on over two decades of USAID experience with support for micro-finance and financial sector deepening, as well as more recent experience in using credit enhancement (including Development Credit Authority) to accelerate development of healthy financial markets. In light of this experience, EGAT's financial sector staff will seek to:

- Provide stronger support and increased strategic focus to USAID field programs in the financial sector.
- Facilitate collaboration between USAID field programs and global multilateral efforts to increase transparency, accountability, and depth of financial sector systems in developing countries.
- Promote regional and/or global financial integration, particularly in small countries where national banking and/or securities systems would be inordinately expensive and/or financially unsustainable.
- Enhance support to field-based financial sector initiatives by developing diagnostic methods to prioritize interventions, and by designing monitoring and evaluation processes.
- Expand the toolkits available to USAID's field Missions, including a) access to expertise through IQCs, IAAs and grants, and b) devel-

opment of tested technical solutions packages to leverage successful work done in other countries.

- Encourage proactive use of credit enhancement and partnerships (e.g., DCA and GDA) to leverage increased private capital and technical resources invested in financial sector development.

The financial markets team will also facilitate coordination with international financial institutions (IFIs) and other donors to ensure that USAID projects effectively leverage and build on other donor knowledge and resources.

Background and Context

Technical assistance for financial sector reform and development has been a modest, but consistent feature of USAID programs overseas - $3.2 billion since 1988. $1.2 billion funded a surprisingly diverse 766 separate projects that provided technical assistance for infrastructure building, such as accounting reform, strengthened financial sector laws, regulations, and supervision, credit information bureaus and specialized ratings firms, tradable financial assets, and trained market participants. $2.0 billion funded 84 active investments, of which 73 were in developing micro- and SME finance institutions that offer diverse credit, savings, insurance, and payment services. More than half of the financial sector work during the 1990s was done in Eastern Europe and the Former Soviet Union. Europe & Eurasia Bureau support for financial sector development is now declining as basic institution-building efforts are completed, while interest elsewhere is increasing as the Agency refocuses on economic growth.

The Agency must now think through the role of financial sector development in its economic growth and poverty reduction work. Per a USAID-commissioned study conducted by Deloitte Touche Tohmatsu (DTT), a significant opportunity exists to assist Mission-originated projects within an enhanced global strategic focus. Focus is made more difficult – yet more important – because the level of financial sector expertise in the Agency has declined.

The financial world has also changed in the last ten years in ways that affect what USAID should do to promote financial sector development in partner countries. USAID approaches to financial sector development will benefit from systematically taking these global changes into account.

The global trends and events affecting financial markets provide context to the strategy. First, the Asian financial crisis of 1997-99 capped two decades of similar, but less dramatic financial sector crises in the developing world. These events led to a re-evaluation of the conventional wisdom that financial sector liberalization in developing countries is beneficial, in and of itself. Significant trends include:

- Recognition that key public and private institutions are essential to protect against systemic crisis.
- Consolidation of financial systems through globalization and technology.
- Convergence of regulation of financial intermediaries.
- Emergence of world standards for transparency and accountability.
- Development of financial sector diagnostic tools by the IFIs.
- Emergence of non-bank financial institutions and specialized micro-finance institutions (MFIs) serving millions of clients.
- Reduction in state ownership of financial intermediaries.
- Demographic trends that increase the urgency for pension reform.

Given these trends, there is a clear need for rigor in the design and implementation of financial sector assistance initiatives to ensure consistency with evolving standards, principles and best practices. The need for greater coordination among donors in this sector is also evident.

Programmatic Objectives

EGAT will strengthen its support of Mission initiatives in the financial sector by providing resources to:

- Enhance project design and implementation
- Develop diagnostic tools and resources
- Develop model solutions packages
- Enhance statements of work
- Provide access to contractors
- Support selected innovations in products, services, delivery techniques, and institutions
- Identify and disseminate best practices
- Enhance performance measurement
- Coordinate with other USG efforts
- Build links to IFI programs
- Leverage external resources
- Enhance financial sector training

EGAT will also broaden and deepen USAID's network of associates, review relevant research, invest in new knowledge, maintain technical leadership and understanding of trends and best practices in the field, and contribute to the financial sector technical skills training of USAID officers. EGAT will accomplish these objectives by leveraging its financial sector development staff with external resources.

This strategy points the way to strengthened field support and collaborative technical leadership on financial sector development initiatives of USAID worldwide. Countries that develop efficient, broad-based financial markets can wean themselves from dependence on assistance and tap into the power of global finance and investment, as well as the resources of their own citizens, to fuel self-sustaining growth.

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Acronyms

ADB .... Asian Development Bank, Manila, Philippines
AfDB........... African Development Bank, Abidjan, Ivory Coast
AMAP .... Accelerated Micro-enterprise Assistance Project
BIS .... Bank for International Settlements, Basle, Switzerland (aka BIZ or BRI)
CDIE .... Center for Development Information and Evaluation of USAID
CEE .... Central and Eastern Europe
CTO............. Cognizant Technical Officer
DTT .... Deloitte Touche Tohmatsu Emerging Markets Group
E&E............. Europe and Eurasia Bureau of USAID
EBRD .... European Bank for Reconstruction and Development, London, UK
EGAT .... Economic Growth, Agriculture and Trade Pillar Bureau of USAID
FDIC............ Federal Deposit Insurance Corporation, Washington, DC
FIRST.......... Financial Sector Reform and Strengthening Initiative of the WB and IMF
FESCO .... Forum of European Securities Commissions
FSA .... Financial Sector Appraisal (by the WB)
FSF .... Financial Stability Forum, based in the BIS
FSAP .... Financial Sector Assessment Program (IMF/WB) – a joint IMF/WB program to assess the level of vulnerability of a country's financial sector to stress
FSSA .... Financial Sector Stability Assessment (public output of the FSAP)
FSU .... Former Soviet Union
FSVC........... Financial Services Volunteer Corps
GDP............. Gross Domestic Product
IAIS .... International Association of Insurance Supervisors
IASB............ International Accounting Standards Board
IBRD .... International Bank for Reconstruction and Development, part of the World Bank Group
IDA.............. International Development Association, part of the World Bank Group
IDB.............. Inter-American Development Bank, Washington, DC
IFA .... International Federation of Accountants
IFAD .... International Forum on Accountancy Development
IFC .... International Finance Corporation, part of the World Bank Group
IFI................ International Financial Institution (WB, ADB, IDB, AfDB, IMF etc)
IMF.............. International Monetary Fund, Washington, DC
IOSCO......... International Organization of Securities Commissions
IQC.............. Indefinite Quantity Contract
MDB............ Multilateral Development Banks
MFI.............. Micro-finance Institution
NBFI............ Non-Bank Financial Institution – typically a financial intermediary that is not permitted to take demand deposits from the public.
NIS .... Newly Independent States (of the Former Soviet Union – FSU)
OECD.......... Organization for Economic Cooperation and Development, Paris, France
OCC .... Office of the Comptroller of the Currency (the senior US bank regulator reporting to the US Treasury), Washington, DC
SEC .... U. S. Securities and Exchange Commission, Washington, DC
SEGIR .... Support for Economic Growth and Institutional Reform
SOW............ Scope of Work
SRO............. Self Regulatory Organization
ROSC .... Reports of Observance of Standards and Codes (IMF/WB) – a joint IMF/WB program to evaluate the level of a country's compliance with international standards
UNCITRAL. United Nations Commission on International Trade Law
WB .... World Bank, Washington, DC

I. Background and Context

Robust, diverse, and well-regulated financial systems are essential for macroeconomic and financial stability in a world of increased capital flows. Financial sector reform leads to reduced risk and increased stability. Financial sector deepening creates a wider range of financial products and services that serve a larger share of the population and are offered by diverse, healthy financial institutions. Financial sector development leads to increased investment, economic growth, and welfare. ***No economy has developed without an efficient financial sector.***

EGAT is tasked with providing USAID field Missions with technical support for financial sector projects. This document lays out how this task will be accomplished. It provides a context for and complements guidance on specific financial sector issues, such as on micro-finance in USAID's micoenterprise policy paper.

Introductory Section I will review what financial markets are and why they are important, and explore the integration and interdependencies in financial markets. This section then provides a brief review of USAID's past support for the financial sector and the role that the International Financial Institutions (such as the International Monetary Fund and World Bank) play in the development of the financial sector.

Section II presents EGAT's Financial Sector Strategy, while Section III presents a systematic approach to achieving these goals and objectives. The Annexes provide supporting material.

EGAT's Financial Sector Strategy seeks to provide a coherent framework for assisting Missions to enhance the effectiveness of their financial sector projects and to increase impacts on host country economic growth and poverty reduction.

1. Why are Financial Markets Important?

An efficient financial sector is central to economic growth. Effective financial markets:

- Collect and then allocate savings to the most efficient uses; and thus
- Increase access to investment and loan funding for businesses, which increases employment, competitiveness and GDP.

Increased business activity increases tax receipts, providing the government with more of the funding needed for schools, health services and other social and infrastructure development needs.

Financial intermediation between sources and users of funds requires the following components:

- Sources of savings – individuals, companies and pooled funds (insurance, pension)
- Functioning intermediaries that are trusted by owners of savings to hold or place their funds reliably; and
- Reliable users of funds – individuals or companies that will use the funds to create value sufficient to repay the funds with interest or profit sharing.

For these components to function, a country must have a legal and regulatory infrastructure that ensures that the individuals who control the sources of funds have confidence that the intermediaries and users of funds will be willing and able to repay.

In addition to financial intermediation, fees based services provide a means for the transfer of value through payments and remittances[i], and for the secure settlement of trade transactions.

Financial intermediaries, particularly those engaged in savings and loan functions to households, such as credit unions, cooperatives, NGO micro-finance institutions, retail banks and the consumer banking component of commercial banks, play a critical role in improving the welfare and productivity of households by enabling them to build assets, reduce vulnerability, and build human capital.

