Chapter 4

Assessing Financial Structure and Financial Development

4.1 Overview

4.1.1 Motivation for Assessing Financial Structure and Financial Development

Extensive evidence confirms that creating the conditions for a deep and efficient financial system can contribute robustly to sustained economic growth and lower poverty (e.g., see Beck, Levine, and Loayza 2000, Honohan 2004a, and World Bank 2001a). Moreover, in all levels of development, continued efficient and effective provision of financial services requires that financial policies and financial system structures be adjusted as needed in response to financial innovations and shifts in the broader macroeconomic and institutional environment.

4.1.2 Scope of Analysis

The goals of financial structure analysis and development assessment for a country are to (a) assess the current provision of financial services, (b) analyze the factors behind missing or underdeveloped services and markets, and (c) identify the obstacles to the efficient and effective provision of a broad range of financial services. The dimensions along which service provision must be assessed include the range, scale (depth) and reach (breadth or penetration), and the cost and quality of financial services provided to the economy. At a high level of abstraction, those services are usually classified as including the following:

- Making payments
- Mobilizing savings

- Allocating capital funds
- Monitoring users of funds
- Transforming risk

Thus, the ideal financial system will provide, for example, reliable and inexpensive money transfer within the country, reaching remote areas and poor households. There will be remunerative deposit facilities and other investment opportunities offering liquidity and a reasonable risk-return tradeoff. Entrepreneurs will have access to a range of sources for funds for their working- and fixed-capital formation; affordable mortgage and consumer finance will be available to households. The credit renewal decisions of banks and the market signals coming from organized markets in traded securities will help ensure that good use continues to be made of investable funds. Insurance intermediaries and the portfolio possibilities offered by liquid securities markets will help maximize the risk pooling and the shifting of risk at a reasonable price to entities that are able and willing to absorb it.

The scope of financial structure analysis and of development assessment is fairly extensive—as illustrated in the above list—and those structural issues cannot be simply broken into self-contained segments corresponding to existing institutional arrangements. Structural and development issues arise across the entire spectrum of financial markets and intermediaries, including banking, insurance, securities markets, and nonbank intermediation. They often demand consideration of factors for which well-adapted and standardized quantification is not readily available. Therefore, the challenge is to translate those wide-ranging and somewhat abstract concepts into a concrete and practical assessment methodology.

The suggested approach begins with a fact-finding dimension that seeks to benchmark the existing financial services provided in (and available to) the national economy—in terms of range, scale and reach, cost, and quality—against international practice. Such benchmarking should help pinpoint areas of systemic underperformance, which can then be further analyzed to diagnose the causes of the underperformance against realistic targets. To some extent, the benchmarking can be quantified, but, in practice, quantification must be supplemented by in-depth qualitative information. The question being asked in every case is, if quality or quantity is deficient, then what has caused this deficiency?

Deficiencies will often be traced to a wide range of structural, institutional, and policy factors.

- First, there may be gaps or needed changes in the financial infrastructure, both in the soft infrastructures of legal, information, and regulatory systems and in the harder transactional technology infrastructures that include payments and settlements systems and communications more generally.
- Second, there may be flaws or needed adaptations in regulatory or tax policy (including competition policy) whose inadequacies or unintended side effects distort or suppress the functioning of the financial system to an extent not warranted by the goals of the policy.
- Third, digging deeper, there may be broad governance issues at the national level, for example, where existing institutional structures impede good policy making (especially favoring incumbents over newcomers).

- Fourth, financial sector deficiencies may also be traced to problems in the country's wider economic infrastructures, including the education, transportation, and communications systems. Furthermore, many developing countries are faced with the difficulty that effective finance requires a scale of activity that may be beyond the reach of small economies, populated as they are by a small number of small clients, small intermediaries, and small organized markets (see Bossone, Honohan, and Long 2002). An effective financial system, while contributing to wider economic growth and development, is also somewhat dependent on the wider economic environment—not least the macroeconomic and fiscal environment.

The most distinctive feature of financial structure analysis and development assessment is the focus on the users of financial services and on the efficiency and effectiveness of the system in meeting user needs. Policy reforms that benefit users and that promote financial development are generally favored in such analysis and assessments.[1] The proposed assessment framework is also guided by the presumption, which is based on a sizable body of empirical evidence, that an effective and efficient financial system is best provided by market-driven financial service providers, with the main role of government being to serve as regulator and provider of robust financial infrastructure. Therefore, the establishment of a government-sponsored financial service provider is not seen as likely to be the first-best solution to deficiencies. Instead, the role and effectiveness of financial service providers are assessed regardless of whether they are government owned. Assessment has two phases: information gathering and analytical reporting.

Phase 1: Information-Gathering Phase

To reflect this focus on users and the services they require, the overall assessment needs to adopt a functional approach and not to be confined to a perspective that is based on existing institutional dividing lines between different groups of providers.[2] Nevertheless, much of the information gathering will inevitably reflect those institutional divisions, not the least because national regulatory structures are typically organized along those lines (notwithstanding the trend to integrated supervisory agencies in several countries).

In addition, the adequacy of the legal, information, and payments infrastructures and of other aspects of the overall policy environment are central to the development assessment: each has relevance cutting across any single sector. Yet, information about the effectiveness of the infrastructures and about the unintended and hidden side effects of the policy environment is often obtained only by learning how each sector works. Likewise, the competitive structure, efficiency, and product mix of the various sectors can be explained only on the basis of an understanding of the design and performance of the infrastructures. So the information-gathering phase of the assessment needs to have a sectoral, as well as an infrastructural, dimension. Cross-cutting policy issues such as taxation also need to be kept in mind. Finally, user perspective can be helpful, especially in identifying gaps in providing markets and services, as well as in discovering deficiencies in quality and cost that might not be revealed from analysis of the suppliers.

The information-gathering phase of the assessment is multidimensional. Typical components of the information-gathering phase may include the following:

- Quantitative benchmarking of the size, depth, cost and price efficiency, and the penetration (breadth) of financial intermediaries and markets, using internationally comparable data (section 4.2)
- Reviews of legal, informational, and transaction technology infrastructures (section 4.3)
- Sectoral development reviews, providing a more in-depth assessment of service provision, structure, and regulation (Sectors covered will normally include commercial banking and nearbanking, insurance, and securities sectors and may also include some or all of the collective savings institutions and of the financial aspects of public pension funds, specialized development intermediaries, mortgage finance, and microfinance. Those sectors need to refer to the functioning both of the industry [financial services providers] itself and of the regulatory apparatus [section 4.4].)
- Demand-side reviews of access to, and use of, financial services by households, microenterprises, small and medium enterprises (SMEs), and large enterprises (section 4.5)
- Reviews of selected additional cross-cutting aspects of the policy environment (for example, distorting taxation and subsidization of financial intermediation) and of implications for competition of cross-sectoral ownership structures (Those reviews also may mention missing product issues, thus focusing on whether key financial products—such as leasing, factoring, and venture capital—are available and identifying the reasons for their absence [see section 4.6].)

Phase 2: Analytical and Reporting Phases

The relative importance of the components of the information-gathering phase and the scope of their analysis will vary according to country circumstances. This wide-ranging scope of information presents a challenge to assessors who must, in the analytical and reporting phases, synthesize the information to identify the major axes of needed policy reform and of infrastructural strengthening for stability and development. Segments of the financial system that are already active, but for which the benchmarking exercise suggests shortcomings, will deserve more-detailed attention. For segments that are missing or are not very developed, the discussion of needed policies can be confined to the level of broad strategy. How those components can be integrated into a policy framework is discussed in section 4.7.

4.1.3 Stability and Development: Complementarities Despite the Different Perspective

Financial structure analysis and development assessment inevitably overlaps extensively with the stability assessment. Even if adequate from a stability perspective, the existing regulatory framework and the supervisory practices may need reform from the development perspective. Certain areas not normally considered in stability-oriented assessments, such as microfinance and development banking, warrant attention from the development perspective. Moreover, every sector that is relevant to stability can have an important development dimension. Notwithstanding the overlap of themes, the focus of the sectoral and infrastructural development reviews is different from, and complementary to, that of the stability assessment. For each sector, the development review is designed to consider whether policy or legislative changes are needed to enhance the ability and incentive of market participants to deliver financial services.

The types of question asked in analyzing financial structure and development are often different from those that take center stage in the stability assessment. For example, are regulatory restrictions on bank entry and conduct (including interest rate ceilings, ownership, branching, and automated teller machines [ATMs]) unduly constraining, and do they act as barriers to competition and to the extension of financial services to underserved segments? Is the regulation of insurance company investments hampering their contribution to long-term funding of enterprises? Is there an adequate enabling legal framework for the emergence of widely accessed credit registries? Are judicial practice, funding, and skills supportive of speedy and low-cost debt recovery? Does the regulatory framework for payments systems support an efficient and low-cost network of retail payments throughout the country?

