Chapter 9

Assessing the Legal Infrastructure for Financial Systems

The legal infrastructure plays a pivotal role in the operation of financial markets, as well as in the efficient intermediation of capital flows and domestic savings. Banks and other financial institutions hold claims on borrowers, the value of which depends on the certainty of legal rights and the predictability and speed of their fair and impartial enforcement. The legal framework that empowers and governs the regulator and the rules for the regulation of the various markets form the cornerstone of the orderly existence and development of the financial markets. In this respect, the key laws are (a) the law governing the formation and operation of the central bank and (b) the law regulating banking and financial institutions and markets.

The key components of an effective legal framework for the regulation and supervision of the financial system are laid out in various international standards for financial sector supervision and are discussed in chapter 5. In particular, the core principles of supervision relating to regulatory governance (box 5.1) explicitly cover the key legal underpinnings. In addition, the effective governance and operations of the regulator and the regulated also depend on the broader legal framework governing insolvency regime and creditor rights, financial safety nets, ownership, contracts, contract enforcement, accounting and auditing, disclosure, formation of trusts and asset securitization, and so forth. The assessment of the legal infrastructure encompasses both the sectoral and the broader components of the overall framework.

9.1 Financial Sector Legal Framework

A review of the overall legal framework encompasses both the laws empowering and governing the regulator and the rules for the regulation of various sectors (such as the central

bank laws, banking insurance and capital market laws, etc.), as well as the broader legal framework underpinning the payments system, government debt management, and other infrastructure elements (such as insolvency regime, creditor and land rights, corporate governance, and consumer protection). The scope and coverage of those components of the legal framework are outlined below.

9.1.1 Central Banking Law

The central bank law should provide for the establishment, organization, powers, and duties of the central bank, with a clear definition of its ultimate objectives, and should grant the central bank autonomy to implement monetary policy. The primary objective of a central bank is usually to ensure price stability, as well as sound banking and payment systems. The law must also provide the central bank with the necessary instruments and powers to enable it to achieve its objectives. Extraneous powers and duties are to be avoided, and the bank ought to be protected from outside interference in its operations and be assured of full operational autonomy.

The law should also stipulate the role of the central bank and that of the government in determining foreign exchange policy, for example, who decides on the country's exchange regime, who determines the exchange rate, and who is responsible for foreign exchange operations and reserves management. The responsibilities of the central bank in matters such as exchange control and the management of international reserves need to be clear.

Coordination between the central bank and the Ministry of Finance should be provided for in the law. In addition to the bank's duty to act as the fiscal agent of the government, the law would strive to provide the government with a risk-free depository, with a mechanism for consultation and coordination in the formulation of a country's macroeconomic policies, and with assistance in defining the institutional relationship between monetary and fiscal operations.

Modern central bank laws limit central bank credit to government and do not permit the central bank to perform non–central banking functions. For proper accountability and to protect the ability of the central bank to achieve its monetary policy mandate, developmental and other social policy objectives should be financed through the government's budget. The law should also place limits on government lending and should make transparent the conditions when that type of lending is permitted.

While the law should grant appropriate operational independence to a central bank, it must also specify the arrangements for its accountability and assurances of integrity. The arrangements include those for internal auditing, auditing and publishing its accounts, providing public information services, and making available central bank officials to report to designated public authority on the conduct of monetary policy and on its performance in achieving its objectives.[1]

9.1.2 Banking Law

The banking law typically provides for the formation and operation of banks and, sometimes, nonbank financial institutions. The law should deal with the requirements for the opening of a bank; the minimum share of capital; the fit-and-proper criteria for sharehold-

ers, managers, directors, and owners of banks; the provisions with respect to terminating licenses; the powers of banks to accept deposits and to carry on banking business; and the prudential supervision of banks, including the obligation on banks to furnish information on their activities regularly to the banking regulator. The law should also deal with distressed banks and with the power of the regulator to implement a range of remedial measures, to withdraw a license, to impose new management, and to ensure orderly liquidation and restructuring with the goal of maintaining financial stability. In addition, the law should deal with issues of confidentiality and bank secrecy. Anti-money-laundering measures are usually enshrined in separate legislation, but this legislation should be closely linked to the banking law framework. The legal aspects of banking supervision have already been considered in detail in chapter 5. The legal and institutional framework for anti-money-laundering activities and for countering the financing of terrorism are covered in chapter 8.