Continuum of Financial Services

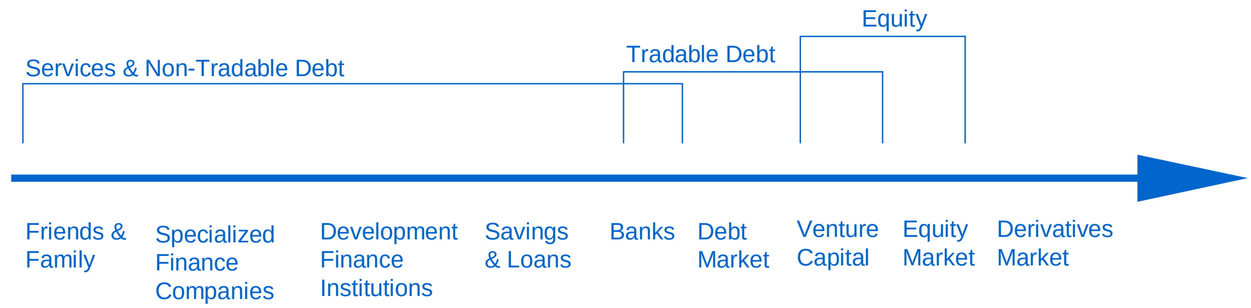


Figure 1 - The Continuum of Financial Services

2. What are Financial Markets?

In a well functioning financial system, financial institutions provide the following services:

- **Payment** – transfers (payment orders), remittances, checks, collections and other payment instruments.
- **Deposit/Savings –** deposit accounts, time deposits, certificates of deposit, annuities, bonds, and investment accounts.
- **Credit –** consumer finance, mortgage lending, and commercial finance through overdrafts, short-term loans, long-term finance for plant and equipment, clean or documentary letters of credit to finance trade, and contingent liabilities.
- **Capital Markets –** government, municipal and corporate bonds, venture capital, initial public offerings, stock market services, mergers & acquisitions, and risk hedging instruments.
- **Insurance –** casualty insurance that spreads individual risk over a pool of insured parties, life insurance that protects living standards and generates long term funding for capital investments, and reinsurance that spreads the risk of a catastrophic event in one area over a wider area.
- **Pension –** which includes the three Pillars, defined by the World Bank (WB) as Pillar I – pay-as-you-go government, Pillar II – mandatory private, and Pillar III – voluntary private systems. Pension systems may be based either on a defined contribution or defined benefit.

Financial intermediation is provided by a range of institutions that collect funds from savers and allocate them to investors. While banks are the most visible players, they are only one of many institutions that provide financial intermediation. The continuum of financial services and the institutions that provide them is shown in Figure 1. The level of sophistication increases from left to right, and the more sophisticated institutions and services will appear as the market matures and the need for the more specialized institutions and services becomes sufficient to support their presence.

Regulatory agencies (either specialized institutions, as in the U.S., or consolidated supervision agencies as is the general trend elsewhere) have the primary responsibility of ensuring that the market "rules of the game" are predictable and fair, and that institutions or individuals who abuse the public trust are removed from the system. Trust in this process has to be earned by the financial markets through successful development of predictability, integrity, fairness and transparency so that comparative risk levels can be identified and priced.

3. Integration and Interdependencies in Financial Markets

A country's financial system does not exist in a vacuum. Rather, it forms an integral part of the economic web of the country and its effectiveness is a reflection of the investment climate within

Dependencies for Financial Intermediation

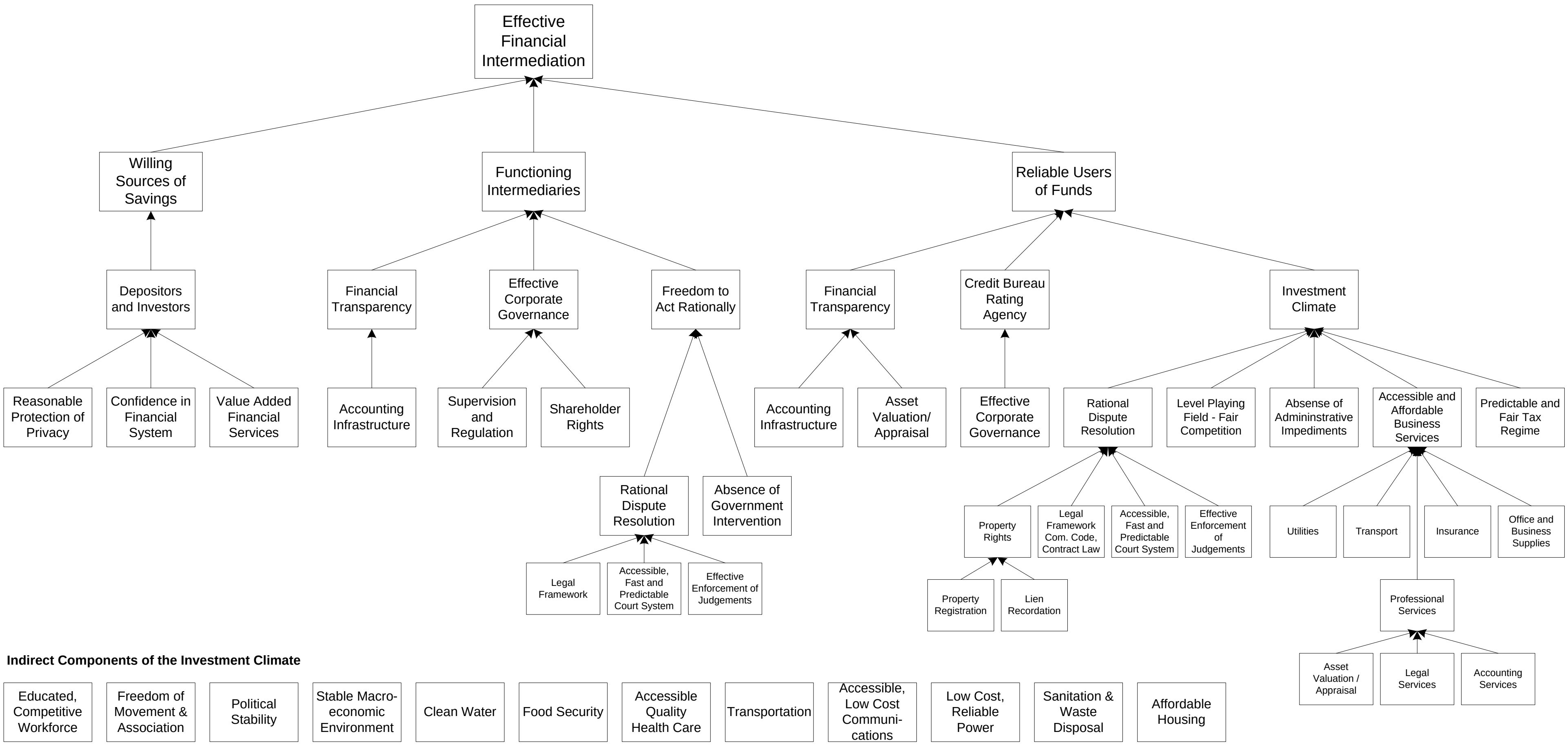


Figure 2 - Dependencies within the Financial Sector

that country. Conceptually, financial intermediation can be seen as the apex of a pyramid, where weakness in any supporting component will inhibit or prevent financial intermediation from occurring. This pyramid of dependencies within the financial sector is shown in Figure 2.

As an example of the dependency of financial intermediation on the enabling environment, financial decision makers will evaluate the risk of a potential loan or investment within the context of the following:

1. A financially viable borrower. For consumer finance, this means an identifiable source of income, such as salary or stable self employment income. For a commercial borrower, the business must be competitive enough within its market to generate the cash flow needed to service the debt. For a central or municipal government borrower, future tax receipts or usage fees must be sufficient to cover the principal and interest payments.

2. Financial transparency sufficient for the borrower to understand its financing needs and for the lender to accurately evaluate the borrower's financial condition and prospects. For commercial borrowers, application of International Accounting Standards (IAS[ii]) and a single set of books help.

3. Effective corporate governance practices, particularly separation of business property from personal property.

4. Independent property appraisal companies to fairly evaluate the orderly liquidation value of assets that support the loan or investment.

5. Rapid, effective collateral registration, repossession and sale procedures and practices that allow rapid recovery of loan funds through the "second way out" in case of borrower default.

6. Property insurance to protect the value of assets against unpredictable risks, such as fire and natural disaster.

7. Credit information on the prospective user of the funds, particularly demonstration of the user's willingness and ability to honor previous obligations, and the extent of debt from other sources.

8. Funding sources for the lender (e.g., deposits) or investor that are sufficiently low cost to permit an adequate lending margin, and with maturities reasonably matching the borrower's funding needs.

One or more of these factors are often deficient in USAID's host countries, including some that appear relatively sophisticated. Any deficiency drives up the probability of losses and the risk premium that the bank will have to charge to cover the cost of building adequate loan reserves, or the investor will require to justify accepting the investment risk. In weak environments, the risk premium is so high that borrowing from banks or raising funds in the capital market to fund commercial expansion is prohibitively expensive, and economic development stagnates.

4. Challenges to Financial Sector Development

In most countries, the basic financial sector infrastructure has already been built. Yet:

- Much of the population does not have access to credit, savings, or other financial services from formal financial institutions.
- Prudential regulation and oversight (including bank supervision and securities market regulation) does not adequately protect the public.
- Financial statements are not a reliable indicator of bank or company financial performance and condition, and the public generally does not have access to accurate, understandable information on financial intermediaries.
- The public often does not trust their savings to the banks, usually with good reason, and unconnected companies cannot get working capital or equipment finance under reasonable conditions.

- Lenders cannot obtain credit information on potential borrowers nor effectively secure loans with the borrower's property.
- Lending policies reflect excessive conservatism, dependence on collateral, mismatch of loan product maturities, and cronyism.
- High risk premiums and transaction costs in financial intermediation impair borrowers' ability to service their debt and compete with producers in more efficient economies.
- The capital markets infrastructure remains shallow, with inadequate non-bank financial institutions and instruments, insurance products, equity and debt markets, money market funds, corporate and municipal bonds.
- Few of the countries that USAID serves have sufficient numbers of widely held investment grade companies to justify even a rudimentary stock market system.
- Some countries that have made the most progress in implementing the World Bank (WB)'s three pillar pension system find that the funds under management quickly exceed domestic investment opportunities, resulting in a concentration in government securities and substandard domestic corporate bonds.[iii]

Slow progress in resolving these weaknesses can be attributed variously to limited political will to implement change, corruption, a limited "absorptive capacity" for technical assistance, or gaps in donor assistance.

In a well functioning market economy, private sector institutions will fill any reasonable gaps in financial intermediation as they develop. Information on financial services is readily available from more economically advanced countries, and opportunities will lead to a response from investors to fill the gap, assuming appropriate laws and regulations. But markets may fail for a variety of structural reasons:

- State involvement that impedes innovation and arms-length transactions – a nationalized banking system or barriers to foreign institutions are prime examples;
- Monopolistic behavior by dominant institutions that inhibits competitive innovation;
- An ineffectual legal and regulatory infrastructure, poor corporate governance or systemic market risks that do not support public confidence;
- An investment climate that does not support business activity; or
- Insufficient demand for the service to justify the cost, which can be due to an underdeveloped real sector, information asymmetries, high transaction costs or simply too small a market.