The overlap between stability and development raises both practical and conceptual issues for the sectoral reviews: At the practical level, there is the need to coordinate information gathering to avoid duplication of effort. At the conceptual level, there is the need to ensure that the recommendations mesh well together. In practice, the two perspectives—stability and development, reinforce each other in terms of recommendations more often than they create a tension or tradeoff. For example, legal procedures for enhancing creditor rights tend both to reduce the risk of loan losses undermining the soundness of the banking system and to increase the willingness of intermediaries to extend credit. Yet there can be some apparent tension, for example, when entry of foreign-owned banks—although improving the quality and price of services to the rest of the economy—is seen as a threat to the profitability of incumbents (a stability issue). Apparent conflicts must be considered and resolved from a wider perspective of ensuring long-term, stable financial development in the interest of the economy at large. One issue in this context is whether the system is sufficiently robust (stability analysis) to withstand the potential shocks associated with liberalization that will eventually be needed for development reasons. In this sense, the stability analysis can provide some guidance to the timing and sequencing of development-oriented reforms. A detailed analysis of sequencing issues is presented in chapter 12.

4.2 Quantitative Benchmarking

If we are to obtain an overall picture of where the financial sector is, or is not, performing well, then the performance of financial intermediaries and markets—in terms of total assets, scope of activity, depth, efficiency, and penetration—can be compared to a carefully chosen set of comparator countries. National authorities are likely to be interested in countries in the same region, as well as those of a similar size and a similar level or higher levels of per capita income.[3] The type of indicators that would be appropriate is discussed in chapter 2 and summarized in box 4.1.

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Box 4.1 Quantitative Indicators for Financial Structure and Development Assessment

The measures chosen as quantitative indicators for financial structure and development assessment will naturally include basic indicators of financial depth expressed as a percentage of gross domestic product (GDP). The indicators are proxies for the size of the different components of the financial sector and could include credit to the private sector and broad money (M2) for banking; number of listed equities and bond issues, market capitalization, and value traded of financial markets for financial markets; and insurance premium income and asset size for insurance.

Data on breadth and penetration—which are proxies for the population's access to different segments of the financial sector and, thus, for outreach—of financial markets include bank branch and outlet intensity and deposit and loan size distribution, as well as number of clients in the banking, nearbanking, and insurance sectors. The data gauge the share of the population with access to financial services. Data on market structure—number of banks, concentration in banking, and share of foreign-owned and government-owned banks—are also relevant. Efficiency measures include interest margins, overhead costs or asset indicators, and turnover ratios for capital markets. Indicators of efficiency and quality of payment services include cash-to-GDP ratio, lags in check or payment order clearing, volume and value of checks or payment orders processed in retail and large value payment systems, and number and density of ATMs.

Indicators for size, depth, and efficiency are available for a large cross-section of countries, thus allowing comparison; however, the assembly of breadth and penetration indicators on a cross-country basis is in the beginning stages. There is a clear ranking of cross-country data availability among different sectors, with data on banking, insurance, and stock markets more readily available than on bond markets and microfinance. Quantitative benchmarking may also include some comparisons over time within countries where feasible and should serve as basis for more detailed analysis.

Infrastructural quality measures—contract enforcement (including measures of the effectiveness of the court systems such as the speed of judicial conflict resolution), speed and effectiveness of insolvency procedures, creditor and minority shareholder rights, presence of a credit registry, and firm entry regulations—can be drawn from the World Bank's Doing Business Database. Also informative are user assessments from the World Business Environment Survey.

Finally, the quantitative indicators for financial structure and development assessment can be rounded off by relevant summary economic and social indicators such as GDP per capita, share of the informal economy, illiteracy rate, total population size, and so forth, which can be selected from the World Development Indicators published by the World Bank.

A more detailed presentation of financial structure indicators, including definitional issues and data sources, is contained in chapter 2.

Ideally, given data availability, it may be possible to use the results of research studies that have identified causal factors for cross-country differences in depth, efficiency, and other dimensions of financial development. For example, several studies have attempted to explain differences in average bank margins—key indicators of the price efficiency of banking in terms of policy, institutional, and macroeconomic variables. Those variables include the bank's size, a measure of property rights protection, and other bank- and country-level characteristics, such as bank concentration, output gap, and interest rate level.[4] If those policy and institutional variables are available for the country in question, the results of the studies can be used to throw light on potential improvements that could be achieved through better policies and better institutions. The residual between the expected value of average bank margins in the country predicted by the study and the actual margins, if positive, will point to the need for closer analysis of idiosyncratic features in the country—features that may be contributing to the gap. (For an illustration of this technique in practice in Kenya, see appendix E.) A similar approach can be used for banking depth where macro-variables, such as inflation and the level of gross domestic product (GDP) per capita, are key determinants along with institutional variables, such as shareholder and creditor rights (e.g., see Beck, Demirgüç-Kunt, and Levine 2003).

There are also some cross-country studies of other dimensions, including insurance penetration, stock market capitalization, and turnover, although those studies may not yet be sufficiently well established for heavy reliance to be placed on them for benchmarking purposes. Along with other dimensions, including access to financial services, cross-country research is not yet sufficiently developed to support this kind of benchmarking. In those cases, simple cross-country comparisons against peers can, nevertheless, be informative and can point to areas of deficiency.

4.3 Review of Legal, Informational, and Transactional Technology Infrastructures for Access and Development

The major cross-cutting infrastructures can be grouped under the three headings of legal, informational, and transactional technology.[5] The robustness of legal infrastructures is universally acknowledged as crucial to a healthy financial system. Creditor protection in principle and in practice is central, as is bankruptcy law and its implementation. In both of those areas, reform of the court system is often at the heart of needed reforms. Corporate governance law and practice can also be seen as coming under this heading. Informational infrastructures include accounting and auditing rules and practice, plus the legal and organizational requirements for public or private credit registries and property registries. Other aspects, such as the ratings industry, may be relevant in more-advanced, middle-income countries. Internationally recognized accounting and auditing standards exist, and assessments of their observance, when available, can be useful for both stability and development assessments. The most important transactional technology infrastructures—relating to wholesale payments and settlements—may already be assessed using the Core Principles of Systemically Important Payment Systems (CPSIPS). (See chapter 11 for details of CPSIPS.) The additional dimension required for development purposes is the functioning of the retail payments system: although it is not vulnerable to sudden failure on a large scale, it is not considered "systemically important" in the sense of the CPSIPS. The efficiency with which the legal, information, and transactional technology infrastructures support financial intermediation in the country plays a critical role in access and development. Detailed assessments of those areas are described in chapters 9, 10, and 11 of this handbook, and they provide information on the quality of the infrastructure elements, which are discussed below.

4.3.1 Legal Infrastructure

The efficient functioning of the legal system is indispensable for effective financial intermediation (e.g., see La Porta et al. 1997, 1998, and Levine, Loayza, and Beck 2000). Although discussed in more detail in chapter 9 of this handbook, the following discussion highlights the aspects of the legal system that are important for development assessment.

In addition to the cross-country quantitative evidence mentioned in box 4.1, underlying factual information for this exercise can come both from any completed assessments of formal codes such as the *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (World Bank 2001b) and from interviews with banks, enterprises, academics, and other market participants.[6]

The effective creation, perfection, and enforcement of collateral is a cross-cutting issue for financial intermediation and requires assessing the appropriate legislation, the property registries (including stamp duties and notary fees), the court system, and the out-of-court enforcement mechanisms. If collateral taking is limited to certain assets or if high collateral-to-debt ratios are required, this limitation can ration credit to certain sectors or size groups of borrowers. The effectiveness of the collateral process can also affect the terms of lending, such as interest rates, along with the competitiveness of the lending market.

The effectiveness of debt enforcement and insolvency procedures in terms of cost and time it takes, both through and outside the court system, is important for effective and efficient intermediation. Expedited enforcement systems that use private negotiation and out-of-court settlement can be very helpful, if available. The possibility of flexible ways of achieving corporate financial restructuring, albeit without undermining creditors' position, is important. A deficient insolvency framework can restrict the use of the court system overall and can lead to suboptimal out-of-court settlements or even restrictions on the access to, and the terms of, lending.

The functioning of the court system is crucial. The evaluation here could include an assessment of the legal profession along several dimensions, such as education, skills funding, fees, and ethical behavior. The effectiveness of specialized courts in local circumstances can be examined if we bear in mind that those courts can help in situations where complex commercial issues arise and even in situations with less-complex issues, such as loan recovery. The courts may work faster and more consistently than regular courts—though experience here is mixed, and it may be better in the long run to work toward an overall improvement in the functioning of the court system.