9.1.3 Payment Systems

Efficient payment systems are critical to the effective functioning of a financial system. Robust payment systems that are resistant to systemic and credit risk are an essential requirement for maintaining and promoting financial stability. Furthermore, in developing countries, an efficient and reliable payment system infrastructure constitutes an essential factor in creating a dynamic market economy. In many developing countries, payment system mechanisms are provided for by way of central bank directives rather than by law. Increasingly, however, the successful operation of payment systems can raise quite difficult issues, and a proper legal basis for such systems is desirable. The legal basis should provide for a variety of systems, including noncash methods of payment such as those relying on electronic debit cards and credit cards. Different types of clearance systems—such as paper-based and electronic clearing and settlement systems that are based on multilateral netting, paper-based gross settlement systems, same-time (intraregion) payment systems, electronic real-time gross settlement systems, and "swift-based terminal" systems—need to be provided for. Issues of confidentiality, supervision, and netting also need to be incorporated in the legislation.

Finality of payment and zero hour rule[2] provisions are important to ensure the safety and soundness of the payment system. These items ought to be provided for in the law. The banking law should also provide that, although banks cannot be liquidated without the consent or knowledge of the central bank, the fact that the payment system also includes other participants whose liquidation cannot be orchestrated by the central bank requires clear and express provisions in the law that provides for the zero hour rule.

9.1.4 Government Debt Management

Government securities usually play an important role in both developed and developing country economies, and the management of those security markets can be crucial for ensuring a robust and stable financial system. The legal regime that deals with this subject should provide for both the primary and secondary market for the securities. The rights and obligations of dealers; the procedures for public auctions, maturities of bills, and reg-

istration and transfer of ownership; and the responsibilities of agent banks are all topics that should be covered in the law.

The law needs to provide a clear legal basis for the issue of debt and the statutory designation of the authorities that are empowered to manage government debt. The law that provides for the issue of government securities must contain sufficient provisions to govern the issuance, transfer, and redemption of those securities. To avoid a legal vacuum, those provisions that deal with "physical securities" need to be reviewed and replaced with new rules and procedures that cover book-entry or scripless securities.

The law should provide for registration, structure, and settlement, including those in book-entry form. The law must contain procedures and rules to establish ownership, transfer, and final settlement of debt by the government on the basis of book-entry or scripless form. It is also important for the law to recognize electronic evidence in a court of law to prove ownership and to ensure the legality of transactions affecting rights of parties.

9.1.5 Capital Markets

Laws to establish a securities markets and stock exchanges play a key role in facilitating the providing of financing for domestic investment. Misuse of securities markets has resulted in the need for strict rules governing (a) the issue of securities to the public; (b) the registration and trading of securities; (c) the operation of stock exchanges; (d) the regulation of dealers, brokers, and other persons involved in the securities industry; (e) the strict requirements for prospectuses as well as for disclosure; and (f) the operation of publicly listed companies. A key component of the capital market is the creation and trading of asset-backed securities, which play a critical role in effective risk management by financial institutions and in strengthening access to finance by creating liquidity. However, securitization transactions call for a sophisticated system of laws on secured transactions, negotiable instruments, and creditor rights, as well as effective enforcement systems, as outlined in box 9.1. Legal aspects of securities markets regulation, drawing on IOSCO objectives and principles, are discussed in chapter 5.

9.1.6 Insurance

Insurance needs to be regulated by law and regulations that support the development of the sector and that provide adequate protection to policyholders while containing claims for insurance fraud. The insurance laws should specify the powers and responsibilities of the regulator; the conditions for the formation and registration of companies; disclosure requirements; prudential supervision; management of distressed insurers; and provisions with respect to payment of premiums, events of default, and reserves. Legal aspects of insurance supervision are discussed in detail in chapter 5, in the context of the IAIS Insurance Core Principles.

The development of insurance business has also suffered from repressive regulations by government in many low-income countries. Those regulations have included the creation of state-owned insurance companies, sometimes with a monopoly over all insurance business or for the benefit of state-owned business of state-owned enterprises. In addition, the regulations have included measures (a) to discourage entry by foreign companies,

Box 9.1 Legal Framework for Securitization

Securitization is achieved through the creation of asset-backed securities, which are capital market instruments that represent debt, equity, or hybrid interests in a pool of financial assets, which most often are loans (secured or unsecured), or other evidences of indebtedness (such as receivables). A pool of assets is formed and sold in an economic and legal sense to a special purpose vehicle, which then issues securities backed by the asset pool. Securitization permits the shifting of risk from one category of financial intermediaries (usually banks or commercial financial institutions that originate loans or debt instruments), to other financial intermediaries and investors (usually participants in the public or private capital markets). The development of asset-backed securities requires a sound and vibrant commercial finance sector and effective and efficient laws and institutions in the areas of negotiable instruments, secured transactions, and creditors' rights generally. In addition to efficient and reliable enforcement of contracts representing commercial indebtedness, the creation of asset-backed securities requires:

1. A sophisticated secured transactions law that clearly defines the rights and responsibilities of the parties with respect to the collateral in the event [that] the underlying debt is not paid in time
2. A system of laws relating to the creation, transfer, and enforcement of negotiable instruments by financial intermediaries
3. A reliable and effective system of enforcing commercial indebtedness
4. Laws permitting the transfer of secured and unsecured loans and the transfer and assignment of collateral and rights therein
5. Laws permitting the creation and regulation of special purpose financing vehicles with the purpose of isolating and clearly defining the financial risks of pools of assets held by such vehicles, and ensuring the transparency and accountability of the vehicle
6. Laws and regulations relating to governance of financial institutions and special purpose vehicles, which not only ensure fairness, transparency and accountability, but [also] impose appropriate fiduciary standards
7. A comprehensive system of accounting and reporting that permits timely and accurate identification, assessment, measurement, and management of risks involved in the creation of the indebtedness and its transfer of interests in the debt; and the ownership, management, and governance of the special purpose vehicles, as well as a system for assessing and managing the risks of off-balance sheet financial structures from the perspective of commercial financial institutions [that are] originating, holding, or participating in the indebtedness
8. A clear system of regulation and disclosure in the capital markets that permits full and fair assessment of the risks involved in purchasing and holding an undivided interest in a pool of financial assets
9. A system of accounting principles and rules that permit a consistent understanding, assessment, and measurement of the prices, values, and risks involved in the transfer and pooling of financial assets for all participants
10. A system of tax and related laws [that] may be necessary to ensure that the economic effects of securitization are consistent with economic or other policy imperatives of the jurisdiction

(b) to set premiums, (c) to control the terms and conditions of offered policies, and (d) to require insurance companies to invest their reserves in low-yielding assets or in social projects of various forms. In many cases, the imposition of minimum local retention ratios (thus discouraging reinsurance with international companies or markets) or the mandated use of a state-owned reinsurance company has acted as an additional constraint on the development of insurance.

Furthermore, insurance business in developing countries often suffers from widespread mistrust between insurance companies and their customers. To protect against fictitious claims and insurance fraud, insurance companies frequently include clauses that limit their liability in cases where material information was not provided at the time an insur-

ance policy was bought. Insurance policies also have exclusion clauses that stipulate that insurance coverage will not be provided under specified circumstances. However, the exclusion clauses make insurance contracts difficult to understand and give rise to disputes. In some countries, those disputes result in long delays in settling claims, which accentuate the mistrust that clients experience toward the insurance companies.

9.1.7 Financial Safety Nets

A deposit insurance scheme for bank deposits or for policyholder and investor protection schemes that are designed for insurance and capital markets should be explicitly and clearly defined in laws and regulations that are known to and understood by the public, as already outlined in chapter 5. Even if those arrangements are specified in separate laws, the relationship to the supervisory agency and the government, as well as the related coordination arrangements, should be transparent. The operation of lender-of-last-resort—both in normal and crisis times—is normally provided for in central bank laws. The scope of emergency lending, however, is often part of a larger legal and operational framework that provides for cooperation arrangements among agencies for crisis management and financial stability policies.

9.2 Commercial Laws

Key components of commercial laws that affect the sound functioning of financial institutions and markets include laws that define the regime for formation of companies, corporate governance of both financial and nonfinancial firms, and consumer protection in the financial system. The scope of those components is outlined below.

9.2.1 Company Law

A regime for the creation and operation of companies is a key element of any commercial system. Laws providing for the formation and registration of different types of companies—including joint stock, limited liability, closed and open partnerships (limited and special), and other forms of corporate entities—should be in place. Those types of laws should deal with the operation of the company registrar, procedures for registering companies, public access to the register, minimum capital requirements, procedures for the issue and transfer of shares, meetings of shareholders, rights and duties of shareholders, provisions for annual meetings, extraordinary meetings, role of the board of directors, duties of directors, role of auditors and audit procedures, accounting and auditing requirements, and penalties for infringements of the law.

9.2.2 Corporate Governance

Governance of the financial sector has emerged as an important factor in financial stability. Particularly in the transition economies where the legal and regulatory infrastructure is still in need of further strengthening, corporate governance has become recognized as

an important factor in establishing trust in the financial system and in ensuring that bank depositors, insurance policyholders, and small shareholders have confidence that their funds have been entrusted to competent and honest administrators. Poor governance erodes customer confidence in banks and financial institutions and deters potential customers from (a) placing deposits with the bank, (b) transferring savings to an investment fund, or (c) purchasing an insurance policy. Poor corporate governance also makes it more difficult for financial institutions to raise additional equity capital, especially from investors outside the group of current shareholders.

