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Development Issues in the FSAP

Prepared by the Staffs of the World Bank and the International Monetary Fund

Approved by Cesare Calari and Stefan Ingves

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DEVELOPMENT ISSUES IN THE FSAP

1. For lower income countries with less-developed financial systems, in order to be relevant to country authorities, the emphasis in the FSAP must change. While still analyzing why markets or institutions (in the sense of intermediaries) might fail, the analysis more fruitfully emphasizes why markets and institutions (in the sense of rule of law or protection of property rights) are missing and how residents can get better access to a wider range of financial services. Often, the assessments reveal that specific parts of the infrastructure needed to support healthy financial sector development are missing or inadequate.
2. The information base for forming the development assessment under the FSAP overlaps with that of the stability assessment. For example, achieving many of the standards set for bank supervision, securities, insurance regulation and financial market integrity will also help ensure that all elements of the financial sector are functioning efficiently with a good flow of information, professional management and the kind of credit culture that helps build a deep and effective financial system.
3. At the same time, there are formal assessment methodologies that help FSAP teams in assessing stability issues. For example, a body of work on stress testing and FSIs informs the analysis done in the FSAP. Moreover, assessment methodologies exist for most financial sector standards and codes, and these, if used selectively, can go some way in aiding in the assessment of development needs and priorities. But no formal methodologies exist for how to address development issues in the FSAP. Below are some of the development-related issues that might usefully be addressed in the FSAP.

A. Infrastructure for Access

4. Since access to credit is one of the keys to balanced and sustainable growth, unleashing enterprise and innovation in any economy, the conditions under which providers of funds can do so with confidence are needed. This requires a well-designed and well-functioning set of collateral and bankruptcy laws; competent and impartial courts, adequately funded and free of political interference; and an information infrastructure. The needed information infrastructure itself has several diverse components. It will include (for the larger companies) coherent accounting rules and a competent and credible auditing profession; and (for smaller concerns and individual entrepreneurs) a credit information industry.
5. Some of what is needed to support the contractual environment is legislative; some involves the development of a private industry (auditing and perhaps credit information). Human capital and an enabling regulatory regime will be required for that.
6. So far as the legislative and regulatory components are concerned, there is a considerable overlap between the information that is gathered in the course of the various standards assessments and the information that is needed to make a diagnosis of the condition of these elements of financial infrastructure. Probably more can be done to incorporate this information in the development assessment.

7. Credit information and similar types of financial ancillaries, such as credit rating agencies or equity analysis, represent an area that appears only tangentially in the standards and codes, or in the stability assessment. But these deserve attention from the development perspective. A stand-alone private credit information industry is probably in its infancy in many countries; the status, performance and potential of the industry need to be looked at, at least superficially.

8. There may be a role for government in encouraging credit registries.¹ More generally, the FSAP team needs to assess the capacity of the government to perform a proactive catalytic role to make sure that all of the elements do in fact come together.

B. Monopoly Power and Related Distortions

9. In a protected or distorted environment, participants in the finance business can often flourish without any risk of failure, even though the sector may not be providing the range and quality of services the economy requires. One characteristic of such systems is a tendency toward financial sector monopolies. Indeed, a small financial system dominated by a handful of institutions with substantial market power can in some cases be a stable model; yet it may be sorely deficient in terms of allowing local non-financial firms (especially the small and medium-sized ones) to grow and compete in the local and international market. A complacent oligopoly becomes satiated on the low-hanging fruit and makes little effort to enhance service quality or pricing, or—even more important—to find ways of doing profitable business with more difficult clients such as small and medium-size enterprises. Monopoly and the wider issue of the contestability of markets, including protection of dominant domestic financial institutions (through restrictions on entry and foreign access, lines of business and pricing) are thus important development issues. Similar issues relate to taxation of financial intermediation and to privileges for state-owned banks. Indeed, the question of privatization policy is one on which stability and development concerns may seem to go in opposite directions and may need to be reconciled.²

10. Concentrations of power are not always easy to detect. Concentration ratios for banking, for nonbank financial sectors, and in the non-financial corporate sector are only one indication. Apart from being alert to indications of collusive behavior, the assessors need to be aware of cross-segment ownership structures: do the main banks own the main

¹ Here and more generally, enhanced communications and information technology will need special legislative and regulatory initiatives, importantly involving the development and regulation of the telecommunications industry.

² Poorly implemented privatization in a liberalized environment is a risk factor for banking crises. Yet state-owned banks tend to allocate credit poorly and as such inhibit growth opportunities. Of course, state banks can also become insolvent, and the largest bank failures in dollar terms have been of state banks.

stockbrokers, the main insurers, the main fund management companies? Is the design of legislation and regulation dominated by a bank-centric central bank? These are subtle issues, but important for development.