The state of corporate governance, including the relationships among management, majority owners, and outside investors, can have an important effect on the ease with which outside investors provide finance and the price thereof. Both the rules and the practice of corporate governance need to be considered; if a formal corporate governance assessment has been carried out, its findings can be drawn upon here.[7]

4.3.2 Information Infrastructures

Asymmetric information between borrowers and lenders and, thus, the transaction costs can be reduced if there is readily available information on the financial condition of borrowers and especially on their history of credit performance. In particular, two areas of the information infrastructure should not be neglected: (a) transparency in borrowers' financial statements enables lenders to assess borrowers' creditworthiness on present and past financial and operational performance, and (b) readily available credit information on borrowers enables lenders to assess borrowers' creditworthiness according to their past performance within the financial system.[8]

Credit registries, if they exist, vary widely in the information that is being collected and that is available to financial institutions; hence, they vary in their effectiveness in improving access. The effect on access is influenced by characteristics such as (a) which financial and nonfinancial institutions provide data and have access to the data (the more the better); (b) whether only negative information (i.e., on defaults and delinquencies) or also positive information, including interest rate, maturity, and collateral, is collected and provided (positive information improves the potential use of the registry for credit appraisal); (c) for what kind of loans is the information collected; and (d) for how long is information kept. While there are reasons to expect privately owned registries to outperform those operated by public agencies, there are instances of effective publicly owned registries. Local conditions can influence the choice here. Existing credit registries should be evaluated not only on their design features, but also on how they have performed in practice. The legal and regulatory environment is important for existence and effectiveness of credit registries and other financial information vendors. While protection of consumer privacy is important, unduly restrictive rules here can hamper information sharing on borrowers to the detriment of their access to credit.

Credit registries may be complemented by other providers of financial information on borrowers. Commercial information vendors, such as Bloomberg or Reuters, trade associations, chambers of commerce, or credit-rating agencies, might also contribute to transparency in the financial market. Finally, there might be private information-sharing agreements between financial institutions outside the formal structure of a credit registry.

Accounting and auditing standards and practices are important elements of the information environment in that they govern companies' disclosure of financial information to the public. A full assessment of the accounting and auditing standards (see chapter 10 for further details on these standards) in this area might not always be practicable, but the standards, nevertheless, represent the overall goals that should be aspired to and can be used as a reference for identifying information-based barriers to enhanced financing for the corporate sector.

4.3.3 Transactional Technology Infrastructures

The effective transfer of money between customers of the same and of different institutions is one of the main functions of the financial systems. While the stability assessment of the payment system is mostly interested in wholesale systems, the development assessment focuses more on the cost of and access to retail payment services. Development assessment includes evaluating the effectiveness of the check and money transfer system in terms of time and cost. It also entails assessing the access to those services, either directly through banks or indirectly through other financial institutions that use banks as agents. Indicators to assess the effectiveness of the payment system include the cost and time to transfer money. As alternative indicators of access, some studies have surveyed the small numbers of the population and of subgroups who have a transactions banking account, debit card, or credit card, as well as the distribution of travel time to the nearest ATM or money transmission point. Unfortunately, as yet, there is no cross-country dataset for such access indicators.

4.4 Sectoral Development Reviews

Sectoral developmental reviews complement the assessments of regulatory standards. Over the past several decades, extensive institutional change and experimentation in advanced economies have led to the emergence of elaborate regimes of regulation and supervision of the banking, insurance, and securities markets. Those regimes are designed to ensure integrity of the functioning within the sectors and to avoid behavior that is likely to contribute to failure. They have evolved largely in response to the rapid development of the financial sector in advanced economies rather than as a means of promoting the development of the sector—though, in several cases, regulatory liberalization has been influenced by a perceived risk to the competitiveness of domestic financial markets in an increasingly global financial system.

The standards and codes used for those sectors essentially codify what has emerged as the common core of what remains a somewhat diverse set of regulatory institutions. While the standards and codes represent a fairly firm and widely agreed framework for assessment on the prudential side, the mechanics of overcoming barriers to development of what are still unsophisticated financial systems in low- and middle-income countries are not something for which a comprehensive template can be distilled from current practice. Indeed, the standards and codes either explicitly or implicitly assume the presence of much of what is sought in the goal of developing the financial system and at the same time contain (to some extent) principles that guide institutional development and good practices in financial institutions. Promoting institutional development, however, raises issues of sequencing and absorptive capacity in implementing policy reforms. Because of those considerations, conducting the development assessment for any given subsector is necessarily less categorical, more subjective, and arguably more difficult than assessing the relevant standards and codes.

For most low- and middle-income countries, a brief and selective review of development issues provides the information that is needed on the preconditions for a full standards and codes assessment. Where standards and codes for a sector are not being fully assessed, the review of development issues can be accompanied by a less detailed, stability-oriented, regulatory assessment. The assessor should highlight deficiencies in quantity (scale and reach), quality, and price of the services provided and should attempt to identify the infrastructural weaknesses that have contributed to those deficiencies, as well as any policy flaws—including flaws in competition and tax policy—that have likely contributed to the deficiencies. Although some of the needed data are covered in cross-country databases (as mentioned in chapter 2), for many other dimensions in each of the sectors, only noncomparable national sources are currently available. Those dimensions would include aspects such as the stock market free-float, reliance by large firms on international depositary receipts, transactions costs for securities markets, prices of insurance and efficiency of insurance products, and maturity structure of intermediary portfolios. The assessors must use their judgment in evaluating whatever information is available on such matters.

Because competitiveness issues have a pervasive influence on sectoral performance, the issues need to be analyzed in all sectors. The competitive structure of the industry is a multi-dimensional concept in itself. That structure is not merely measured by concentration ratios and by Herfindahl indices, but—in acknowledgment of the distinction between concentration and contestability—also requires an understanding of regulatory influences, including restrictive regulations on branching or cross-regional service provision, on permissible lines of business, on product pricing (e.g., interest ceilings and premium rate floors), or on portfolio allocation (especially for insurance companies, including localization rules, but also including reserve requirements and so forth). Is the market de facto segmented, thereby limiting the pro-efficiency forces of competition? Is ownership of the main intermediaries linked to government or to industrial groups, thereby tending to entrench incumbents rather than enabling new entrepreneurs?

In addition to our looking at the aggregate national position, it is important, though often difficult, to assess the reach of each financial sector along the dimensions of geographic region, economic sector, size of firm, and number of households. Of course, the large and well-established firms in the main cities will have greatest access. The question is whether the gap between those and smaller firms and households in smaller centers and in rural areas is more than it should be. Sources of information on direct access to financial services—with a focus on those at different levels of income—are diverse and scarce. There is a growing appreciation of the importance of compiling data on who has access to what financial services, and efforts are under way to increase systematic coverage of financial issues in surveys of households, business users, financial service providers and their regulators, and national experts. All four types of information are needed for a comprehensive review.[9]

Going beyond aggregate measures of efficiency, availability, and cost of more-advanced products needs to be benchmarked for each of the main sectors. What products do users identify as lacking? How much maturity transformation does each sector achieve? How much is achieved overall through the interaction of the sectors? One may also mention consumer protection legislation, which, though present, is not uniformly at the fore in stability assessments.

Often, the review will reveal that the source of shortcomings is mostly in the policy environment (including the nonprudential or unneeded prudential regulations and taxation and the effects of state ownership) or in deficiencies in the legal, information, or transactional technology infrastructures. Such policy and infrastructural issues will often have a cross-cutting effect on several subsectors and need to be reported as such (see section 4.6).

4.4.1 Banking

The sectoral assessment for banking is at the heart of development issues in finance because of the central role of banking in the financial systems of most developing countries. In addition to what can be quantified on the basis of available statistics, the fact-finding requires broad-ranging discussions with market participants, as well as with the regulators.[10] An effective banking system will be characterized by considerable depth (measured, for example, by total assets); breadth in terms both of customer base (lending to a wide range of sectors and regions, without neglecting the needs of creditworthy borrowers in any sector or region) and of product range (maturities, repayment schedules, flexibility, convenience, risk profile, and nonbanking products where permitted); and efficiency. Overhead costs, interest spreads, and interest margins give an indication of efficiency, though taxes and other requirements can substantially influence the spread, as explained below.

Quantitative Benchmarking

Benchmarking the performance of the banking system needs to go well beyond tabulation of cross-country comparisons of available indicators and should be based on an analysis of factors governing the variations in the indicators. The main indicators need to be looked at in terms of their development over time, in relation to the rest of the national financial system, and in terms of national causal factors. In addition, international comparisons should ideally be made in a more structured way, thus drawing on research findings.