A strong corporate governance framework improves the quality of the enterprise sector and is an important issue in determining the quality of a country's investment climate. Well-governed companies are likely to be more creditworthy as bank borrowers. In addition, the equity shares of well-governed corporations can provide solid investments for investment funds, pension funds, and insurance companies. Where weak corporate governance is associated with insufficient competition in the business sector, improved corporate governance practices can open the way for new entrants and increase competition for customers and new markets.

A corporate governance framework encompasses three primary areas:

1. Laws, regulations, and decrees that provide the legal framework for the commercial sector
2. Regulatory agencies responsible for the enforcement of legislation
3. Common marketplace practices (or business culture) that, in some countries, are as important as legislation and institutions

In the financial sector, it is important that the legal framework provide for (a) the ownership structure of banks, (b) appropriate fit and proper provisions for shareholders and key administrators, (c) transparency, and (d) strong regulatory oversight. The law also should provide detailed stipulations for the obligations of directors; directors' duties of care; procedures for the convening, operation, and termination of meetings; the relationship between management and owners; shareholder rights; audit responsibilities; accounting practices; public access to the records of the company registry; ability of the shareholders to obtain copies of shareholder lists; disclosure of shareholdings by public sector officials; fiduciary obligations of members of boards; and presence of codes of corporate conduct.

9.2.3 Consumer Protection

Consumers are an important stakeholder in the financial market. In fact, they are the reason for the existence of markets and, thus, they sustain markets. It is imperative that the legal framework provides for appropriate legal arrangements to safeguard the interest of consumers. Consumer protection in the financial system involves the protection of personal and credit information data; the right to security and safety in electronic and e-commerce transactions; the availability, access, and inexpensive cost of services such as remittances and the opening and maintaining of accounts; and an appropriate mechanism to address grievances in the event of a dispute with a bank. Often, cost-effective

and efficient out-of-court dispute settlement arrangements serve a useful purpose in the protection of consumer rights.

Also, banks need to have sound systems in place to ensure that financial data, especially credit information, is secure, is accurate, and is released to relevant parties in accordance with prescribed legal safeguards that are permitted under the law or as agreed to by the customer. The customer has a legal right to require the systems used for electronic transactions, including ATMs and wire transfer systems, to be secure and to not expose the customer to unnecessary risk and loss. In this regard, a fair fees structure and availability of basic services is essential for access to finance by the poor. The consumer protection legislation should also provide for full and adequate disclosure of prices and of retail sale terms and conditions. In addition, an appropriate disclosure regime for financial institutions is a key ingredient of a comprehensive consumer protection regime.

9.3 Creditors Rights and Insolvency Systems

Effective creditor rights and insolvency systems play a vital role in helping to sustain financial soundness, and they promote commercial confidence by enabling market participants and stakeholders to more accurately price, manage, and resolve the risks of default and nonperformance. The extension of credit is predicated on repayment, and its costs are influenced by the risks and potential for default, as well as the associated costs and delays of recovery. Insolvency systems also promote a number of salutary goals: to promote market discipline, as well as good corporate and financial governance; to support optimal resolutions of financial distress for businesses; and to mitigate asset deterioration through swift and reliable enforcement channels. Experience with financial crises has shown that effective creditor rights and insolvency systems also facilitate prompt resolutions and recovery.

Attracting loans and investment requires that repayment risks be reasonable and manageable. Systems of credit protection, resolution, and enforcement will underpin and uphold those expectations in the commercial relationship. Collateral is increasingly significant and quite varied in today's markets. With competitive pressures on domestic and international businesses, those businesses must tap latent asset values to secure financing and capital so they can grow their business. Modern security laws take advantage of current developments in access to security in all of its various forms and shapes. Collateral without reliable enforcement, however, affords little genuine protection. Consequently, the full dimension of broad security must be complemented by effective and efficient enforcement processes.

A modern, credit-based economy requires (a) predictable, transparent, and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency and (b) a sound insolvency system. The systems must be designed to work in harmony. Commerce is a system of commercial relationships predicated on express or implied contractual agreements between an enterprise and a wide range of creditors and constituencies. Although commercial transactions have become increasingly complex as more sophisticated techniques are developed for pricing and managing risks, the basic rights governing those relationships and the procedures for enforcing the rights have not

changed much. Those rights enable parties to rely on contractual agreements, thus fostering confidence that fuels investment, lending, and commerce. Conversely, uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of nonperformance, and in severe cases, uncertainty leads to credit tightening.