Sequencing Lessons Learned

Banks and other financial intermediaries exist to provide financial services that make economic sense within the context of their markets. In the absence of external distortions, prudent managements will provide financial services that are cost effective, for which the rewards adequately cover the risks and cost of capital. Managers will add new services as market conditions permit. Adding services prematurely results in losses. Delaying new services once conditions allow an adequate yield represents an opportunity cost most managers will seek to avoid.

- If the public is not placing funds with the banks, it is not necessarily because the public has no funds to place, but more likely because the banking system is perceived by the public to be untrustworthy – the benefits of placing funds in a bank (convenience, safety, interest income) are outweighed by the transactions costs and the risk of losing the deposit if the bank fails.
- If banks are not lending, it is probably because they understand all too well how risky lending is in their market. Risk factors banks consider unacceptable include a lack of predictable court support for contract enforcement, a limited market for repossessed collateral used to secure loans, a low level of credit information and inadequate credit discipline within the market, macro-economic instability, tight or unpredictable market liquidity and a lack of bankable lending opportunities because of limited real sector economic activity.
- If stock market activity is low, it is more likely to be due to a lack of investment grade companies than to a lack of capital markets infrastructure.

The extent, to which a financial service may be available in a particular country, and the existence of the institutional infrastructure to provide that service, will depend on whether that service is economically attractive.

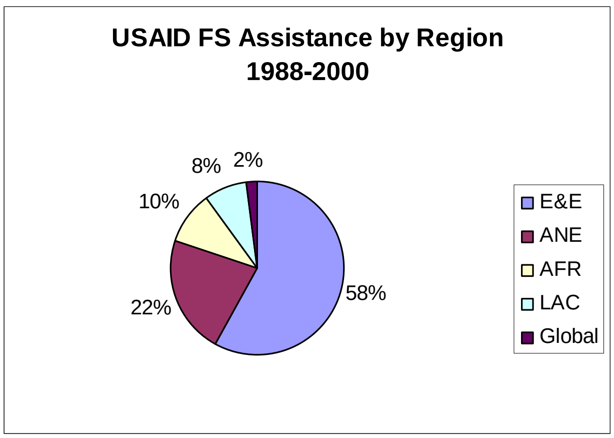
Financial markets first develop services that are suitable to a simple economy. More complex services develop as the market demand for such services develops and the enabling environment evolves to lower the transaction risk. Short-term trade finance by banks will develop long before asset based finance and capital markets become commercially viable services. The institutional infrastructure of the financial system will develop in response to evolving market needs and opportunities for particular services, typically starting with simple services and banking institutions.

Trying to force the pace by targeting desirable effects, such as pushing the introduction of services or institutions where market demand does not justify the cost, risks burdening the host country with an infrastructure that consumes rather than creates value.

A systematic approach is needed to identify the impediments to financial intermediation and to determine what can reasonably be done to remove them.

5. USAID's Support for the Financial Sector

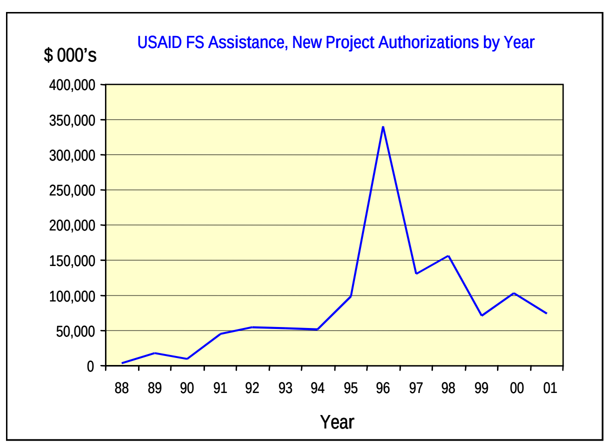
Support for financial sector development has been a consistent feature of USAID programs – $3.2 billion since 1988.[iv] $1.2 billion funded a surprisingly diverse 766 separate projects that provided technical assistance for infrastructure building, such as strengthening of accounting and financial management, financial laws, regulations, and supervision, developing credit information bureaus and specialized ratings firms, enabling tradability of financial assets, and training of market participants.



While this represents only 2.4% of USAID's total funding during the period, the long term impact is likely to have been disproportionately large – USAID's ability to put long term teams on the ground, to work with private groups as well as governments, and to build institutions to meet unfilled needs in the financial sector, creates the potential for unusually effective programs and a source of comparative advantage vis-à-vis most other bilateral donors.

In the E&E region, for example, where much of this work occurred, the banking system had to be rebuilt. USAID technical assistance has been the dominant factor in this work, resulting in levels of financial intermediation and economic growth that would have been unthinkable otherwise. While more than half of the financial sector work during the 1990s was done in Eastern Europe and the NIS, a major focus of USAID Missions elsewhere was SME development and micro-finance. E&E support for financial sector development is now declining as basic institution-building efforts are completed, but the range of financial sector work undertaken by USAID worldwide remains broad. USAID-financed activities include:

- **Legal Infrastructure** – USAID has funded strengthening for the financial sector legal infrastructure worldwide, including in Africa: Ethiopia, Guinea, Madagascar, Niger, Senegal, Swaziland, Uganda and Zambia. Work in property rights and title registration may not be counted as financial sector work, but still is essential to financial sector development.
- **Supervision of Financial Intermediaries** – In Latin America alone, USAID provided supervision support in Bolivia, Ecuador, Guatemala, Honduras, and Paraguay.
- **Institution Building** – In Mongolia, a USAID funded team restructured the management of the Agricultural Bank of Mongolia, turned the bank around, and privatized it. In Kosovo, a USAID funded team built a successful bank from the ground up, demonstrated its capacity to develop sound SME business, and privatized it to a strategic investor.
- **SME and Micro-Finance** – In micro-finance, USAID has been heavily engaged worldwide in building financial institutions to serve a broader segment of the population, with 183 projects accounting for 20% of financial sector



technical assistance funding and, with 73 projects, 90% of the active investment.

- **Housing Finance** – USAID supported housing finance through 76 projects in 23 countries.
- **Capital Markets** – USAID funded teams have provided institution building for capital markets worldwide, including in Bangladesh, Egypt, India, Indonesia, Jordan, Lebanon, Morocco, Pakistan, Philippines, Sri Lanka, the West Bank & Gaza and throughout the NIS.
- **Pension** – Missions initiated 38 pension related projects in 16 countries.
- **General Financial Sector** – a further 151 projects accounted for 30% of Agency financial sector assistance.

A breakdown by sector for technical assistance and direct funding projects in the financial sector is shown in Annex 1.

In addition to the technical assistance projects, USAID provided $2.0 billion to fund 84 active investments, of which 73 were in developing micro- and SME finance institutions, including enterprise funds. USAID has assisted in filling market gaps where the infrastructure has evolved to allow market deepening, but where a catalyst was necessary to demonstrate commercial viability. This catalyst has been provided through establishing SME and micro-finance institutions and by supporting new financial sector activity through risk sharing using the Development Credit Authority to correct market imperfections. These institutions offer diverse credit, savings, insurance, and payment services to previously underserved segments of the population.

This diversity represents an appropriate field level response to local conditions and opportunities. But a review by Deloitte Touche Tohmatsu of all USAID's work in this sector since 1988 indicated that the random pattern of Mission-originated projects may reflect the lack of a global strategic focus. ***The Agency should have a clearer approach to the role of financial sector development in its renewed focus on economic growth.***

6. Globalization of Financial Markets

The financial world has changed dramatically in the last ten years. Global events affecting financial markets provide context to the strategy.

The Asian financial crisis of 1997-99 capped two decades of similar, but less dramatic crises in the developing world. These events led to a fundamental re-evaluation of the conventional wisdom that financial sector liberalization in developing countries was beneficial, in and of itself. One resulting lesson is that the IFIs and international donors must ensure that key public and private regulatory institutions are in place to provide transparency and accountability in financial transactions before, or in parallel with, market liberalization.

Convergence in world financial systems has broken down the traditional separation of banking, securities, and insurance markets. While developing countries may not have to face the most complex of the regulatory issues that result from this convergence, some will have to begin developing regulatory policies now (often as a precondition to membership in international institutions like the European Union) – with few precedents to go by.

There is a global movement to establish new world standards for transparency and accountability in national financial systems (led by the IFIs, the OECD, the WTO, the UN, the Basel Committees, the EU, and other international bodies). These new standards, as adopted and implemented, are defining the new norms which all countries must achieve and maintain in order to have access to global investment and the benefits of accession to international organizations (e.g. the WTO) that facilitate cross-border trade and financial intermediation. This movement offers significant leverage to USAID and other donors positioned to assist host country governments to meet international standards of governance and accountability.

Reaction to the Asian crisis led the IFIs to develop diagnostic tools that provide an analysis of the soundness of developing country financial systems and the ability to benchmark one country against others. The Standards and Codes used in these analyses are listed in Annex 2. USAID field programs can be strengthened by increased use of the results of these diagnostics to identify areas where grant-funded technical assistance could most productively be applied.

There is also a growing awareness among host country governments and IFIs of the need to refocus on developmental aspects of financial sector reform. As crises abate and core problems of accountability and insolvency are resolved, attention is turning to issues of access, diversity, and financial sector deepening. Focus on stability must be balanced against efforts to foster economic growth and poverty reduction through financial sector development.

Finally, demographic trends in developing countries will require virtually all USAID host governments to assess the role of pension systems as one mechanism to respond to the needs of aging populations. Well-designed systems could help ensure the livelihood of an increasing number of dependent people in developing countries, while creating a much needed pool of capital for domestic investment.

Globalization, driven or facilitated by information technology, means that some financial sector services may most effectively be provided on a regional or global basis. The view that every country should have a securities trading system or even its own bank regulatory body may be anachronistic – yet USAID, like other donors, has tended to think and program resources on a country-specific basis.

The approach proposed in this Financial Sector Strategy will encourage a more systematic implementation of financial sector development in the countries that USAID serves. Closer coordination with the IFIs and other donors on project development is a key component of this strategy.

7. Role of International Financial Institutions

The global response to the financial instability that hit developing countries particularly hard in the 1970-90s has been led by a loose collaboration of international organizations that set the context within which USAID's financial sector work will take place. Annex 3 briefly describes the different organizations, their subsidiary bodies, and activities. Their focus ranges from directly organizing the reform of the international financial architecture, to overseeing macroeconomic and financial sector policies and conditions, to lending and other forms of financial assistance, to training, technical assistance and research.