As an example, assessment of bank efficiency and competitiveness requires information on interest rate spreads and margins,[11] which are influenced by both bank- and country-level characteristics. The analysis and decomposition of interest spreads and margins can help assess the existence and severity of deficiencies in the banking sector.[12] A useful device is to use accounting identities to decompose interest rate spreads into five components: (a) overhead costs, (b) loan–loss provisions, (c) reserve requirements, (d) taxes, and (e) (the residual) profits. Decomposition helps identify institutional and legal deficiencies that explain high spreads. Both spreads and margins can be compared across countries and across the underlying factors derived (see appendix E, which is based on Kenya).

Penetration of and access to banking services are important dimensions for which a broad international database is not yet available, but for which national statistics can be very informative. Geographic branch, ATM, and bank outlet data give a first indication of the penetration of banking services across geographic areas of the country. A comparison of bank branch density with other countries can give an indication of bank penetration but has to be treated with care, because it does not include data on nonbank service providers. Similarly, a within-country geographic comparison of penetration should consider other nearbank providers, such as savings banks or cooperatives. Where appropriate, account should also be taken of alternative delivery channels, such as ATMs, phone banking, and Internet banking, plus novel ways of providing access to financial services in more remote areas, such as mobile branches and correspondent banking. There may be regulatory obstacles to penetration: What are the regulatory requirements for opening and closing branches and other delivery channels, and what are the licensing procedures and fees for doing so?

Scope of Activities

If one is to understand the role of the banking system in contributing to the functions of finance in the country being assessed, it is necessary to clarify what are the range and types of financial services being provided by both banks and nearbanks. The institutional organization of the financial service provision varies significantly across countries. On the one extreme might be universal banks that offer not only deposit, loan, and payment services, but also leasing, factoring, insurance, and investment bank products. On the other extreme, one might find a system where banks are restricted to deposit, loan, and payment services and where there is a large number and variety of other banklike and nonbanking institutions that offer leasing, factoring, and mortgage finance. The institutional organization of the financial service provision is often driven by historic development and by the regulatory environment. Even if specialized financial services are offered by specialized financial institutions, there are often ownership links between them and banks. Finally, an institutionally diverse financial system may have converged with nominally different institutions that offer the same services. In this case, it is important to assess whether there is a level playing field between institutions and nondiscriminatory regulatory treatment.

Competition and Market Segmentation

Market structure can be measured using concentration ratios (assets of largest three or five banks to total banking assets), number of banks, and Herfindahl indices. One has to be careful, however, in equating market structure with competitiveness. Contestability of the market—the threat of entry—can be a more important determinant of bank behavior. Regulatory indicators, such as formal entry requirements, share of bank applications rejected over the past five years, and openness of the sector to foreign entrants, can give an indication of contestability of the market. Competition from other financial institutions (such as insurance companies, large credit cooperatives, and capital markets) can play an important role in determining banking system competitiveness. The ownership structure of banks (foreigners, closely held by locals, nonfinancial corporations, government, widely held, cooperative structure, and so forth) can be important for the degree of competition, because banks of different ownership often have different mandates and different clienteles (e.g., see Claessens and Laeven 2004 and box 4.2). In turn, ownership patterns are influenced by regulation and policy on entry, exit, and mergers and acquisitions.

Is the market structure segmented (with less competition than might appear from an overall concentration index) to the extent that different groups of banks deal with different classes of customer (with each customer facing relatively few options)? Evidence on market segmentation is often more anecdotal than quantitative. Interviews with both banks and enterprises often help to determine categories of banks, with competition within each category but with little across categories. There might also be variation in competitiveness across different products. Loan and deposit size distribution data can give supporting evidence for market segmentation, if such data are available. It is also important to assess segmentation between the banking system and other parts of the financial system. This assessment can be important for microenterprises and small enterprises that start their "careers" as borrowers with cooperative or specialized financial institutions; segmentation might prevent them from growing into customers of mainstream banks. If one has established the main features here, it is important to attempt to determine the extent to which they are influenced in a harmful way by inappropriate regulation. This examination could include looking at limits on their lines of business, universal banking, and branching restrictions.

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Box 4.2 Access to Financial Services from Abroad

Development Role of Foreign Banks

National authorities and local commentators often express concern at the likely development consequences of a growing share of the financial sector coming under foreign control. The typical fears are that small enterprises and remote, rural areas will not be served by foreign-owned banks and that cherry-picking by foreign-owned banks will weaken local banks. In fact, although the client profile of foreign-owned banks often differs sharply from that of locally owned banks (especially when foreign-owned banks have only a limited retail presence because of regulatory restrictions or their own business strategy), it is often observed that an expansion in a foreign-owned bank's share of the total market is associated with a greater emphasis on the small and medium enterprise (SME) sector by local banks. Checking on such dimensions of the competitive dynamics of the sector will help alert national authorities to any shortcomings along those dimensions.

The implicit training provided by the leading international banks both for other market participants and for regulators can represent an almost costless gain for national authorities. The relationship between foreign-owned banks and regulators can be somewhat delicate in that regulators are responsible for local oversight of the foreign entity. Nevertheless, that entity likely enjoys superior risk management practices and other systems and head office scrutiny. By observing and learning from those practices, the local supervisor can accelerate technology transfer to the local market.

Access to Foreign Securities Markets

The tendency of larger companies to take their stock market listings to larger international markets—whether through a primary listing or dual listing abroad, or by issuance of depository receipts—is often seen as an adverse development by local market intermediaries because the intermediaries receive a smaller share of total fees and commissions. Thus, local market liquidity may be adversely affected. However, from the perspective of the economy as a whole, the net benefit is likely to be positive, with not only a lower cost of capital, but also an indirect effect through the importation of enhanced standards of corporate transparency, which are likely to be spread, at least partly, to firms that do not have international listings.

Opening the local equity market to foreign investors is also generally seen as a positive dimension with lower average cost of capital and probably lower net volatility. However, opening nonresident access to domestic financial markets and enhancing resident access to foreign financial markets will require the careful sequencing of capital account liberalization measures as part of a broader financial market development strategy. These considerations are further explained in chapter 12.

Taxation of Banking

Taxation and quasi-taxation issues are important for banking. Among the most prominent are (a) the issue of loan–loss provisioning (can banks deduct provisions allowed by the banking regulator from income before calculating tax?) and (b) the implicit taxes through reserve requirements. The former can affect the incentive to make adequate provisions promptly, while the latter can affect interest spreads, especially in times of high inflation and high nominal interest rates.

Other Issues

Are minimum deposit requirements or fees for customers effectively cutting out the small depositor? What lines of business do banks find most profitable and unprofitable? Are there any pressures from government to do lines of business that are unprofitable? Do banks submit to such pressure? Analyzing the interbank market is important, so one should ask the following: How liquid is the market, is there tiering (another indicator of segmentation), and who are the main takers?

4.4.2 Near-banks

While some nearbanks, such as finance companies, can be seen as an annex to the commercial banking system, some smaller scale near-banks may have sufficient development importance to call for special treatment. Such near-banks consist of specialized microfinance firms, cooperative credit unions, specialized mortgage banks, and government-sponsored specialized development intermediaries. Because of their modest size or the fact that their source of funding is stable and may come from stable external or wholesale sources, they do not raise systemic stability concerns but do expand access to financial services. Some near-banks provide a focused set of services to a broad clientele (e.g., postal savings banks and mortgage banks); others specialize in serving a particular economic sector (e.g., specialized microfinance institutions [MFIs] that may target microenterprises or the poor and near-poor).

Many categories of nearbanks are not operated on a for-profit basis (especially donor-promoted microfinance entities, government-owned development banks, and, to an extent, cooperatively owned entities such as credit unions). This feature generally calls for a distinct regulatory framework, and a review will be appropriate in many countries where those institutions are sizable.[13]

Among the major categories are non-depository finance companies, many of which specialize in particular types of lending such as leasing and factoring. Many of them are captive subsidiaries of banks that have been separately constituted for reasons of legal convenience or in response to regulatory restrictions on banks. The funding of those institutions is typically from the parent bank. Independent finance companies need to find funding in the wholesale markets, typically through private placement of notes, though they may use an organized bond market if one is present. The entities can be important in providing borrowing facilities for SMEs, and obstacles to their effective operation should be monitored.

Mortgage banks (see box 4.3), savings banks, and cooperative credit unions typically concentrate on the needs of households both in terms of deposits and for lending products. However, some savings banks operate as narrow banks, lending their resources to government. To the extent that they are locally or regionally based, their survival increasingly depends on the effectiveness of national umbrella organizations. They also depend on not suffering from tax discrimination (though they will often go further and argue for tax privileges that are hard to rationalize from a welfare point of view). Interviews with those entities will often reveal special environmental challenges that inhibit their effective functioning. Because detailed prudential regulation of the institutions is not cost-effective, they often operate under blanket restrictions that limit their expansion and activities. Judgment must be exercised as to whether such restrictions can safely be relaxed.