The legal framework for creditor rights includes mechanisms that provide efficient, transparent, and reliable methods for recovering debt, including seizure and sale of immovable and movable assets, as well as sale or collection of intangible assets such as debt owed to the debtor by third parties. An efficient system for enforcing debt claims is crucial to a functioning credit system, especially for unsecured credit. A creditor's ability to take possession of a debtor's property and to sell it to satisfy the debt is the simplest, most-effective means of ensuring prompt payment. It is far more effective than the threat of an insolvency proceeding, which often requires a level of proof and a prospect of procedural delay that in all but extreme cases make it not credible to debtors as leverage for payment.

Although much credit is unsecured and requires an effective enforcement system, having an effective system for secured rights is especially important in developing countries. Secured credit plays an important role in industrial countries, notwithstanding the range of sources and types of financing available through both debt and equity markets. In some cases, equity markets can provide cheaper and more attractive financing. But developing countries offer fewer options, and equity markets are typically less mature than debt markets. As a result, most financing is in the form of debt. In markets with fewer options and higher risks, lenders routinely require security to reduce the risk of nonperformance and insolvency.

The legal framework for secured lending should provide for the creation, recognition, and enforcement of security interests in all types of assets—movable and immovable; tangible and intangible, including inventories, receivables, proceeds, and future property and, on a global basis, including both possessory and nonpossessory interests. The law should encompass any or all of a debtor's obligations to a creditor—present or future and between all types of persons. In addition, it should provide for effective notice and registration rules to be adapted to all types of property, and it should set clear rules of priority on competing claims or interests in the same assets.

The legal framework for corporate insolvency should establish a collective process for resolving or adjusting the rights and interests of a variety of stakeholders in a failed business. Each country's system balances a number of policies and objectives as determined by the policy makers within that country. Invariably, a system includes a number of potentially diverging policies and interests that must be balanced and harmonized to make it functional and meaningful within the context of the needs of a particular country. The policies and interests that must be balanced include governmental and political objectives, cultural and social concerns, and economic and commercial interests. A country's system is also defined by three main pillars—the legal, institutional, and regulatory frameworks—each of which is equally important to creating an effective and efficient system for users. The absence or inefficiency of any one of those pillars compromises the entire system.

Though approaches vary, a number of common objectives and goals apply to commercial insolvency systems. They should attempt to

- Provide for timely, efficient, and impartial resolution of insolvencies.
- Integrate with a country's broader legal and commercial systems.
- Maximize the value of a firm's assets and recoveries by creditors.
- Provide for (a) efficient liquidation of nonviable businesses and those where liquidation is likely to produce a greater return to creditors and (b) rehabilitation of viable businesses.
- Strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one procedure to another.
- Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors.
- Prevent the improper use of the insolvency system.
- Prevent the premature dismemberment of a debtor's assets by individual creditors who are seeking quick judgments.
- Provide a transparent procedure that contains—and consistently applies—clear risk allocation rules and incentives for gathering and dispensing information.
- Recognize existing creditor rights, and respect the priority of claims with a predictable and established process.
- Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

Where an enterprise is not viable, the main thrust of the law should be swift and efficient liquidation to maximize recoveries for the benefit of creditors. One the one hand, liquidations can include the preservation and sale of the business, as distinct from the legal entity. On the other hand, where an enterprise is viable—meaning it can be rehabilitated—its assets are often more valuable if retained in a rehabilitated business than if sold in a liquidation. The rescue of a business preserves jobs, provides creditors with a greater return on the basis of higher going-concern values of the enterprise, potentially produces a return for owners, and obtains for the country the fruits of the rehabilitated enterprise. The rescue of a business should be promoted through formal and informal procedures.

Rehabilitation should (a) permit quick and easy access to the process, (b) protect all interested parties having a financial stake in the outcome of the process, (c) permit the negotiation of a commercial plan, (d) enable a majority of creditors in favor of a plan or other course of action to bind all other creditors (subject to appropriate protections), and (e) provide for supervision to ensure that the process is not subject to abuse. Modern rescue procedures typically address a wide range of commercial expectations in dynamic markets. Though those types of laws may not be susceptible to precise formulas, modern systems generally rely on design features to achieve the objectives outlined earlier.

Corporate workouts should be supported by an environment that encourages participants to restore an enterprise to financial viability through informal workouts that are negotiated in the "shadow of the law." Accordingly, the enabling environment must (a) include clear laws and procedures that require disclosure of or access to timely and accurate financial information on the distressed enterprise; (b) encourage lending to, investment in, or recapitalization of viable distressed enterprises; (c) support a broad range of

restructuring activities such as debt write-offs, reschedulings, restructurings, and debt-equity conversions; and (d) provide favorable or neutral tax treatment for restructurings.