C. Nonbank Financial Intermediaries and Organized Markets

11. Although insurance companies and other nonbank financial institutions are also prone to failure, and stock market volatility can transmit itself to the rest of the economy, the smaller role these businesses play in developing countries and the fact that the systemic implications of bank failure appear to be greater, have meant that nonbank financial institutions and markets are not typically the focus of stability assessments.

12. In the medium- to long-term, however, nonbank financial institutions have been characterized as a spare wheel which can prevent excessive reliance on banking from making a financial system vulnerable. A healthy nonbank financial sector increases the diversity of financing instruments, allows ventures that for one reason or another would never be bankable to obtain finance and get off the ground (because of a diversity of opinions as much as the degree of risk tolerance), and can provide some competition for the banking system (at least where the firms in the nonbank financial sector are not largely owned by the banks—as they are in practice in several countries).³ Thus, development motives call for a strong nonbank financial sector.

13. This has sometimes been thought to warrant costly initiatives to create stand-alone national markets, such as a stock market, in unpromising environments. It has also been held to justify monopoly for state-owned insurers. And the role of the social security system is central in influencing the development of the nonbank collective savings and fund management industries. All of these need attention with national development in mind, with the focus on functions rather than on institutions.

14. Once more a catalytic as well as regulatory role for government will be needed, with some limited potential for operational responsibilities by a state-owned or, more likely, regulated monopoly, as with securities clearance, settlement and depository functions.

D. Special Institutions for Access

15. A long tradition in development finance has been the establishment of specialized and subsidized institutions for filling supposed gaps in provision of financial services (usually loans, though access to simple savings and money transmission services can be equally important for poor households). Current development thinking tends to minimize the role of

³ In some countries, lack of competition outside the financial sector has affected competition within the sector. In Brazil, for example, corporations, when offering new issues, are required to advertise their balance sheets and income statements in one of several newspapers; the lack of competition among the newspapers adds substantial costs to new issues.

subsidized institutions of this type as players in the financial system. Indeed, such subsidies can inhibit the emergence of market-driven financial service firms that would deliver services to the small-scale and to the poor, or inhibit the existing banks from entering that market. Directed credit and selective credit controls also cause distortions.

16. Nevertheless, specialized financial institutions (whether subsidized or not) do exist with the mission of serving particular segments of the economy traditionally underserved by the mainstream banks. These could include agricultural development banks, low-income mortgage banks, credit cooperatives/unions and similar entities. They are often supervised separately and have a quite different management approach and may function under different fiscal conditions. Thus, specific issues affecting specialized micro-finance institutions may need to be included in an FSAP, including the question of whether or how to regulate such entities cost-effectively and with a sufficiently light touch so as not to crush them.

E. The Demand Side—Corporate and Households

17. Knowing the financial condition (e.g., leverage, profitability, maturity, and exchange rate mismatches) of the nonbank corporate sector—as well as their ownership structure—both helps the vulnerability assessment and throws light on whether corporations have access to finance that they need in a development context. From the stability point of view, looking at just the major companies may be sufficient, but answering development related questions seems to call for a more comprehensive information base going beyond those companies that are listed on the stock exchange. The availability of information on unlisted corporations differs widely across countries. Collecting and processing the information can be time consuming, and to do it properly may represent a major investment of resources into the collection of statistics which could be wasted if not properly integrated into an institutional development effort with the national statistical authorities. One task for FSAP teams is to judge how much effort should be put into this, given competing priorities within the overall assessment. A further question which must be addressed is how reliable and useful is the accounting information that can realistically be expected from even the middle-size firms.

18. Likewise, to understand how well the financial needs (not just credit) of small firms and poorer households are being served may require survey-based information, which is hardly practicable in the timescale over which the FSAP is conducted. FSAP teams need to look for other sources of information to fill these gaps.

F. Taxation of Financial Intermediation

19. An area which impacts on development but which may be too large to cover in the FSAP in other than its key aspects is taxation of financial intermediation. This covers such matters as special taxes and quasi-taxes facing financial firms, such as financial transactions taxes and stamp duties, special taxes on bank income, the arrangements for deducting loan-loss provisions against corporate income tax, and unremunerated reserve requirements. It includes the question of how savings are taxed and whether the tax system is biased against saving, or as between different savings media (bank deposits vs. government bonds vs.

equities). It also extends to the taxation of corporate income, including allowances and incentives for different types of investment.

20. In many countries, years of accretion to the tax code have made even understanding the tax rules—let alone working through the implications and possible reforms—a daunting task. Furthermore, the necessary facts do not normally all reside with one counterpart, and resolving contradictory information is a particularly common problem in this area.