Non-deposit-taking microfinance firms (typically donor funded) may not require prudential regulation from the financial authorities, although an element of forced saving is often built into their operations. Increasingly, though, MFIs seek to move into offering deposit services, so the challenge of ensuring that prudential regulation is no more intrusive than is needed arises here also.

Box 4.3 Finance of Housing

Financing residential mortgages is a key function of financial systems in advanced economies, thereby accounting for a relatively high share of total financial assets. Traditionally, specialized mortgage intermediaries offering a limited range of other services were the major players in this segment, and they often benefited from fiscal privileges. More recently, the removal of fiscal privileges and the addition of enhanced competition have tended to widen the range of originating intermediaries for mortgage lending. Those intermediaries, in turn, have increasingly securitized much of the mortgages that they originated and have sold them in the wholesale market.

Long-term mortgages entail particular risks whether they are at fixed or floating rates. Fixed-rate mortgages may require high real yields or even may not be able to be sold in a volatile macroeconomic environment. Holders of such mortgages can face advance repayment risk if the general level of market rates falls, unless prepayment penalties can be enforced. Conversely, high inflation rates may shorten the effective duration of conventional mortgages, thus creating a demand for price-index-linked or other low-risk contracts (compare to Jaffee and Renaud 1996).

Availability of long-term mortgage finance enhances the quality of housing, especially for middle-income households. Cross-country experience suggests that macroeconomic stability and financial sector policies are more important in ensuring such availability than is the general level of per capita income. Improved housing finance policy reaches well beyond the financial sector and includes measures to improve the supply of serviced land, building codes, adequate legal framework for land development and real estate, well-targeted subsidies for those who cannot afford adequate housing, and so forth. Because of this wide reach and because mortgage finance has increasingly become part of mainstream finance, a particular focus on the subsector of housing finance may not be warranted for financial sector assessments in most countries.

The indications are that sustained effectiveness of MFIs will require that they should operate on a relatively large scale. If so, policies that encourage larger-scale operation over a proliferation of small entities is to be preferred. Subsidized interest rates offered by MFIs are not compatible with graduation to self-sustaining operation and are generally not to be encouraged, though the limited spillovers into mainstream finance mean that a subsidy need not be considered crucial.

Subsidized lending by larger government-sponsored development banks causes distortions (see box 4.4). Those banks can seriously distort the incentive for a balanced provision of lending products by commercial banks, as well as creating the conditions for corruption. Moving government-sponsored development banks as far as possible either (downstream) toward a commercial operation or (upstream) to become explicitly the lending arm of the fiscal authority (with loans at unsubsidized rates) will, in most cases, seem the optimal direction of policy.

4.4.3 Insurance and Collective Investment Arrangements

As with the banking sector, insurance and collective savings generate financial services on both the asset and the liability side. On the liability side, they provide investment outlets and risk-reduction instruments; on the asset side, they typically represent the most important block of professionally managed long-term funds. Both aspects need to be kept in mind in the assessment. Insurance and fund management industries often overlap, in that insurance firms often sell pensions or manage pension funds, other mutual funds and

Box 4.4 Role of Government-Owned Banks

The disappointing performance—not only of government-owned banks but also, more important, of systems in which the banks will play a major part—has been extensively documented in recent cross-country empirical literature (see Barth, Caprio, and Levine 2004 and La Porta, Lopez-de-Silanes, and Shleifer 2002). This performance does not imply that individual countries and individual government-owned banks cannot perform exceptionally well along this dimension, but it does call for special attention to some dimensions along which many government-dominated banking systems are known to underperform.

In the context of development assessment, the effect of government ownership is not simply a question of embedded fiscal costs in a nonperforming or problematic loan portfolio reflecting the inheritance of politically or socially motivated loans. Such fiscal costs can imply a future national tax burden that will tend to slow growth. However, development assessment must pay attention to subsidized and other loans made on other-than-commercial principles insofar as those loans tend to discourage private banks from incurring the cost of developing risk-assessment techniques that are needed to lend into difficult segments, such as small and medium enterprises (SMEs) and rural areas. Government-owned banks often fail to deliver services to their stated target markets—with subsidies often being captured by large, state-owned borrowers or politically connected firms—which can damage the performance of the sector as a whole.

The mission of government-owned banks should, therefore, be examined for compatibility with the competitive provision of financial services generally; their governance structures should also be scrutinized for consistency with the stated mission.

unit trusts, and so forth. Some investments of those industries are in the form of bank deposits or other unit trusts, so that a measuring scale in a manner that adequately nets out intersectoral claims can be both important and sometimes difficult in the attempt to benchmark scale. In addition to one's looking at the current position, projections of future developments, especially of pension funds, can be possible and relevant for a view as to the likely contribution of those sectors to funds availability.[14]

The range of products supplied, as well as their pricing (relative to actuarial fairness), is also an area where deficiencies may exist. It is important to determine whether such gaps are attributable to overregulation, to lack of competition (including restrictions on entry), or to lack of organizational capacity and skills in the industries. Because of the diversity of potential insurance products,[15] a comprehensive analysis of cost and availability would be an extensive exercise. Absent such a study, information can, nevertheless, be obtained from market participants. Industry professionals will typically be vocal in identifying policy barriers (including regulatory failure to approve policy design) that inhibit their provision of particular services and products; users will be a better source for identifying others that are unavailable or overpriced because of industry inefficiencies or market power. A similar situation prevails with regard to other collective investment outlets. The tax and regulatory treatment of different insurance, pension, and mutual fund–type products has been a strong influence on the development of the insurance and collective investment sectors, and the whole market can be skewed by distorting incentives that should be avoided as a matter of sound development policy.[16]

Coverage of the subsectors also needs to examine market structure in terms of concentration and ownership. In countries where there is a mandatory private tier to pension provision, issues of competition become especially important, because the rules regarding switching, fee structures, and the like can have a large effect on the net return to pension investors.

The investment policy of insurance firms, pension funds, and other collective savings entities is a key to increasing the availability of term and risk finance to domestic industry. This policy can be subject to severe restrictions (such as ceilings on permissible percentages of the portfolio that can be placed in certain broad categories of investment, such as property or equities), which must be examined for their appropriateness in the context of local capacity. While most of the restrictions are supposedly intended to be prudential in nature, in practice some can have the opposite effect, lowering the return on the funds' overall portfolio without reducing volatility. This effect can be especially true with regard to requirements to hold government securities and prohibitions on international diversification.[17] Requirements to cede reinsurance to a state-owned reinsurance company have similar effects.

The long-term viability of the social security and government employee pension schemes needs some examination. Their wider effects on the economy, including the effects of compulsory contributions, are generally fiscal matters that are beyond the scope of the financial sector assessment. However, it is necessary to be generally aware of those wider dimensions if one is to understand the likely evolution of the system. Some examination of the issues could strengthen the assessment of both the financial structure and development.

The health of the insurance and collective investment sectors is often intertwined with that of the organized securities markets. Those sectors are the major investors in securities, and the level and volatility of asset returns in the sectors depend on the micro-structure and soundness of securities markets.

4.4.4 Securities Markets

The sectoral development assessment is to some extent subsumed in International Organization of Securities Commissions's (IOSCO's) Objectives and Principles of Securities Regulation (see box 4.5). Investor protection, fairness, efficiency, and transparency are among the most important prerequisites for the development of organized securities markets. These important elements of effective securities regulation are also covered in the IOSCO objectives and principles. When investors have confidence, the market tends to grow.

In addition, the assessor needs to verify, by looking at the quantitative measures, that the market is, in fact, deep and liquid; that transactions and issuing costs are reasonable; and that an adequate range of both debt- and equity-type instruments are available. The range of instruments would include some derivatives if this inclusion can be supported by the scale of activity and by the technical needs and sophistication of the market participants. The assessor also needs to look at the degree to which the market can provide new funding through public offerings. Benchmarking of the securities markets needs to pay attention to some hidden factors. For instance, in addition to market micro-structure and market size, the liquidity of the securities markets also depends on the degree to which securities are not held in blocks by insiders and, as such, are not normally available for

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Box 4.5 Standards Assessments and Financial Sector Development

Standards assessments can inform development assessments. Sectoral reviews, plus an understanding of the state of development and the soundness of sectors, are needed to inform standards and stability assessment. The standards, codes, and core principles that are important for the sound and efficient functioning of the financial system cover both financial supervision and financial infrastructure, and they are listed in box A.2.

International standards and codes for financial systems supervision have been designed to promote effective supervision and regulation of individual financial institutions and markets. Those standards (for banking, insurance, and securities market supervision) promulgate a set of objectives, core principles, and good practices that cover regulatory governance, regulatory practices, prudential framework for the operations of financial firms, and financial integrity and safety net arrangements. All supervisory standards recognize that a set of preconditions (outside the scope of those standards) must be met to allow effective implementation of the standards. The preconditions include sound and sustainable macroeconomic policies; a well-developed public infrastructure (accounting and auditing, corporate governance, legal framework, and so forth); procedures for resolving problem institutions; and an appropriate level of systemic protection and safety nets.