A country's financial sector should promote (possibly with help from the central bank or finance ministry) an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency is systemic. An informal process is far more likely to be sustained where there are adequate creditor remedies and insolvency laws.

Strong institutions and regulations are crucial to an effective system for commercial enforcement and insolvency proceedings. The institutional framework has three main elements: the institutions responsible for the proceedings, the operational system through which cases and decisions are processed, and the requirements needed to preserve the integrity of those institutions—recognizing that the integrity of the system is the linchpin for its success.

A sound regulatory framework requires insolvency administrators who are competent to exercise the powers given to them and who act with integrity, impartiality, and independence. Finally, the bodies responsible for regulating or supervising insolvency administrators should be independent of individual administrators and should set standards that reflect the requirements of the legislation and public expectations of fairness, impartiality, transparency, and accountability.

In 2001, the World Bank endorsed the "Principles and Guidelines for Effective Insolvency and Creditor Rights (ICR) Systems"[3] (principles) for use in connection with assessments of creditor rights, commercial enforcement, and insolvency systems under the program to develop reports on the observance of standards and codes (ROSC).[4] The principles provide a framework for comprehensively assessing the effectiveness of insolvency and creditor rights systems against international best practices. The principles contain a set of core principles elaborated under 35 topics in four primary areas: (a) creditor rights and enforcement systems (for secured and unsecured credit); (b) corporate insolvency systems (liquidation and rescue legislative procedures); (c) credit risk management, debt recovery, and informal enterprise workout practices; and (d) effective implementation of legal mechanisms (institutional and regulatory frameworks).

The insolvency and creditor rights assessments have a number of applications for international financial institutions, policy makers, and the private sector. The assessments support diagnostic and strategic work, underpin policy dialogue and lending operations, and provide input to technical assistance and capacity building efforts. Assessments can be seen as building blocks for diagnostic work such as investment climate assessments in which creditor rights and enforcement systems are viewed as pivotal to assessing nonperformance and regulatory risks for lending and investment. They also provide useful inputs into key policy documents, such as sectoral strategies for the private and financial sectors or countrywide development strategies. As in the case of other Bank-led ROSC assessments, their strengths lie both in the systematic standardized coverage and in their ability to benchmark against an internationally recognized standard, and they provide an easy guide to policy dialogue and reform.

9.4 Access to Credit and Land Rights

Land law constitutes an important factor for sustainable development and private sector growth. It creates property rights systems for individuals, businesses, and the state, which, in turn, will create incentives to conserve and produce. It sets out the circumstances in which, and processes by which, rights in land can be transferred, permanently or temporarily, or used to secure loans. It also embodies some limitations imposed by the state on those rights, for instance, zoning rules that limit land use or rules prohibiting transfers of land to foreigners. The legal structures reflect basic allocative decisions of the society and influence the extent of poverty and prosperity in an economy.

Land law provides a critical portion of the legal infrastructure for private sector investment and a modern financial system. Secure land rights allow investors with a safe time horizon to invest and to recoup investments and, thus, are an important element in the incentive structure for investment. Also, marketable land rights allow land to move to those who will use it more efficiently and who are thus willing to pay more for it, increasing its productive use. In addition, mortgageable land rights can be used to raise capital for investments, and those rights can play a key role in capital formation in developing economies.

In many countries, landholders do not enjoy secure and transferable tenure. Often, vast bureaucracies administer systems of tenure, such as long-term leaseholds from the state in which official permission is needed for transactions, and the transactions are subject to onerous taxation. Use controls built into titles may freeze land in what have become inappropriate uses. Mortgaging or real estate development may be flatly proscribed. In such situations, local land administration officials often take full advantage of the rent-seeking opportunities posed by their discretionary power.

Businesses commonly complain of the shortfalls and frustrations of land laws and land administration and of the cost they pose for doing business. The frustrations occur because, even where land law is adequately framed to promote private sector development, reliable proof of titles may be difficult. Land survey services and services to determine and register titles are essential to making land rights effective, and they are often almost as important as the content of the right itself.

On the financial side, mortgageability is the critical characteristic of land. It is vital to allow individuals to be able to raise capital for the capitalization of the economy. Land is the primary form of collateral for credit. Land registration also can provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, a basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (such as mortgage-backed bonds) that can then be rediscounted and sold in secondary markets.