The World Bank, IMF, OECD[v] and other multilateral agencies conduct substantial analytical work on the financial sector and have developed a body of knowledge on international practices and standards that can be used to enhance the effectiveness and consistency of USAID financial sector projects.

Several of the IFI analyses are particularly important for USAID programs. The Financial Sector Assessment Program (FSAP), a joint IMF and World Bank effort introduced in May 1999, aims to increase the soundness of financial systems in member countries. Supported by experts from a range of national agencies and standard-setting bodies, the program seeks to identify the strengths and vulnerabilities of a country's financial system; determine how key sources of risk are being managed; ascertain the financial sector's developmental and technical assistance needs; and help prioritize policy responses. Detailed assessments of observance of relevant financial sector standards and codes, which give rise to Reports on Observance of Standards and Codes (ROSCs)[vi] as a by-product, are a key component of the FSAP. The FSAP also forms the basis of Financial System Stability Assessments (FSSAs), in which IMF staff address issues of relevance to IMF surveillance, including risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks.

These analyses are typically conducted at the request of the host country[vii]. The reports generated by these diagnostics detail the areas that need strengthening within the host country's financial sector. USAID can use the publicly available extracts from these reports in its own assessment and diagnostic process, and where appropriate assist countries in responding to issues identified by the FSAP.

Requests for USAID assistance will increasingly focus on responding to issues identified during the WB/IMF assessments, and on harmonizing financial sectors on the international standards (guidelines for best practices) being established on a global basis.

Since the Asian Crisis in the late 90s, the WB and IMF have been particularly active in financial sector policy. Work done by these institutions highlights gaps in the financial sector infrastructure and increases host country demand for technical assistance to implement WB and IMF recommendations.

USAID's counterparts in other OECD countries (shown in Annex 3) are active in the financial sector – USAID may enhance the impact of its own programs by collaborating with these other donors. More so than possibly any other area of USAID activity, close coordination between donors is essential in the financial sector.

This Background and Context section has outlined the importance of the financial sector, the ongoing roles that USAID has been playing in financial sector development, and has shown the need to work closely with the IFIs to strengthen financial sector programs. Improving EGAT's support for Mission initiatives in the financial sector can have a significant impact on the effectiveness of USAID's programs and contribute to increased economic growth in host countries. This requires a cohesive financial sector strategy, which is laid out in the following Section II.

II. Financial Sector Strategy

1. Goals

EGAT will strengthen the effectiveness and consistency of USAID's initiatives in financial sector development, and encourage application of lessons learned and international "best" practices.

The goal is to increase the efficiency of financial intermediation – the allocation of savings to the most productive private sector activities – and deepen financial markets by expanding access and the range of financial products and services available, leading to economic growth, job creation, and poverty reduction.

2. Programmatic Objectives

In response to the internal and external factors cited above, EGAT will enhance its support for field Missions to engage in financial sector projects. EGAT will complement the country and situation specific knowledge of field staff with a systemic approach to financial sector development – supporting new projects through a "holistic", integrated, and sequenced perspective on financial markets development. EGAT will keep abreast of regional and global trends in strategy development and new activity design, in light of international standards and regional best practices, and use this information to inform new work by Missions worldwide.

EGAT will coordinate closely with the IFIs – assisting Missions to assess country-specific diagnostics prepared by the IFIs, identify gaps and technical assistance requirements, leverage USAID assistance through co-financing, and coordinate policy dialogue. EGAT will provide in-house expertise and access to quick-response procurement mechanisms to source the financial market professionals required by field Missions for country-specific diagnostics and to develop, implement and monitor financial sector projects.

EGAT will strengthen its support of Mission initiatives in the financial sector by providing resources to:

1. Enhance project design and implementation
    A. Develop diagnostic tools and resources
    B. Develop model solutions packages
    C. Enhance statements of work
2. Provide access to contractors, grantees and USG partners
3. Support selected innovations in products, services, delivery techniques, and institutions

4. Identify and disseminate best practices
5. Enhance performance measurement
   A. Set performance indicators
   B. Measure results
   C. Compare results against “best practices” and international standards
6. Collaborate with USG policy setters
7. Build links to IFI programs and other donors
8. Leverage external resources
9. Enhance financial sector training

Achieving the goal of improving financial intermediation requires building an enabling environment in which financial intermediaries can work in confidence and that merits public trust.

But financial sector work is not solely a stand-alone activity. Successful projects that are not intended to focus on the financial sector may well require a financial sector component to ensure that domestic financial resources can be used to increase the impact of non-financial sector projects. For example:

- **Trade** requires that goods be paid for, and that the inputs, production and distribution costs be financed.
- **Agriculture** requires the financing of inputs during the growing cycle, and the processing and distribution costs between harvest and sale to the consumer. Services are provided by a range of sources from the farmer’s savings to micro/rural finance providers to traders through domestic banks and the international banking network if the produce is exported.
- **Enterprise Development**, whether micro, small, medium or large, is dependent on leveraging own funds to finance inventory, sales receivables and production costs, to spread the cost of plant and equipment over its useful life, and to protect against casualty loss through insurance. For larger companies, leveraging existing capital through the capital markets is essential to sustained growth.
- **Water** and other natural resource management requires infrastructure that will have an extended useful life, where deferring the cost through financing to match the revenue stream (either usage fees or taxes) enables funding of projects that are not reachable with today’s resources. And of course getting water bills paid requires financial intermediaries.
- **Education** requires school buildings – in the US funded by tax anticipation bonds through the financial system – to match the cost of housing future students with the use of the facilities. The cash required to pay teachers and for supplies moves though the financial system.
- **Urban Development** depends on financing of everything from mortgages for housing stock to home improvements to infrastructure. Revenue anticipation bonds allow for construction of urban facilities – schools, roads, clean water – by matching the current cost with anticipated future tax and usage fee receipts over the useful life of the facility.
- **Remittances** account for a major portion of many country’s cash inflows, whether it be from Washington to Guatemala, Johannesburg to Lilongwe, or Moscow to Dushanbe. Getting these remittances to flow smoothly and affordably while discouraging money laundering and terrorist finance leverages the development work that USAID can do.
- **Safety Nets** depend on personal savings as the general public’s main social safety net. Providing a safe haven for financial savings reduces the need for non-cash savings, such as in jewelry, consumer goods, or livestock. Where they exist, pension systems can help people avoid poverty in old age and weather emergencies. Both build financial resources that can be invested in economic activities until needed. Trusting savings to the financial system depends on public confidence in the financial intermediaries.
- **Household finance** provides families with access to a variety of financial services beyond production finance, savings, and remittances – insurance, payment services, and loans for school fees, emergencies, health expenses, weddings, and other social obligations, home improvement, etc. These services are essential

to help them build income and assets, smooth their consumption in hard times, and invest in their own human capital.

These are just samples of the importance of financial services – the financial sector is pervasive throughout every economy. Accessibility, the range of services available, transaction costs, the speed of execution and public confidence in the safety of their funds directly impact each country's economic efficiency, the wellbeing of its citizens, and social stability.

Projects that ignore essential financial sector components, or which fail to take into account the overall financial sector environment, best practices and international standards, may have limited or even negative impact on the host country's development. Project design must take into account potential implications of intentional or unintentional involvement with the financial sector. EGAT can help Missions review the financial sector enabling environment to determine the extent to which sector-specific initiatives are likely to encounter broader financial sector constraints. Where such constraints could undermine the effectiveness of sector initiatives, EGAT can advise Missions on ways to help address or mitigate the impacts of poor financial sector policy or weak institutions – either directly or in consortium with IFIs or other donors.

The following section will lay out the approach that EGAT proposes to take in supporting Mission activities that support development of the financial sector.

III. Approach

Section III details how EGAT intends to implement these objectives to strengthen its support to Mission financial sector projects. Figure 3 shows an idealized collaborative relationship EGAT can build with Mission staff. This approach is detailed below.

1. Enhance Project Design and Implementation

Responsibility for the development and management of financial sector projects rests with field Missions. EGAT's role is to provide technical support as required. Within this framework, EGAT will seek to minimize "ad hoc-ism", lend strategic direction, and assist Missions to consider regional and global trends in strategy development and new activity design.

Idealized collaboration between EGAT and field missions

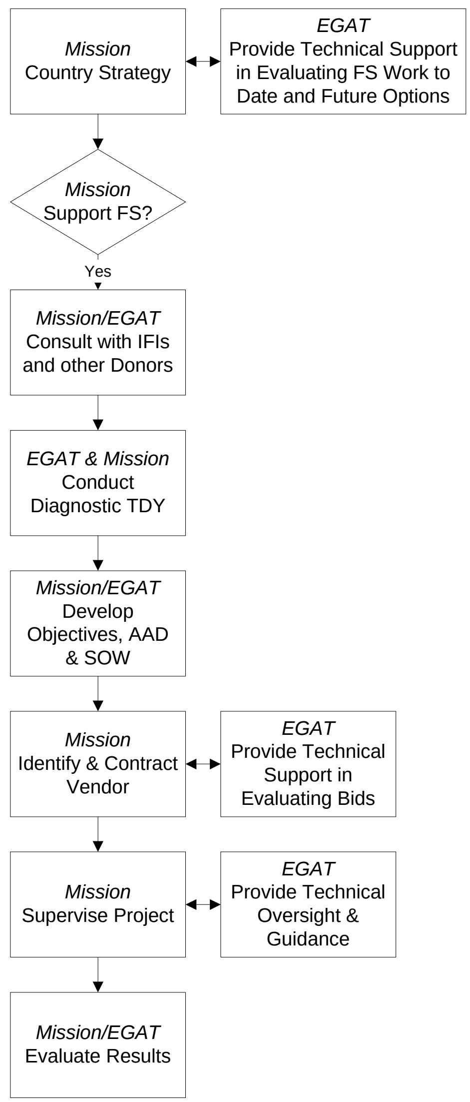


Figure 3 Collaborative Relationship

Upon request, EGAT will support Missions with country-specific diagnostics to identify the level of financial markets development and identify the steps required to strengthen the financial sector. EGAT can then help Missions to develop appropriate activity designs, if necessary. During this process, EGAT will provide Missions with comparative information and data on other-country and regional approaches to similar issues, useful lessons learned, and solutions that could be used.

At the discretion of the Mission, EGAT may assist with processing the task orders or other procurement documents, and provide technical support to review proposals from potential implementers.

EGAT will also support Missions in technical oversight and guidance on project implementation, if requested, and can work with contractors and other implementing partners to resolve technical issues. EGAT will support Missions to define and conduct performance monitoring and evaluation of financial sector projects, as requested by Missions.