A review of preconditions for effective supervision—some of which are covered by their own standards—can clearly help identify gaps in infrastructure and can provide inputs into development assessment. Similarly, assessments of the financial infrastructure as part of development assessment can give information on the adequacy of preconditions for effective supervision. A significant part of financial sector development policies relate to strengthening the public infrastructure. This strengthening not only promotes more efficient financial services with greater depth and access, but also creates conditions for effective supervision.

Standards assessments themselves provide key information needed for development assessment and for a range of policies to implement standards to help improve efficiency of financial firms and to assist with their institutional development.

- All supervisory standards include a set of principles relating to the prudent operations of financial intermediaries covering risk management, risk concentration, capital adequacy, corporate governance and internal controls, customer protection, and prevention of financial abuse. Policies that promote such prudent operations can help strengthen the efficiency of the institutions, strengthen their governance, and enable more effective and appropriately priced delivery of financial services. Information on those matters from standards assessments provides valuable input into development-oriented policy formulation.
- Some development concerns are addressed in IAIS Insurance Core Principle (ICP) 1. ICP 1 sets out preconditions for effective insurance supervision, which represent a subset of the preconditions for a well-developed insurance sector. Prudential insurance assessments can also help in the fact-finding efforts for the development assessment, for example, in relation to investment requirements (ICP 21). Several other useful sets of standards and guidelines have been developed for other elements of this broad subsector (for a compendium, see OECD 2002).
- IOSCO Objectives and Principles of Security Regulations promote robust and efficient financial markets. Thus, IOSCO principles 14–16 aim to ensure that issuers are transparent and fair, principles 17–20 to ensure that collective investment schemes are equally trustworthy, and principle 28 to ensure that secondary market manipulation is inhibited. IOSCO principle 23 deals with standards for the internal organization and operational conduct of market intermediaries to ensure adequate client protection and risk management.

trading. Estimates of this free-float can greatly reduce the apparent size of the market and can put its true scale into perspective.

The domestic bond market is often more weakly developed than equities, and causes of this weakness should be reviewed. The reasons typically lie in tax rules; in the systemic dominance of banks, for whom a developed bond market would represent competition; or in crowding out by heavy domestic government borrowing. More generally, government debt management can have a decisive influence on the functioning of the bond market.[18] Effective public debt management can help provide the benchmarks needed to price more risky securities, and the physical and institutional infrastructures for government debt markets could reinforce and complement the needed infrastructure for bond markets generally. The transactions technology infrastructure—in this case, also potentially including such features as privileged market makers—may also be inadequate. These and other prerequisites for bond market development are clearly described in World Bank (2001c), which also notes how sensitive bond market development is to monetary policy management and generally macroeconomic stability—prerequisites that lie beyond the scope of development assessment.

Liquid securities markets require a minimum scale to be cost-effective. Certainly, the cost built into the design of the trading platform and the regulatory burden can become decisive. Overheads of the market itself and of the regulator can also be too heavy to be borne by fees on the existing level of transactions. Where possible, the assessor should attempt to calculate those costs and the degree to which they are being subsidized. This calculation is especially important where consideration is being given to further computerization, a step that often may not be cost-effective or necessary in small exchanges. With many small securities markets, the inherent viability of the brokerage industry needs to be checked, which has been a problem in several countries. In some cases, most brokers are subsidiaries or divisions of banks, an arrangement that may help reduce overheads but may limit the energy with which the brokers develop their services. Of course, the important goal is not survival of the stockbrokers per se, but achievement of an optimal way of giving local firms and investors access to liquid securities markets.

Many securities markets have been subsidized through tax concessions to listing companies, but with limited success. Several countries have forgone substantial revenue in this way with the objective of encouraging the development of the stock exchange but without generating any sizable activity in the market.

The degree to which larger firms are going outside the country to issue shares or depository receipts in advanced stock exchanges should be examined. While such behavior can reduce local market liquidity, it also has the potential to result in the importation of improved transparency and other practices by a demonstration effect. It also results in lower funding costs for the companies that do have such access.

More generally, the question for small countries of whether outsourcing and closer integration with regional or global markets would be more effective than promotion of an onshore securities market must be seriously considered (compare to Bossone, Honohan, and Long 2002).

4.5 The Demand-Side Reviews and the Effect of Finance on the Real Sector

Whereas stability assessments have normally emphasized the regulator and the regulated financial intermediaries and markets with comparatively little focus on the system's users,[19] development assessments are interested in the users and the extent to which the financial services they receive (including from abroad) are adequate to their needs. Development assessments must express a general view on this issue, though in many countries, especially low-income countries, detailed quantification may be beyond the scope of the assessment. Special studies of the finances of the corporate sector or of household, microenterprise, and SME access to finance can be considered where data can be made readily available.

4.5.1 Enterprise Finance

An assessment of demand for and access to financial and especially credit services by enterprises relies on financial information from firms and on surveys and anecdotal evidence from financial institutions, banks, and other market participants. While data on listed companies are often readily available, few developing countries have consistent databases on SMEs. Ideally, corporate data should be combined with bank data to assess both the different sectoral and business line focus of banks and the competitiveness of the banking market (e.g., by considering the number of bank relationships per firm). Such analysis should also be informed by the available data on infrastructure, especially about the legal system and the information environment. The available data could reveal that certain products, such as leasing or factoring, do not constitute valid financing options for enterprises. Factors behind such missing markets would have to be examined.

When one considers financing patterns, in addition to bank or equity finance, it is also important to focus on trade finance, which is an important financing source, espe-

Box 4.6 Use of Research-Based Micromodels—Liquidity Constraints in Capital Formation

Several research-based exercises carried out as background for recent financial sector assessment programs (FSAPs) have assessed financing conditions using firm-level data for nonfinancial firms. In a world without financially constrained firms, investment and financing decisions are independent from each other. However, the investment decisions of financially constrained firms often depend on the availability of cash flow (compare to Fazzari, Hubbard, and Petersen 1988).

For the recent Mexican FSAP accounting data for 73 nonfinancial-listed Mexican firms were drawn from WorldScope, a commercial data provider. The exercise estimated the extent to which firm investment depended on cash flow rather than on the marginal profitability of capital. Although WorldScope tends to include only larger firms, it may be assumed that smaller firms are at least as financially constrained. Regressing investment ratios on marginal profitability, financial leverage, and cash flow found cash flow to be a statistically significant variable, which can be evidence of Mexican firms being cash-flow constrained. In principle—given sufficient data—the exercise could be divided by class, size, or geographical region of firm.

A similar exercise carried out for the Czech FSAP found that firms operating in the utilities, construction, and trading industries invested significantly more than other nonfinancial firms. If the firms are listed and the stock market is sufficiently liquid, marginal accounting profitability can be substituted by Tobin's q-ratio. These kinds of data can throw additional light on firms' financing characteristics. For instance in the Czech FSAP, it was found that trade credit was generally not used as a financing source for investment and that firms that were able to attract new bank loans used them, to a large extent, for purposes other than investment, for example, to repay old loans. The results suggested that the general reduction in the supply of bank credit during 1999 may have increased the financing constraints of firms, especially those of small and highly leveraged firms.

Sources: Financial System Stability Assessments (FSSAs) for Czech Republic and Mexico, respectively.

cially for small firms. Trade credit can be both a substitute to and a complement for other external financing sources. Trade credit might vary systematically across size groups, with one group being a net creditor or debtor relative to others. For example, if the small firm group is a net debtor in trade credit, this debtor position might indicate a trickle-down effect, with large firms effectively passing on bank credit to small firms through the trade credit channel. Moreover, many developing countries and emerging markets rely on bank-financed trade credits to support exports at preshipment and postshipment stages, as well as imports. Such financing provided by international banks tend to be channeled to local borrowers through domestic banks and to constitute an important source of working capital.

Development, directed credit, or both might be another important source for certain enterprise groups in many developing countries. While it is typically beyond the scope of a financial sector assessment to produce a detailed cost-benefit analysis of the effectiveness of such programs, an indication of whether those programs reach the target groups and whether they have complementary or crowding-out effects might be interesting.

If appropriate data are available, testing for financing constraints among firms can be an interesting complement (see box 4.5). A further step would be to link firm characteristics, such as size, sector, and profitability, to financing constraints so one can compare access to finance across different firm groups and can test for potential segmentation in the market.

4.5.2 Households, Firms, and Microenterprises

While reliable data for a quantitative assessment of SMEs' access to financial services are hard to come by, it is even more difficult to quantitatively assess households', firms', and microenterprises' access to financial services. There do not seem to be any cross-country databases available, and only a few countries have detailed survey or census data on access to financial services by households, farms, and microenterprises. The World Bank has undertaken Living Standards Measurement Surveys (LSMSs) in several countries, but the finance component is relatively small in most cases.