Secured transaction law can yield significant financial and fiscal benefits. Advanced secured transaction laws provide more credit by reducing the costs of borrowing and thus can increase the amount of available credit in the economy. Any reduction in the costs of borrowing enhances the advantage, thus ensuring that debt offers an advantage to firms. And for public finance, the existence of an adequate system of records of rights in land can provide the basis for land taxation, a relatively simple and easy-to-administer tax

that has been critical in many countries to the funding of decentralized local government programs. The land law ought to establish (a) basic property rights, (b) transferability and basic mortgage ability, (c) adequate systems for recording those rights and their transfer, and (d) framework for securities that are based on the value of assets in land.

9.5 The Judicial System

It is widely accepted that economic growth and social development cannot be sustained and promoted in countries where the justice system fails. By consistently enforcing clear rules, an independent and impartial judicial system supports legal reform and promotes economic and social development. An effective judiciary should apply and enforce laws and regulations impartially, predictably, and efficiently.

Whether the legal system is one of civil law or common-law tradition, it is imperative that its structure ensure adequate checks and balances on the three branches of the government—legislative, executive, and judicial. The legislature ought to act as the enabling and enlightened arm that makes, adds, and amends the rules for the regulation of the financial sector. The executive branch needs to be efficient and effective in carrying out the mandate of the legislature, whereas the judiciary ought to act as the guardian of the nation to ensure that the other two arms operate within their mandate.

The process through which laws and regulations are conceptualized, drafted, enacted, publicized, and enforced is the foundation of a society governed by the rule of law. When the law-making process is not effective, the legal system suffers from outdated and badly written laws that do not provide a sound legal basis for executive action. This situation must be avoided because it encourages reversal of policy and practices and it makes executive action and acts of regulatory bodies vulnerable to legal challenge.

The legal and judicial system must provide a method for resolving disputes not only between private agents but also between private agents and the state. Courts are a way to resolve disputes justly. Courts must resolve disputes by judgments that are based on independent fact-finding. Those judgments must be enforced by the state. State enforcement distinguishes courts from alternative forms of dispute resolution. State enforcement also limits potential violence and can improve the business climate. But for courts to be effective, the other branches of government must also comply with the law. The judicial system must provide checks and balances against arbitrary state action. If the judiciary is to fulfill its role as the guardian of the nation, the judiciary and its work must be perceived as fair. Courts must work efficiently, and they should be sufficiently accessible.

The fairness of judicial decisions is determined first by the judges' independence—real and perceived. There must be sufficient safeguards to ensure that judicial decisions are independent of both political decisions and the influence of powerful private parties and that government officials can be made to obey the law. Other branches of government should not override or ignore judicial decisions. When they do, they should be subject to legal action. Judges' independence entails that their decisions are not determined by anything other than the facts in the case and the applicable law.

Fairness of judicial decisions must be safeguarded by adequate procedural provisions. Hearings should be open to the public. Assignment of cases should follow standardized

procedures. There must be sufficient guarantees in the law governing civil procedure for party input, oral proceedings, and independent fact-finding. Rules of evidence and standards for evaluating arguments should be in place and should be applied in a predictable fashion. Possibilities for the review of decisions should be adequate because they safeguard the quality of judicial decisions. There should be a three-tiered system in place: (a) a court where the cases are heard initially; (b) courts of appeal, which review cases as to the facts and with respect to the law; and (c) cessation by a final instance court with respect to conformity to existing law.

Judges' independence must be supported by objective selection and career planning and by training. Judges must be selected according to objective criteria. The criteria must be job relevant and merit based. The criteria must also be public. Selection must be done in a transparent manner. Judges should have life or fixed-term tenure. They should be sufficiently trained. Compulsory training at entry should be followed up with permanent education to guarantee judges' independence and the quality of their decisions. Judicial salaries should meet living wage and some reasonable proportion of good wage in the private sector. Existing laws and the body of jurisprudence must be readily available to judges and their staff members and should be regularly updated. Another safeguard for judicial independence is the existence of an independent, competent association of lawyers.

Governance of the judiciary—including its accountability and efficiency—should underpin its independence. Existing institutional arrangements on this point vary considerably. Responsibilities with respect to the budget of the judicial organization; the judicial career, including matters of discipline; the court management; and the other issues should be distributed among the judicial administration body—such as a judicial council, the Supreme Court, and the Ministry of Justice—in such a way that judicial independence is not compromised. Changes in the budget for the judicial organization should be commensurate with the development of the national budget and also should reflect changes in demand for judicial services. Court management should follow set rules, and the management processes should be monitored and audited. The courts' efficiency is defined in terms of the speed, cost, and quality of the judicial decisions, as well as the access that aggrieved citizens have to the court. Those four factors are interdependent. Procedures for resolving a dispute must be proportionate to the value, importance, and complexity of the dispute.