One overriding objective will be to harmonize legal and regulatory assistance with international standards and regional best practices. Another will be to accelerate financial sector deepening consistent with market principles.

EGAT assistance to Missions will be provided by in-house expertise or access to quick-response procurement mechanisms to source financial markets professionals required by Missions to develop, implement and monitor financial sector projects.

A. Develop Diagnostic Tools and Resources

EGAT will develop typologies for the most significant issues facing financial sector development. The topologies[viii] will classify developing countries by state of the financial sector, size and receptivity to reform, and will help Missions target financial sector development initiatives. This process will be supported by analytical tools, such as shown in Figure 4. Once Missions decide on objectives, EGAT staff can assist in developing financial sector programs, using the topology as a reference point, but ensuring that country specific variables are factored into the process.

Identifying the specific impediments to development of efficient financial intermediation requires a country-specific, comprehensive financial sector diagnostic that builds on previous analysis, particularly that done by the IFIs. Mission staff will determine whether a more detailed diagnostic is necessary based on feedback from the IFIs and their own understanding of the host country needs and environment, and may request that EGAT conduct diagnostic analysis to confirm needs and opportunities, or to sharpen the focus of support to be provided. This detailed diagnostic will provide a Mission with a better understanding of needs and opportunities. A simplified version of this approach is shown in the illustrative decision tree for identifying TA needs in the banking sector is shown in Figure 4. A sample diagnostic tool for identifying the impediments to mortgage finance is shown in Annex 4.

EGAT will support these diagnostics through easily accessible contracting mechanisms (e.g., SEGIR-FS, AMAP-FS and RFD), its cooperative agreement with FSVC, interagency agreement with the SEC, and a quick response pool of pre-qualified independent financial sector experts[ix] working under the supervision of EGAT and through EGAT's own staff resources. In-country coordination with IFIs will occur as appropriate, along with discussions with IFI head office decision makers.

Funding for the core contract with FSVC is provided by EGAT, with individual tasks funded by Missions through buy-ins to the assistance agreement. FSVC short term volunteers incur no salary expense, but the Mission must cover the travel and per diem costs, the salary cost of any FSVC staff directly involved in the work, plus the FSVC NICR.[x]

Financial sector projects focus on reform, as in building the enabling environment, or on deepening, which focus more on expanding the capacity of individual financial intermediaries. The diagnostic tools will be designed to span the range of financial sector needs.

While Missions will generally contract for any specialized expertise required, in certain circumstances EGAT may fund short-term technical

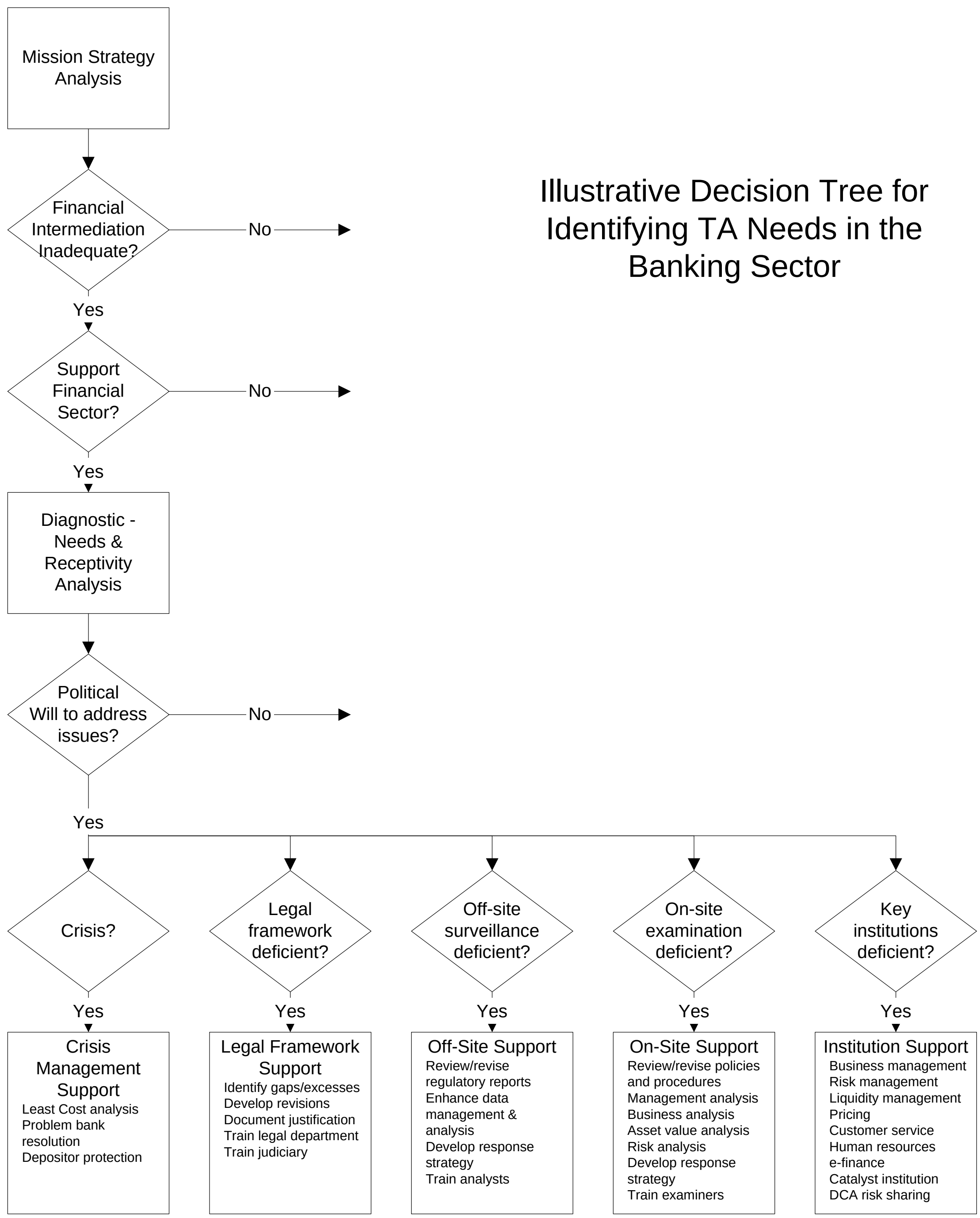


Figure 4 - Illustrative Decision Tree

assistance for early-stage design work or strategic activities that are particularly time-sensitive.

B. Develop Model Solution Packages[xi]

EGAT will develop model solutions packages that will allow materials developed in conformity to international “best practices” to be available for use by subsequent projects. These solution packages will avoid the expense of re-inventing material and will encourage greater harmonization with international standards.

EGAT will implement an enhanced knowledge management process. This approach will support program efficiency by providing easy access to materials and best practices developed under previous projects.

EGAT will assist with coordination between IRM and field project implementers on projects using IT packages. The subject matter expertise of EGAT can help to leverage prior product development, ensure that system development is based on sound objectives, and focus systems development on tools that are not available through normal commercial channels.[xii] Examples of potential and actual Solutions Packages are shown in Annex 5.

C. Enhance Statements of Work

EGAT will develop a modular approach to SOWs based on the central components of financial sector development. This process will enable Missions to build up SOWs that correspond to the desired results. The intent is to simplify and ensure consistency in the development of SOWs for the financial sector. This approach incorporates the following principles:

- Focus on consistency in implementation, enhancing harmonization and use of "best" practices.
- Tailoring to local circumstances as appropriate.
- Measurable, sustainable results.

2. Provide Access to Contractors

EGAT's contractual mechanisms will continue to provide access to leading contractors of financial sector technical assistance. Also important is access to institutions that set specific standards for industry practitioners.[xiii] Some contractors are already accessible through the inter-agency and cooperative agreements that EGAT has developed with the SEC and FDIC, and access to standard setters will be expanded to ensure Mission access to the best expertise available.

EGAT can, if requested by a Mission, also assist with the evaluation of consulting teams proposed for individual projects. This can include verifying the qualifications of the proposed staff through direct interviews that will add a level of comfort that the team selected has the necessary experience and professional qualifications to successfully implement the Mission's project.

EGAT will seek the collaboration of Mission CTOs to build a consultant performance tracking process that will assist Missions in evaluating potential consulting team members. EGAT will also seek to enhance access to the USG contractor performance monitoring service managed by the National Institute of Health (NIH).

3. Support Selected Innovations in Products, Services, Delivery Techniques and Institutions

EGAT is now attempting to gain a better understanding of what has worked well in financial market development and deepening, and what has not. EGAT's goal is to identify and disseminate proven approaches and innovations in financial service delivery to enhance USAID programming.

Research is underway to identify successful institutional models and techniques, including rural financial market interventions, post-conflict finance, value chain financing and linkages to non-bank financial service providers; innovative financial products such housing, insurance, and leasing; and actions and strategies to mitigate the impact HIV/AIDS, and/or interventions that can help deepen and broaden access to financial services. Missions are encouraged to participate in this knowledge generation process by contacting EGAT with suggestions about how EGAT can better target its research and by partnering in this knowledge generation initiative.

4. Identify and Disseminate Best Practices

Over the years, USAID Missions have gained significant experience in financial market development. The knowledge gained has been disseminated only narrowly or lost altogether amid staffing changes within Missions.

EGAT is now focused on capturing those lessons learned to identify best practice techniques to assist Missions in assessing and overcoming the constraints they face in developing local financial markets. EGAT hopes to avoid the mistakes of the past and use the lessons learned to develop tools and training materials to upgrade Mission skills and enhance their ability to design and implement quality financial sector programming.

5. Enhance Performance Measurement

A. Set Performance Indicators

Clear, consistent performance indicators exist at the level of individual micro-finance institutions (MFIs) and other retail institutions supported by direct USAID investments, including credit union strengthening programs. At the level of the broader financial sector, however, for at least the last decade USAID has concentrated more on implementing its financial sector programs than on measuring results. Increased attention to performance measurement is appropriate and necessary. EGAT will help to focus indicators on effective measures of performance.

Indirect measures of success, for example ***an increase in the level of financial intermediation within the country***,[xiv] may lag the application of technical assistance by years, since the public and private sector business may be slow to respond to changes in the investment climate. It is particularly difficult to measure the counter factual – what the performance of the economy might have been, had the project not taken place. Missions have tended to work around this issue by measuring outputs, such as "conduct five examinations within the quarter", or "initiate changes in the banking laws". But while completion of such tasks is easy to measure, it may result in little practical impact if the host country implementing institutions do not know how to conduct an examination or if the changes in the law are not helpful. At the level of national financial markets, more meaningful and measurable determinants of success would include:

- An increase in the credit extended to the private sector, net of loan loss reserves.[xv]
- A reduction in the intermediation margin and transaction costs, reflecting an improvement in the efficiency of the financial system.[xvi]
- Percentage of the population accessing formal financial institutions.[xvii]

EGAT will assist Missions to define project objectives that define the net results of actions to be taken by a project implementer and are measurable based on statistics typically provided to the IMF or WB, or published in the central bank's periodic economic bulletins.