In other cases, the dearth of data precludes a detailed analysis of households', firms', and microenterprises' access to financial services. However, anecdotal and even limited quantitative evidence can provide some indication of social and geographic variation in access by those groups and can help define follow-up work.

Additional evidence on access may be available from suppliers of financial services. If such evidence is available, for example, one can analyze loan and deposit size distribution data for corporate sectors, household sectors, or both. This analysis would indicate the extent of small loans and deposits, which would show indirect evidence about access by small firms and households. In addition, data from the providers of financial services to those segments—such as microfinance, development finance institutions, or savings banks—can provide further evidence on access. An indication of the outreach and penetration of the different provider groups can help evaluate their effectiveness. Sometimes, quantitative and anecdotal evidence on the competitiveness and possible segmentation of household and microenterprise sector can be obtained. Unlike in the enterprise sector, savings and payment services are often in greater demand in this sector than credit services.

4.6 Reviews of Cross-Cutting Issues

The development assessment draws both on infrastructural assessments (for each of which one or more sets of standards have been developed by the relevant international bodies) and on sectoral assessments. As explained, development dimensions must be added to, or built on, aspects of the sectoral prudential standards. Among the development dimensions that have been highlighted in this regard are the competition issues such as entry and exit policies, the taxation issues, and the distorting or chilling side effects of poorly designed prudential regulation. Some of the issues also arise on a cross-sectoral basis or in respect to undeveloped sectors and segments, which will now be discussed.

4.6.1 Missing Markets and Missing Products

Experience shows that a number of potentially useful products or markets, though readily observed in some low- and middle-income environments, are not present in others. The sectoral and demand analyses of sections 4.4 and 4.5 should detect the absence of key markets or services, and those analyses should be assiduous in discovering the reasons for missing products and markets. Many such products—leasing, factoring, reverse factoring, venture capital and other forms of private equity, and various types of long-term finance—can be provided by commercial banks. Otherwise, they may be provided through finance companies or other specialized banks or nearbanks, which are often nondeposit taking. Insurance and collective savings funds are also important potential providers of those and other products (especially for longer terms and for higher-risk profiles).

It is useful to distinguish between the following underlying causes of underdeveloped or missing markets: macroeconomic or legal. Macroeconomic causes may include an inflation history that impedes long-term contracting at reasonable interest rates. Regulatory impediments may include restrictions on contractual savings institutions to hold private sector assets. Those factors effectively restrict the supply of long-term resources or prohibit financial institutions from entering certain markets. Taxation rules or the lack of clear rules can result in higher costs for certain financing products, such as leasing. While deficiencies in the legal system can impede effective financial intermediation overall, the negative marginal effect may be especially strong for certain products that depend more on its effective functioning, such as leasing. It is important to analyze whether there is a lack of appropriate legislation, a consistent lack of application of the legislation by the court system, or a lack of appropriate registration systems at reasonable costs. But there may also be demand factors; the demand for certain services may not be sufficient to justify the set-up costs.

4.6.2 Taxation Issues

Tax policies are critical to the sound development of most segments of finance, yet taxation is a highly complex and country-specific matter within which the issues relating to the financial sector cannot ever be fully isolated. A full analysis of taxation issues will normally be outside the scope of financial sector assessments, but each sectoral review should be alert to particularly important tax aspects and should take a cross-cutting overall view of how urgent or important it is to correct the most prominent distortions (Honohan 2003).

Taxation policies should aim at broad neutrality between similar financial products and services, especially between identical products provided through different institutional forms. The tax burden on financial intermediation should be commensurate with that on other sectors. Tax design should avoid sensitivity to the inflation rate. Financial transaction taxes have been used in several countries with weak fiscal systems as a means of tapping revenue quickly. Though they can be effective in the short run, they should be scrutinized for the degree to which they are being arbitraged away (eventually resulting in transactions costs rather than tax revenue), with the remaining revenue having an unintended and perhaps regressive incidence. Although the application of a value added tax (VAT) to financial services raises administrative complications that are unlikely to be overcome in low- or low-middle-income countries, a theoretical VAT does represent a useful benchmark against which to measure and compare the actual financial tax burden on intermediation and other financial services. This comparison can be especially useful in checking how inflation-proof the financial tax system is.

In some respects, especially through quasi-taxes that masquerade as regulations (such as unremunerated reserve requirements), finance has been overtaxed in many countries. But it is the removal of such special impositions that will be beneficial, not the creation of special privileges. Special pleading by financial sector participants must be treated with a degree of skepticism in this regard: Neutrality, rather than tax-based incentivizing of particular markets or institutions, is preferred. Instead of attempting to use financial sector taxes as "corrective instruments" in this way, the authorities would be well advised to concentrate on making the financial tax system as arbitrage-proof and as inflation-proof as is practicable.

Subsidy of finance creates damaging distortions and can have a chilling effect on the development of more-effective and less-corruptible commercial substitutes for the product or market being subsidized. Such distortions are especially relevant in the context of government-sponsored providers of financial service, providers whose activities may undercut private provision without delivering adequate quality. Detailed examination of credit programs from government agencies will typically be beyond the scope of financial sector assessments, but a general awareness of these and similar subsidies needs to inform analysis of the missing market issue and of the performance of the nearbanks in particular.

4.6.3 Competition Aspects

Effective competition can provide the incentives to expand financial services. Both prudential and competition policies (including licensing and entry, exit and merger policies, and branching and similar regulations) should facilitate the presence of intermediary owners and management that are independent of government and of the major local, nonfinancial groups. Line of business restrictions should avoid the creation of uncompetitive market segments.

The structure of cross-ownership among financial institutions also matters for effective competition. Often seen as complements, banks and markets do compete for financial sector value added. Where banks control the major nonbank financial institutions, competition between the two will tend to be lower, resulting in less variety and higher cost in the provision of financial services. The same may apply to regulation, because a bank-dominated regulator may be slow to sanction desirable institution building on the nonbank side. For example, if the banks own the collective investment institutions, they may discourage measures that tend to open up the development of that sector, to the extent that it would undermine their future profitability. Information on such cross-ownership can be very informative as to the future development prospects of the financial sector as a whole.

4.6.4 Development Obstacles Imposed by Unwarranted Prudential Regulation

Supervision and regulation have important implications for the effectiveness of intermediation and access to financial services, in addition to their roles in fostering stability. Entry regulation and uneven supervisory practices across different groups of financial institutions (either by type or ownership) can hamper competitiveness and, thus, effectiveness. Different regulatory and supervisory standards across different financial institutions that offer similar products and compete directly with each other can negatively affect competitiveness. Heavy regulation of branch openings (as already mentioned) or other delivery channels can limit access to financial services. For example, prudential policies should avoid undue reliance on tools that are likely to disadvantage small and new firms (such as excessive mandatory collateralization requirements for bank loans). Supervision and regulation also impose transaction costs on financial institutions and, ultimately, on the users. The benefit of regulation and supervision in terms of promoting soundness and stability must be balanced with the costs that they may impose in terms of efficiency and access. Given the high fixed-cost component of financial supervision, that balance is especially important for small financial systems and for components of financial systems that are made up of small institutions, such as the cooperative movement or microfinance.

4.7 From Finding Facts to Creating Policies

Once the data gathering and analysis have been conducted (as outlined in sections 4.2 through 4.6), policies and reforms must be identified and prioritized. The task of policy formulation consists of distilling those findings into an overview of the principal strategic issues and development gaps—specifically in terms of the functions that finance is supposed to perform—and of opportunities. The reforms needed to enhance development of the financial system typically fall under the headings of (a) infrastructural strengthening, (b) policy corrections to reduce unintended side effects of regulatory or tax policies, or (c) governance reform. Those reforms must be prioritized and synthesized.

A medium-term vision for where the financial sector should be going helps to focus the recommendations and to avoid being distracted by the immediate political imperatives and obstacles that often make progress seem impossible. Because the quantity, term, and price of credit and other financial services are crucial and will generally depend on the efficiency and competitiveness of the sector and on the cost structure facing market participants (including the cost of taxation and regulation), these elements should be among the major dimensions considered in such a vision. Thus, the vision could include an indication of likely ownership patterns: what share to be owned by government and by foreign concerns, how much competition in banking and insurance, what change in the scope of activities allowed to banks, and what degree of subsectoral specialization. The vision could also address the likely growth in the assets of insurance, pension, and contractual savings and how they are likely to be allocated among domestic and foreign equities, bonds, and bank deposits. The institutional prospects for the securities markets, including the potential for collaboration or integration with securities markets abroad, will also be relevant.