Procedures and the way courts work should facilitate timely judicial decisions. Pretrial settlement of disputes may be encouraged but not enforced. Procedures and procedural law should not be unnecessarily complicated. Procedures should be reasonably efficient, as well as designed and reformulated in the interests of eliminating unnecessary steps and bottlenecks. Judges must have the power to move cases ahead and to punish or deny efforts to create additional delays. Adequate case management systems should be in place. Where there are small claims courts and other specialized courts and where there is the possibility of oral proceedings, trials tend to go faster. A forum for provisional judgment can prevent the need for full proceedings, which take more time.

Cost is an important factor in the courts' ability to provide an adequate service. Courts should be managed in an economic manner. The funding for staffing, equipment, and offices of the courts must be adequate to allow the performance of the courts' duties. Internal resource distribution should be based on need and workload. Court fees are part

of the cost, but most of the cost for taking a case to court relates to fees for legal assistance. Low value or simple disputes should be assigned to simpler and faster procedures that consume fewer court resources. For example, disputes over small amounts of money should be handled by small claims courts, where parties can represent themselves.

The judiciary and the courts must be sufficiently accessible. To provide access to justice, courts should be reasonably close to the citizens and not exclusively concentrated in the capital. Courts must be managed in such a way that taking a case to court is not unnecessarily cumbersome. Cost should also not hinder citizens' access to courts. The cost of taking a case to court should not be so high that it prohibits access to justice. There should be sufficient possibilities for low-cost or free legal advice and assistance. Ways of providing legal aid in case of need should guarantee access to courts.

Although judicial review in developing countries is helping to ensure checks and balances, it can also be abused if the law does not lay down the perimeters for the role of court judicial review. The banking law ought to circumscribe the role of the courts in judicial review by defining it in the law and by disallowing a stay of regulatory decisions. A further useful provision is one that confines the relief of the court to compensation. The foregoing will help to prevent vexatious and unwarranted proceedings against regulatory action.

Alternative dispute settlement systems can be designated in relation not only to the disputes between banks and customer and between a bank and another bank but also to the disputes that arise between the banks and the regulator. Experience has shown that installing effective dispute settlement mechanisms for all types of disputes has paid off handsomely. They reduce litigation cost, resolve disputes faster, and instill greater faith in the banking system as far as customers are concerned while also establishing better relationships between banks and between banks and the regulator. In this respect, options such as a banking ombudsman to resolve customer–banker disputes, banking tribunals to deal with differences between the banks and the regulator, and use of arbitration by banks should also be explored.

Notes

1. For a discussion of key elements of central bank autonomy and accountability, see Lybek (1998). Accountability arrangements are also discussed in the Code of Good Practices in Transparency of Monetary and Financial Policy (IMF 1999).
2. The definitions of when a settlement of payment instruction is final in a payment system—settlement finality rules—may come in conflict with the "zero hour rules" in an insolvency regime. In the context of a payment system, zero hour rules make all transactions by a bankrupt participant void from the start (zero hour) of the day of bankruptcy (or similar event). In a real-time system dealing with gross settlements, the effect could be to reverse payments that have apparently already been settled and were thought to be final. In a system with deferred net settlement, such a rule could cause the netting of all transactions to be unwound, with possible systemic consequences. For a discussion of the legal basis of payment systems, see Bank for International Settlement (2001).

3. The principles and guidelines for effective insolvency and creditor rights systems (principles) were developed in collaboration with a number of international partner organizations and numerous international experts who constituted the Bank's task force and working groups. From 1999 to 2000, regional practices were examined, and various drafts of the principles were discussed in regional workshops involving more than 700 public and private sector specialists from some 75 countries. The principles and background papers can be accessed in the Global Insolvency Law Database (http://www.worldbank.org/gild), which has been designed as a research tool to promote access to and awareness of country practices. This broad dialogue process yielded strong international support and consensus on the principles, which establish a uniform framework to assess the effectiveness of corporate insolvency and creditor rights systems. Since April 2001, the principles have served as the basis for formal assessments in countries around the world, including in the context of the financial sector assessment program. The Bank is currently collaborating with the IMF and the United Nations Commission on International Trade Laws (UNCITRAL) to develop unified standards on insolvency and creditor rights systems.
4. The principles on insolvency and creditor rights (ICR) systems have been used in a series of experimental country assessments in connection with the program to develop reports on standards and codes (ROSC).

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