Relevant indicators will depend on the project objectives. Appropriate indicators for resolving a crisis, for example, are different from those relevant to promoting more diverse financial services.

B. Measure Results

EGAT can assist Missions in demonstrating the results achieved by their financial sector projects by aiding systematic measurement of progress towards achieving the performance indicators. The approach would be to highlight a) progress towards achieving each project objective and b) any impediments or additional actions required to achieve those objectives.

EGAT can assist Missions by providing mid-project and close out assessments that would enhance Mission insight into what was actually achieved and what might be required next. Such a process would also provide USAID with better information on the performance of contractors and their consultants.

EGAT will also collaborate with the donor community in evaluating the effectiveness of its own and other donors' financial sector assistance programs.

C. Compare results against "Best Practices" and International Standards

For financial sector development more broadly, the IFIs and international organizations, such as the OECD, have been working to establish international standards and to move countries towards harmonizing their legal and regulatory structures with these standards. These standards codify consensus on "best practices." The expectation is that common standards facilitate cross-border trade and investment and thereby stimulate global economic growth. These standards and codes now cover most aspects of the financial sector, and the WB/IMF ROSC analysis directly measures the level of a country's compliance with a number of these standards and codes.

For micro-finance, best practices in institutional development are relatively well developed and promoted by CGAP, USAID and other leading donors. These best practices are codified in the ADS guidance and other documents and tools. CGAP, donors, and micro-finance networks at the national and international levels have also developed standardized performance indicators and standards.

EGAT will assist Missions to ensure that implementers of USAID projects work to promote harmonization on these "best practices" and international standards.

EGAT will also support Missions in ensuring consistency of the advice and recommendations being provided by contractor teams. For example, bank supervision departments are linked through the Basle Committee on Banking Supervision and informal consultations – USAID funded teams that make recommendations that are found by the host country officials to be inconsistent with the prevailing consensus will lose credibility, and the advisors may be marginalized and become ineffectual. EGAT will support Mission staff to identify when credibility has been lost and in getting the project back on track, through participation in discussions with host country officials and contractors, as requested by the Mission.

6. Collaborate with USG Policy Setters

EGAT will seek to build a collaborative relationship with the financial sector specialists within the Department of State, the Department of the Treasury, and, as appropriate, with the National Security Council. Each is involved in financial sector policy issues – USAID will inform itself of the USG financial sector policy framework and assist Missions in ensuring that USAID programs are consistent with broader USG financial sector objectives. Coordination with other USG agencies, particularly Treasury and the Overseas Private Investment Corporation (OPIC), will also ensure that USAID's investments in financial sector deepening complement those of the multilateral development banks (overseen by Treasury) and OPIC.

Where appropriate, EGAT may also assist with coordination with U.S. Treasury and other USG agencies that may be involved in oversight of the multilateral development banks (MDBs) or on specific technical issues such as money laundering or implications of the Patriot Act[xviii].

7. Build Links to IFI Programs and other Donors

EGAT will maintain a close relationship with key individuals within the IFIs and with other donors engaged in financial sector development. These relationships will assist in coordination and in assessing country-specific diagnostics prepared by the IFIs. This process will help to identify gaps and technical assistance requirements, leverage USAID assistance, and coordinate the policy dialogue.

USAID Mission staff typically review IFI and other donor reports on their host countries as a normal part of building their information base for prioritizing assistance projects. As needed, EGAT technical specialists can support this process by engaging with the Washington based IFIs to review their recommendations and gain further insight into areas of concern identified during the ROSC and FSAP analyses performed by the WB and IMF.

EGAT also plays a leadership role in the Consultative Group to Assist the Poor (CGAP, the 29-donor consultative group for micro-finance) and is active in the IFI Working Group on SME Finance. EGAT will represent USAID in the Donors Working Group on Financial Sector Development and other donor coordination fora. EGAT will also develop links with technical counterparts in the EC and bilateral donor community, and will assist Missions on coordinating financial sector assistance, as requested by Missions.

8. Leverage External Resources

The resources available to Missions may not be adequate to address all the financial sector needs of a host country. Joining with one or more IFIs and other donors to conduct joint or complementary programs can expand the results achieved by the Mission.

The Financial Sector Reform and Strengthening (FIRST) Initiative, initiated by the World Bank and IMF with other donor support, is a particularly important example. FIRST represents a significant new approach to grant based support for developing robust and diverse financial sectors in developing countries. EGAT will work closely with FIRST to provide short-term technical assistance on a quick reaction basis. FIRST can act as a bridge by providing short-term assistance while USAID identifies an appropriate long-term assistance team, or FIRST can complement USAID Mission projects to work around funding constraints.

In addition to providing project funding, the IFIs fund development of substantial analytical and prescriptive material. Some of this material may be relevant to USAID objectives and enable Missions to avoid funding duplication.

Much of USAID's technical assistance in the financial sector involves training. EGAT will collaborate with the World Bank Institute and joint WB/IMF training programs, as well as the FDIC, SEC and other U.S. agencies, to leverage their training resources. EGAT also co-sponsors micro-finance training with CGAP and provides USAID staff with scholarships to attend the annual Micro-finance Summer Institute at Naropa University in Boulder.

In addition, EGAT will assist Missions in incorporating credit enhancements into programs through accessing the Development Credit Authority.[xix] Such credit enhancements can lower market entry risks, promote growth of specialized NBFIs, and accelerate introduction of new financial services made viable by changes in the enabling environment. By leveraging USAID resources to act as a catalyst for market deepening, DCA support can have a multiplier effect that substantially increases the developmental impact. EGAT may also assist Missions collaborate with private sector institutions through the Global Development Alliance.

9. Enhance Financial Sector Training

Financial sector work is complex, and requires close coordination with evolving best practices. EGAT[xx] will support Missions by contributing the financial sector component of the Economic Growth Training program, and will lead the separate in-depth training courses on micro-finance, rural finance and broader financial sector deepening.

EGAT will also provide "on the job" training to Mission staff by providing technical support on financial sector issues on an as needed basis.

IV. Implementation

EGAT Support Structure

EGAT support for Mission initiatives in the financial sector is provided by five units within EGAT, as follows:

- Office of Economic Growth, Enterprise Development and Financial Markets Team
- Office of Poverty Reduction,
  - Micro-enterprise Development Team
  - Urban Programs Team
- Office of Agriculture, Rural Policy and Governance Team
- Office of Development Credit

The focus of each of these offices is based on the aspect of financial sector development they support. Many of the issues are crosscutting and the principles involved in finance are very similar, whether capital markets, banking, rural finance or micro-finance. These units are all part of EGAT, occupy contiguous space, and cooperate closely to ensure responsiveness to Mission support requests. Contact information will be maintained on the intranet web site.

This Financial Sector Strategy will be supplemented from time to time with issue papers from each unit that will provide guidance and feedback to Missions on financial sector issues.

Communicate Strategy

The Financial Sector Strategy will be reviewed by EGAT management with Regional Bureaus and key Missions to ensure that it accurately responds to Bureau and Mission needs and priorities. The strategy will also be reviewed with other USG agencies, as appropriate, to ensure consensus. The strategy will be communicated Agency wide through:

- Internal communications channels, such as Front Lines and EG Matters.
- Training programs
- EGAT web site
- Notification to Missions

Conclusion

The Bureau for Economic Growth, Agriculture and Trade (EGAT) has been tasked with supporting USAID Mission projects that enhance economic growth and poverty reduction by strengthening the financial sector. The EGAT Financial Sector Strategy has been developed to respond to this task.

Effective implementation of this strategy and assurance of appropriate responsiveness to field Missions will rely on a core group of financial sector professionals based in EGAT who will help inspire and coordinate financial sector assistance to USAID field Missions. This financial markets team will also support coordination with international financial institutions (IFIs) and other donors, and assist Missions to ensure that USAID projects are developed with a systematic approach, that best practices and policy prescriptions are conveyed in a consistent manner, and that the potential for effectively leveraging donor resources is maximized.

This Financial Sector Strategy is likely to evolve over time – Bureau and Mission feed-back will be welcome.

Annexes

Annex 1. USAID Financial Sector Activity 1988-2000

Projects

Technical Assistance	*Projects*	*Authorized*	*Obligated*	
Banking	192	240,176,542	235,959,022	21%
Capital markets	172	273,061,913	225,408,740	20%
Housing finance and real estate markets	31	81,220,687	78,265,687	7%
Non-compulsory pensions, insurance and contractual savings	37	39,117,991	30,079,121	3%
Micro- and SME finance	183	240,882,851	229,731,619	20%
General finance sector	151	348,933,241	335,119,904	30%
Total	766	1,223,393,224	1,134,564,093	42%
Active Investment	*Projects*	*Authorized*	*Obligated*	
Banking	6	31,364,000	28,953,000	2%
Housing finance and real estate markets	3	117,368,000	42,368,000	3%
Micro- and SME finance	73	1,827,261,000	1,472,416,000	95%
General finance sector	2	10,927,828	10,879,000	1%
Total	84	1,986,920,828	1,554,616,000	58%
Total	850	3,210,314,052	2,689,180,093	100%

Source: EGAT financial sector project database, based on analysis performed by Deloitte Touche Tohmatsu.

Technical Assistance projects provide consultants who assist host country officials to implement reforms. Funding is on a grant basis, but with little or no actual cash flowing to host country institutions. Successful technical assistance will enable general economic development without favoring any private sector institution at the expense of competitors.

Active Investments involve establishing a financial intermediary (enterprise fund or micro-finance institution), providing the core funding for its capital and loan portfolio, and/or providing the management expertise to establish and manage the institution. Active investments focus on smaller institutions that fill gaps in the market, where the institution would add value to the development of the economy and expand opportunities for its citizens without impairing the environment for other private sector institutions.