Institution building to enhance the soft infrastructure tends to be the least contentious area, though the reforms are not always easy to accomplish in practice. In particular, the infrastructure for payments transactions can usually be strengthened with noncontroversial legislation and with the introduction of cost-effective technology. Credit information and accounting improvements may take longer and may demand the formation of more sustained human capital. Some legal reforms to enhance creditor rights (such as those needed to underpin a leasing industry) are also straightforward, but effective reforms in such areas as bankruptcy and enforcement of collateral tend to be more controversial and difficult to bring into effect.

Shortcomings in regulatory and tax policy design often represent a judgment call relating to some tradeoff (perhaps involving stability against efficiency) and, as such, require careful analysis to arrive at an acceptable compromise. Even then, special interests may have congregated around the regulations (for example, entry restrictions) that hamper reform. Nevertheless, the removal of regulatory and tax barriers to competitive provision of needed financial services is a crucial component of most financial sector development strategies. In some countries, the special interests of incumbent financial service providers (including the employees of government-owned financial agencies) have become entrenched through disproportionate representation in regulatory bodies or even in the legislature. If so, implementation of reforms is likely to be blocked indefinitely. Wider constitutional reforms, such as establishing or strengthening independence of the regulators from such special interests, may be a prerequisite for achieving deep reform of finance and—through that achievement—enhanced growth and poverty reduction. Yet such recommendations are, of course, the most difficult to sell.

Having identified the infrastructural weaknesses and policy flaws, assessors should formulate a clear prioritization and justification of recommendations addressed to senior policy makers and top politicians. The reform program is likely to entail short-term political costs, as well as fiscal outlays, and the program needs to be justifiable in terms of a simple and compelling rationale. In contrast to the stability assessment, where the consensus behind the core principles may be sufficient justification for some policy reforms, the more debatable nature of the development assessment, as well as the often more far-reaching nature of the reforms, calls for reliance on careful justification of policy proposals. For example, if what is needed is greater independence of the regulatory authority or greater liberalization of interest rate spreads, elimination of compulsory reinsurance cessions, commercialization and privatization of the major banks, or liberalization of entry by foreign financial service providers, then this need must be embedded in terms of the vision of the future financial system and of the desired potential benefits.

Reforms will take time, and policy makers need to know what the priorities are—both what is more important and whether specific sequencing is required. Sequencing and coordination of different measures are important to ensure a robust transition path. For example, early liberalization of deposit rates may not be appropriate in a system still dominated by poorly managed state-owned banks whose insiders' apparent goal is market share rather than sustained profit. Similarly in a system with large nonperforming loans and significant corporate financial fragility, some initial bank and corporate restructuring and some strengthening of prudential supervision may be needed before substantive liberalization of interest rates and entry. Thus, the scope and priorities of policy measures would depend both on the state of development of the financial sector and on the initial level of financial stability.

Against this background, rather than (or in addition to) presenting a comprehensive list of reforms, it is suggested that four or five themes may be identified in order of their importance, and the major thrusts of reform under each theme may be explained and prioritized. The particular conditions in each country would determine what those themes should be. No template is offered here nor should one be. Some of the themes might cut across sectors. For example, it could be a needed strengthening of political independence of regulatory authorities in several subsectors, or it could be a lack of competition and contestability reflecting inappropriate regulation in several sectors, or it could be the need for a root-and-branch reform of the tax code. Identifying the fact that such problems crop up in several sectors will help decision makers who are concerned with each sector realize the common position that they are in and may help point to the potential for organizational or legislative approaches that may not seem feasible to those in charge of any one sector. Other themes may be sector specific, such as either inadequate enforcement of stock exchange rules on transparency or a chaotically dysfunctional credit registry. Even if a similar problem exists to a lesser extent in other sectors, pointing the finger at a particularly damaging weakness can help ensure that top policy makers will allocate the financial and political resources necessary to fix it. The design and prioritization of broad themes and specific measures under each theme should help support financial and macroeconomic stability and should facilitate effective implementation. The principles and considerations in sequencing of reforms are more fully explained in chapter 12.

Notes

1. For example, if it is found that some services, such as reinsurance or elements of investment banking, are more effectively provided to a particular small country by foreign markets or firms, then there is a presumption that policies blocking access to foreign provision of those services should be dismantled, even though this dismantling may

damage the interests of local financial firms. Because of their specialist knowledge, incumbent providers are often in a strong position to resist policy changes that, though good for growth and overall financial development in the economy generally, may damage their sectoral interest. For a detailed and instructive account of how bankruptcy professionals, judges, and lawyers systematically blocked bankruptcy reform in the United States throughout the twentieth century, see Skeel (2003).

2. For the importance of the functional approach as opposed to the institutional approach, see Beck and Levine (2002) and Levine (1997).
3. Beck, Demirgüç-Kunt, and Levine (2000) provide a set of benchmark indicators for different parts of the financial system. Research is ongoing to enrich the cross-country data, notably on access.
4. For example, Demirgüç-Kunt, Laeven, and Levine (2003) find a significant role for bank-level variables (such as bank size, equity and liquidity ratios, and fee income), together with national-level variables (such as bank concentration, inflation, GDP per capita, quality of governmental institutions that are based on governance indicators compiled by World Bank), property rights, and restrictiveness of bank conduct and entry regulations).
5. Regulation and supervision are also part of the infrastructure review, here covered in the information-gathering phase on a sector-by-sector basis.
6. Chapter 9 contains a discussion of the scope of the insolvency and creditor rights standards.
7. Chapter 10 contains a discussion of the scope of corporate governance standards.
8. Jappelli and Pagano (2002) present an early study on the positive relationship between the availability of debtor information through credit registries and financial development. Miller (2003) is a collection of papers on different aspects of the issue. Levine, Loayza, and Beck (2000) discuss the importance of accounting standards for financial intermediary development. The Center for International Financial Analysis and Research Inc. provides data for 44 countries on accounting standards.
9. Honohan (2004b) describes of a wide range of data sources, including recent efforts to increase systematic coverage of financial issues in surveys. For example, the World Bank–led Enterprise Surveys have already covered approximately 50 countries since 2002 and are being rolled out at the rate of about 20 countries per year. The World Bank has also surveyed bank regulators in approximately 70 countries about overall access indicators—such as number of branches and ATMs, average loan and deposit size—and provider banks in approximately 60 countries about product and process technology.
10. The Basel Core Principles (BCPs) for Effective Banking Supervision state that "banking supervision is only part of wider arrangements that are needed to promote stability in financial markets" (see chapter 5). Those prerequisites are spelled out in the BCP source document, and they include much of what is needed for efficiency and reach, as well as stability. If a BCP assessment is being conducted in parallel, the assessors will also be gathering information relevant to the sectoral development assessment on banking. For an overview of relation between standards assessments and sectoral reviews, see box 4.5.

11. For recent cross-country studies on interest rate margins, see Demirgüç-Kunt and Huizinga (1999) and Demirgüç-Kunt, Laeven, and Levine (2004).
12. The interest spread studies by the Brazilian Central Bank (http://www.bcb.gov.br/) are a good example.
13. The Microfinance Consensus Guidelines by the Consultative Group to Assist the Poorest (CGAP) (Christen, Lyman, and Rosenberg 2003) provides a useful framework defining good practice for the MFI subsector.
14. International Association of Insurance Supervisors (IAIS)'s Core Principles also address aspects of development issues in Insurance. See box 4.4.
15. Even a listing of broad lines of business would include categories such as auto; employer's liability, product liability, and medical malpractice; marine (including other transport); commercial fire and theft; machinery; flood and other weather-related occurrences such as earthquake, etc.; mortgage protection, export credit, and other credit-related items; homeowners; health and disability; and life and annuity.
16. For example, overly generous tax incentives for life insurance can result in what are little more than tax-avoidance schemes dressed up as insurance policies. Or, onerous regulation of the investment of insurance or pension funds can result in too much being placed in short-term bank deposits, effectively resulting in reverse maturity transformation for the system as a whole. Again, unduly favorable differential tax and regulatory treatment of managed funds can result in a large fraction of investable funds being diverted into inadequately regulated fund management concerns that are sometimes associated with self-dealing.
17. For a discussion of these restrictions and how development and prudential considerations may be balanced, see Vittas (1998). A draft code for the regulation of private occupational pension schemes has been prepared for the Organisation for Economic Co-operation and Development (OECD) (OECD 2003).
18. Indeed, weaknesses in the government's institutional and strategic arrangements for debt management may be the focus of a special side study, for example, using the guidelines recently developed by the IMF and World Bank (2001).
19. Except to the extent that the financial condition of the corporate, household, government, and external sectors has been examined with a view to forming an opinion on the quality of the banks' loan portfolio. See chapters 2 and 3 on the use and analysis of balance sheet-financial soundness indicators of those sectors.

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