Annex 2. The Twelve Standards and Codes

The Financial Sector Assessment Program (FSAP), a joint IMF and World Bank effort introduced in May 1999, aims to increase the soundness of financial systems in member countries. Supported by experts from a range of national agencies and standard-setting bodies, the program seeks to: identify the strengths and vulnerabilities of a country's financial system; determine how key sources of risk are being managed; ascertain the financial sector's developmental and technical assistance needs; and help prioritize policy responses. Detailed assessments of observance of relevant financial sector standards and codes, which give rise to Reports on Observance of Standards and Codes (ROSCs)[xxi] as a by-product, are a key component of the FSAP. The standards and codes on which these analyses are based represent the international consensus on best practices. They are developed by the following institutions:

Module/Date	Name of Standard or Code	Design	Monitor
Monitored by the IMF			
Data Dissemination - 1996/7	Special Data Dissemination Standard (SDDS) General Data Dissemination System (GDDS) Http://dsbb.imf.org	IMF IMF	IMF IMF in ROSC
Fiscal Transparency - 1998	Code of Good Practices on Fiscal Transparency (www.imf.org/fiscal)	IMF	IMF in ROSC
Monetary and Financial Policy Transparency 1999	Code of Good Practices on Transparency in Monetary and Financial Policies (www.imf.org/monfintransparency)	IMF	IMF in FSAP
Banking Supervision - 1997	Core Principles of Effective Banking Supervision Www.bis.org/publ/bcbs30a.htm	BIS' Basel Committee	IMF in FSAP
Monitored Jointly by the IMF and the World Bank			
Securities Markets - 1998	Objectives and Principles for Securities Regulation Www.iosco.org	IOSCO	IMF/WB In FSAP
Insurance Supervision - 2000	Insurance Supervisory Principles Www.iaisweb.org/framesets/pas.html	IAIS	IMF/WB in FSAP
Payments Systems - 2001	Core Principles for Systemically Important Payment Systems at www.bis.org/publ/cpss43.htm	BIS' CPSS	IMF/WB in FSAP
Money Laundering - 1996	Adaptation of the 40 recommendations to prevent money laundering at www.oecd.org/fatd	FATF/ IMF	IMF/WB in ROSC
Monitored by the World Bank			
Corporate Governance - 1999	Principles of Corporate Governance Www.oecd.org/daf/governance/principles.htm	OECD WB	WB in ROSC
Accounting	International Accounting Standards at www.iasb.org.uk For banking at www.bis.org, for securities at www.iosco.org, and for insurance in process	IASB	WB in ROSC
Auditing	International Auditing Practice Statements (IAPS) Www.ifac.org	IFAC	WB in ROSC
Insolvency Regimes and Creditors' Rights - 2001	Standard under development Www.worldbank.org, www.uncitral.org/en-index.htm, Www.imf.org/external/pubs/ft/orderly/index.htm.	WB, UNCITRAL IMF, INSOL	WB in ROSC
In general, ROSCs can be found at:	Www.imf.org/exteranl/np/rosc/index.htm Www.worldbank.org/ifa/rosc/html		

Source: IMF SURVEY Supplement (September 2001 p. 20) and FSF (2001).

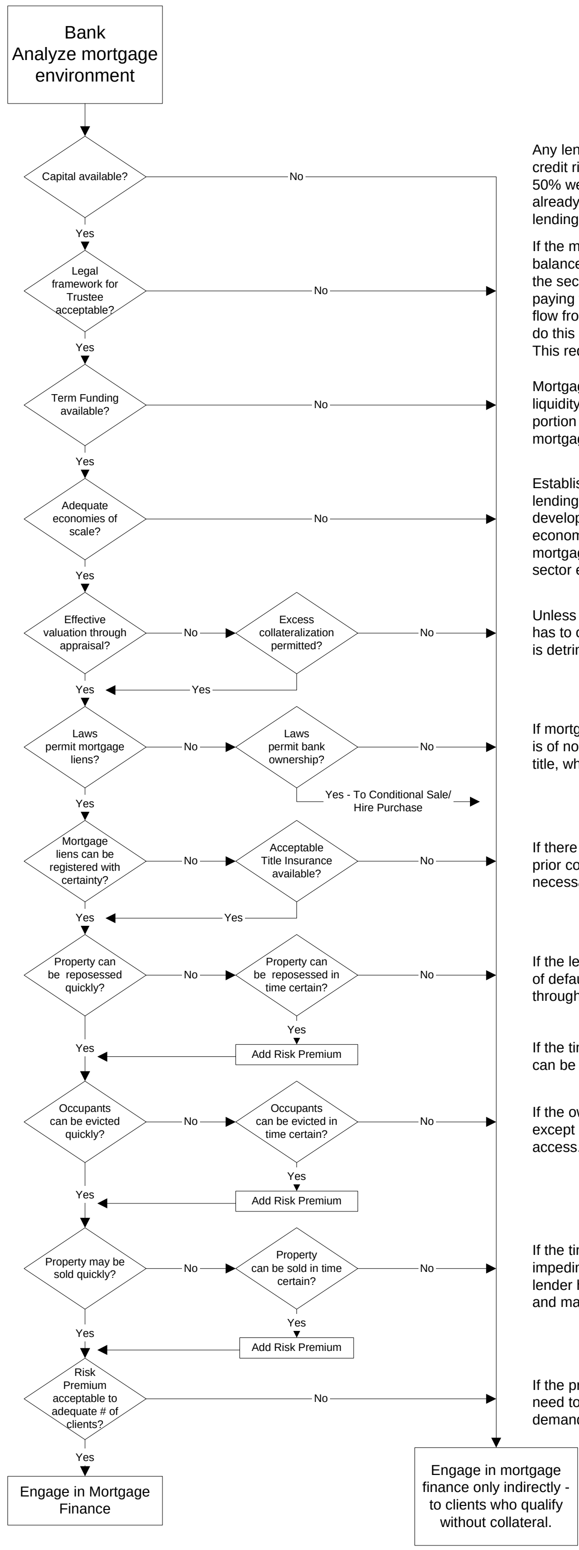
Annex 3. Introducing the Players

The Organization and its Subsidiaries	Acronym	Activities
INTERNATIONAL ORGANIZATIONS/OPERATING IN DIFFERENT REGIONS		
International Monetary Fund Poverty Reduction and Growth Facility	IMF PRGF	Surveillance and crisis management Provides low-cost loans to low-income countries
World Bank Group International Bank for Reconstruction and Development International Development Association International Finance Corporation Multilateral Investment Guarantee Association FIRST Initiative	WBG IBRD IDA IFC MIGA FIRST	 Created to aid post-WWII reconstruction now aids the developing world Provides loans at low rates to poor countries Invests in private businesses Offers guarantees to developing countries; e.g., against political risk Created by the WB & IMF to provide short term grant based TA
Bank for International Settlements	BIS	A bank for central banks and a discussion forum for regulators
Financial Stability Forum	FSF	Created by the G-7 to increase international financial stability
Financial Stability Institute	FSI	Created by the G-7 to provide training to improve supervision
Organization for Economic Cooperation and Development	OECD	Originally western, now does research and publishes data worldwide
Paris Club		Reschedules government debts
World Trade Organization	WTO	Regulates world trade (Successor to GATT)
International Fund for Agricultural Development	IFAD	Multilateral agency that focuses on rural development
REGIONAL DEVELOPMENT BANKS		
African Development Bank	AfDB	Offers FA and TA to African nations
Asian Development Bank	ADB	Offers FA and TA in Asia
European Bank for Reconstruction and Development	EBRD	Promotes development in the EU and beyond
Inter-American Development Bank Multilateral Investment Fund Inter-American Investment Corporation	IDB MIA IIC	Aids development in Latin America and the Caribbean Encourages private-sector development in the region Provides financing for small and medium-sized enterprises
BILATERAL DONORS		
European Union European Investment Bank, Europe Aid, TACIS, and PHARE	EU, EIB, TACIS, PHARE	The aid organizations promote development in the EU, countries applying for membership, partner countries, and beyond.
France's Agence Française de Développement with Proparco	AfD	Provides financial and technical assistance to the developing world
Germany's Kreditansalt für Wiederaufbau Gesellschaft für Technische Zusammenarbeit Deutsche Investitions- und Entwicklungs-gesellshaft	KfW GTZ DEG	Germany's investment bank for developing countries. Germany's technical assistance arm for developing countries Promotes private enterprise in developing and transition countries as a contribution to sustainable growth.
Swedish International Development Cooperation Agency	SIDA	The goal of Sidas work is to improve the standard of living of poor people and, in the long term, to eradicate poverty.
Canadian International Development Agency	CIDA	Equitable and environmentally sustainable development that strengthens the economic, political, and socio-cultural capacity.
Swiss Agency for Development Cooperation	SDC	Combats poverty by providing help towards self-help and promotes economic and government autonomy.
Norwegian Agency for Development Cooperation	NORAD	Assists developing countries to achieve lasting improvements in political, economic and social conditions.
Japan International Cooperation Agency Japan Bank for International Cooperation	JICA JBIC	Japan's technical assistance arm for developing countries Japan's investment bank for developing countries
U.K.'s Dept. for International Development Commonwealth Development Corporation Knowhow Fund	DfID CDC KHF	Undertake the U.K.'s development assistance activities for the developing and commonwealth countries
U.S. Treasury's Exchange Stabilization Fund Treasury's Office of Technical Assistance Agency for International Development	ESF OTA AID	Purchases and sells foreign exchange and provides crisis aid. Provides technical assistance to developing countries. Provides financial and technical aid to developing countries.
Other OECD donors		Dutch, Danish, Spanish, Italian and other agencies
PRIVATE SECTOR ORGANIZATIONS		
Group of Thirty	G of 30	Influential on major issues
Institute for International Finance	IIF	Protects investors' interests, especially in the major markets

Sources: Donors' publications and web-sites.

Annex 4. Sample Diagnostic Tool for Mortgage Finance

Credit Decision Tree - Mortgage Business Justification



Any lending activity requires capital for so long as the lender retains the credit risk. Even though residential owner occupied mortgages allow a 50% weighting under Basle I and lower under Basle 2, any bank that is already experiencing capital contraints will not be able to expand its lending.

If the mortgage loans are to be packaged, securitized and moved off balance sheet, then there must be a trustee that takes on the servicing of the security - collecting mortgage payments, foreclosing on defaults, paying the interest and principal on the security when due out of the cash flow from the underlying mortgages. Typically, the originating bank would do this or the trustee role would be assumed by a specialized institution. This requires Trust Law.

Mortgage lending is long term (5-30 years), so must be match funded for liquidity, and at a fixed rate if the mortgage rate is to be fixed. While a portion of the deposit basis can be considdered stable enough to originate mortgages, viable securitization must be in place to ensure match funding.

Establishing the credit approval and management process for mortgage lending is expensive, and the lender must have a reasonable certainty of developing an adequate portfolio at acceptable rates to produce the economies of scale needed to keep costs down. GoE subsidized mortgage lending would undercut the private sector and undermine private sector economies of scale.

Unless there is an effective property appraisal process available, the bank has to over-collateralize to ensure that its credit exposure is covered. This is detrimental to the borrower by limiting the credit available.

If mortgage liens are not provided for in the legal framework, then property is of no value as collateral. The only alternative is for the lender to retain title, which weakens ownership motivators for the borrower.

If there is uncertainty over whether a lien can be registered (possibility of prior conflicting claims, lack of judicial enforcement) then title insurance is necessary to ensure recoverable value.

If the lender cannot take posession of property quickly and reliably in case of default, then the property may be asset stripped or degrade in value through lack of maintenance during the time gap.

If the time period for foreclosure is reasonably certain, then a risk premium can be added to cover the impairment of value.

If the owner or a tenant cannot be evicted, then the property is not salable except at a steap discount to take into account the buyer's costs in delayed access.

If the time taken to sell a property is long, either through procedural impediments or through lack of an adequate secondary market, then the lender has a carrying cost of the funding plus iincreasing legal expenses and management cost.

If the price at which the lender can profitably lend is too high (due to the need to factor in risk premia) then there will be an inadequate market demand for the product.

Risk Premium covers a) internal admninistrative expense, b) cost of funds during delay, c) legal expense, d) any level of uncertainty on recovery.
Interest rate includes a) cost of funds, b) cost of capital, c) cost of standard loan analys and administratiion, d) base margin, e) product risk premium

Annex 5. Representative Solutions Packages

Some issues occur with sufficient frequency and consistency that development of a “Solutions Package” is warranted to ensure that good solutions that can be applied in other countries can be accessed without repeating the development cost. Some of the existing and prospective solutions packages are listed in this Annex.

FinA International Off-Site Surveillance System

Implementing structural improvements, particularly in the regulatory supervision of financial institutions, requires the ability of the host country institution to absorb and analyze significant volumes of financial data, often using staff that does not have the technical skill to do so reliably. Establishing an effective regulatory reporting process does little good if the recipient of that information flow does not have the tools to manage and analyze it.

The World Bank (Kenya, Hungary) and IMF (Zambia) have funded development of off-site surveillance systems. USAID has done likewise in Kazakhstan. Each of these systems required hard coding of the regulatory reporting formats, making them country specific and difficult to modify to keep pace with changes in regulatory reporting requirements. This rigidity limited the ability of the host country to modify the system.

For Armenia, USAID funded development of a flexible financial reporting and analysis system. The conceptual design and initial version was produced by First Irish Financial Computer System in Ireland and is currently operating in Armenia. The conceptual design was then adopted by a project team based in the National Bank of Georgia, which re-engineered the product to be much more efficient and more user friendly. This version has been in operation in Georgia. The third iteration, also much improved, is (as of writing) being installed in Kyrgyzstan and Tajikistan as FinA International under the supervision of SETA under contract to IRM. USAID now has a financial reporting and analysis system that can be quickly adapted for any country that does not already have an effective off-site surveillance system, with installation costs reduced to setup and training. Once setup (with USAID TA) it becomes a flexible expert system that can assure consistency of analysis and early warning of developing problems within a regulated institution.

FinA International is a classic example of collaboration among field Missions, IRM and EGAT to develop and off-the-shelf tool that can easily be used to leverage USAID’s technical assistance projects to strengthen regulatory supervision of financial institutions. In addition, it is being paired to a highly sophisticated financial analysis system in Excel developed by the World Bank, so is in effect a joint effort between USAID and the World Bank.

Credit Bureau System

USAID has funded a credit bureau system in Poland, and is currently re-creating a system in Kazakhstan. Georgia, Armenia and Mongolia have been looking at introducing credit bureaus. In developed markets, commercial credit bureaus can be expected to pick up provision of this service. In developing markets, such a system is unlikely to be commercially viable. However, a credit bureau is an essential component of the financial sector, since it:

- Enables lenders to avoid lending to borrowers who have established poor debt service records. This lowers the lending risk and the risk premium that would be charged to good borrowers and increases their access to credit.

- Encourages the development of a credit culture within borrowers by providing an incentive for routinely honoring commercial obligations.

Both of these factors have a powerful influence on the pace of economic development.

As part of USAID's financial sector strategy, a simple but effective credit bureau product needs to be developed as a collaborative effort between EGAT and IRM for implementation in countries that cannot yet attract commercial companies to perform this service.

Property and Collateral Registration

Asset based finance, including mortgage lending and long term financing of plant and equipment, can only occur if the property being financed can be pledged as collateral to form a reliable second way out of the loan in case the cash flow of the lender fails to ensure orderly repayment of the loan. In addition to changes in the legal infrastructure, these projects can be equipment intensive as well as require extensive technical assistance for implementation, so are particularly appropriate for joint implementation with other donors. EGAT recognizes the need for enhancing the process for designing property and collateral registration systems and selecting appropriate vendors.

Stock Market System

Of all the stock market systems that USAID has paid for, the one that has become an off-the-shelf product is a Microsoft Access application, most recently being installed in Montenegro. This system may have application in other countries. However, MS Access is only suitable for a relatively low volume environment, which raises the question of whether market conditions would justify work on a local stock market in the first place. The risk is in building an infrastructure that is not supportable by the underlying market realities, effectively reducing the economic efficiency of the country.

While this product will remain available, it is unlikely to be a core product with significant use.

Treasury Management System

USAID has funded a treasury management system in Bosnia, based on Oracle. This highly successful project has provided the government with effective management control over budget expenditures and has substantially reduced opportunities for diversion of funds. This project was closely coordinated with the US Treasury and IMF, which took the lead on designing the chart of accounts. The software licenses and hardware are essentially fixed costs that would be incurred on each similar project. However, the architecture, functionality and implementation and training know-how represents intellectual property that can be re-used in other countries to lower the project cost and minimize the performance risk during implementation.

This product fits the profile of an essential product for which reasonably priced commercial alternatives are unlikely. The subsequent similar project for Azerbaijan took note of the Bosnian project, but did not seek to leverage that work.

EGAT will collect project documentation relating to the Bosnian project and ensure that it is available as a semi-turnkey "solutions package" for use in other client countries that are interested in strengthening government governance.

This system requires an extensive hardware network, so can be implemented in collaboration with an IFI where the IFI provides a loan for the hardware and operating software while USAID takes the implementation lead, provides grant based TA for the USAID developed software components, installation, training and any development of any adjustments required in the legal infrastructure.

Training

EGAT has been developing Economic Growth training for Mission staff, including a financial sector component, and will expand on and refine this training. For host country officials, EGAT will expand collaboration with the SEC, FDIC and other US institutions to provide technical training and knowledge sharing programs that Missions can access through EGAT cooperative and inter-agency agreements.

Annex 5. Key Areas for USAID Financial Sector Support

This table was developed by Deloitte Touche Tohmatsu, based on their analysis of financial sector development needs. They are potentially useful as an additional "checklist" as USAID Missions review country specific diagnostics and identify areas for potential engagement.

	Technical Area	Indicative Donor Interventions Driven by Trends
Globalization, consolidation and convergence	Crisis 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 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

	Technical Area	Indicative Donor Interventions Driven by Trends
	Banking and Non-Banking	• Support for the development and implementation of risk management systems and procedures in response the proposed new Basle II 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
	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 underserved 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)

	Technical Area	Indicative Donor Interventions Driven by Trends
		• 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 • 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 through 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 Banking	• 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)

Deloitte Touche Tohmatsu Emerging Markets, Ltd, Task 5, Pages viii-ix (edited to remove typos)

End Notes

[i] On a global basis, worker remittances to their home countries provide a greater flow of resources to developing countries than official foreign aid.

[ii] International Accounting Standards or a country specific equivalent.

[iii] In the absence of financial transparency and an internationally credible rating mechanism, pension fund managers do not have the ability to evaluate credit risk, even if they have the technical skill to do so. This creates a major systemic risk - failure of a major bond issuer could trigger a loss of public confidence in the pension system and negate the work USAID has done to build up a viable alternative to the State pay-as-you-go system.

[iv] Statistics provided by the Deloitte Touche Tohmatsu study, which may understate actual activity.

[v] The Organization for Economic Cooperation and Development is active in standards setting, for example the Financial Action Task Force that sets standards for the control of money laundering. It has also taken the lead on insurance regulation and many other financial sector issues.

[vi] The twelve Standards and Codes are listed in Annex 3.

[vii] FSAPs can be done for any country that requests one, with a recent example being Germany.

[viii] These topologies will build on the extensive work done in this area by the WB and IMF to extract information of direct relevance to USAID program design.

[ix] EGAT may allocate this work to short-term, pre-cleared consultants who have established a track record for such work. Assistance may be available through EGAT's cooperative agreement with FSVC, interagency agreements with SEC, and buy-ins to contractual vehicles.

[x] Currently 36.1% of the costs incurred.

[xi] These Solutions Packages are not intended to be prescriptive, since each country makes its own decisions on its legal system and financial sector infrastructure. Rather they are intended to bring together reasonable practical solutions to common problems, based on successful past projects.

[xii] Commercial products, particularly those that are complex and highly specialized, require a sufficiently large market to amortize the development costs, so may not be available for highly specialized applications.

[xiii] As an example, the US Appraisal Institute is an SRO that defines the professional standards for US appraisers.

[xiv] This is the core Strategic Objective of any financial sector technical assistance, is a direct indicator of the efficiency of the financial system, and is routinely measured by the IMF and WB.

[xv] However, initial success in improving the regulatory environment can and probably will result in a decline in this index, as loan loss reserves are built up to more accurately reflect the true recoverable value of the loan portfolio, thus decreasing the net loans outstanding.

[xvi] Here again, initial results may be negative as banks seek to stabilize their net income to offset the cost of the increased loan loss reserves.

[xvii] Where this information is available, the change in time of the number of commercial and retail deposit and loan accounts as a percentage of the total population would be a good indicator of access to the financial system.

[xviii] The major implications of the Patriot Act are to require any bank that has a deposit account in the United States to know its depositors. This is intended to allow tracking of terrorist funding, but is controversial since it provides reach through to non-US entities in foreign countries, which may contravene sovereignty issues. The implementing regulations are developed and promulgated by the U.S. Treasury.

[xix] The Development Credit Authority (DCA) is part of EGAT. It provides risk sharing guarantee support that is particularly useful as a catalyst to deepen financial markets by mitigating market entry risks for private sector lending programs that have become viable due to structural changes in the investment climate.

[xx] As a collaborative effort between the EG, AG and MD offices of EGAT.

[xxi] The twelve Standards and Codes are listed in Annex 3.